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IFRS 17 *Insurance Contracts* as amended in June 2020 Draft Final Endorsement Advice

Annex 1 - Application of annual cohorts to intergenerationally- mutualised and cash-flow matched contracts

EFRAG's assessment of the results of case studies with preparers (paragraph 227 Appendix III), the Economic Study (paragraph 297 Appendix III), the User Outreaches (paragraph 548 Appendix III) and the cost/benefit analysis (paragraph 564 Appendix III) contains inputs that EFRAG received on the issue of annual cohorts.

Contents of Annex 1

- 1 This Annex constitutes an attachment to the Cover Letter of IFRS 17 Draft Final Endorsement Advice ('FEA') and presents an illustration of the aspects that contributes positively and negatively to the endorsement criteria about the application of annual cohorts to intergenerationally-mutualised and cash-flow matched contracts.
- 2 Annex A to this document presents an illustration of the issue, a description of the contractual features and its pervasiveness in some European jurisdictions.
- 3 This Annex is composed of two sections, Appendix II and Appendix III, that present respectively the areas of the FEA assessment that are of interest for the purposes of, respectively, Appendix II (qualitative characteristics of the reporting) and Appendix III (European Public Good).
- 4 EFRAG's observations on this topic are presented in the Cover Letter to the IFRS 17 FEA.

Pervasiveness of the issue

- 1 A number of markets are affected by the annual cohort issue, including Austria, Denmark, France, Italy, and Spain. Based upon information provided by EFRAG stakeholders, the following markets are affected:
 - (a) approximately 67% of life insurance liabilities in Austria;
 - (b) approx. 55% of Danish guaranteed life insurance market;
 - (c) approx. 76% of the French life insurance market;
 - (d) approx. 75% of the Italian life insurance market; and
 - (e) approx. 70% of the total technical life provisions in the Spanish life insurance market.
- 2 Similar contracts are issued in Germany¹ (approximately 100% of all life and health insurance liabilities in Germany which represents 50% to 67% of all insurance liabilities), but German respondents noted the requirement is not a concern to them.
- 3 Further detailed information about these contracts can be found in Annex A to this Annex.

Appendix II on annual cohorts

Relevance

- 4 Information is relevant when it influences the economic decisions of users by helping them evaluate past, present or future events or by confirming or correcting their past evaluations. Information is also relevant when it assists in evaluating the stewardship of management.
- 5 EFRAG considered whether IFRS 17 would result in the provision of relevant information – in other words, information that has predictive value, confirmatory value or both – or whether it would result in the omission of relevant information.

Annual cohorts

- 6 Introduction: The impact studies run by EFRAG (Case study in 2018 and Limited Update of the Case Studies in 2020) brought to EFRAG's attention financial reporting and operational issues that arise when applying the requirement to exclude from the unit of account (a group of contracts according to paragraph 22 of IFRS 17) contracts that have been issued more than one year apart. The issues relate in particular to contracts with cash flows that affect or are affected by cash flows to policyholders of other contracts for contracts with intergenerational mutualisation.
- 7 Feedback from EFRAG's constituents confirms that the issue relates to contracts with the characteristics described in paragraphs B67 - B71 of IFRS 17 that have substantial risk sharing. Most of these contracts that prevail in some European jurisdictions are eligible for the variable fee approach (VFA): in the remainder of this endorsement advice, we refer to these contracts as "intergenerationally-mutualised contracts". In some other jurisdictions, the issue relates to contracts eligible for the general model including contracts without the characteristics described in paragraphs B67 – B71 of IFRS 17 for which cash flow matching techniques are

¹ Please refer to paragraph 23 for a description of a proposed approach to implement annual cohorts from a German stakeholder. Paragraph 18 describes why other stakeholders are not convinced by this approach.

applied across generations: in the remainder of this endorsement advice, we refer to these contracts as “cash-flow matched contracts”. Annex A to this Annex of the endorsement advice provides a description of the products that exist in different European jurisdictions.

- 8 EFRAG holds the view that the reporting objectives of the level of aggregation requirements in IFRS 17 is to provide useful and relevant information. These include depicting profit trends over time, recognising the profits from contracts over the duration of those contracts and timely recognising losses from onerous contracts.

INTERGENERATIONALLY-MUTUALISED CONTRACTS

Contracts with cash flows affected by cash flows of other groups

- 9 The IFRS 17 requirements (paragraphs B67 to B71) ensure that the fulfilment cash flows of any group are determined taking into account the legal and contractual extent to which the cash flows of different groups affect each other. Thus, the fulfilment cash flows for a group:

- (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.

- 10 The reference to future policyholders is necessary because sometimes the terms of an existing contract are such that the entity is obliged to pay to policyholders amounts based on underlying items, but with discretion over the timing of the payments. That means that some of the amounts based on underlying items may be paid to policyholders of contracts that will be issued in the future that share in the returns on the same underlying items, rather than to existing policyholders. From an entity’s perspective, the terms of the existing contract require it to pay the amounts, even though it does not yet know when or to whom it will make the payments.

EFRAG notes the following aspects or views by some stakeholders that contribute negatively to relevance of IFRS 17 requirements

- 11 The annual cohorts requirement in the context of paragraphs B67–B71 of IFRS 17 is burdensome and operationally complex, in particular after initial recognition of newly-issued contracts. The objective of providing useful information about mutualised contracts could be reached through other means.

EFRAG notes the following aspects or views by some stakeholders that contribute positively to relevance of IFRS 17 requirements

- 12 The annual cohorts requirement together with the requirements in paragraphs B67–B71 of IFRS 17 that take into account the sharing of risks aim to provide an appropriate depiction of the results of mutualised contracts and avoid recognising losses on contracts when this is not the case.

Artificial allocation of cash flows and reporting not reflective of contractual terms and economic reality

EFRAG notes the following aspects or views by some stakeholders that contribute negatively to relevance of IFRS 17 requirements

- 13 The prohibition to include contracts issued more than one year apart in the same accounting group would distort the reported result of those contracts and would be operationally burdensome.

- 14 For the contracts under scrutiny, the annual cohorts requirement results in limited usefulness to users of the financial statements. The splitting of ‘mutualised’ amounts into groups of contracts issued not more than one year apart is artificial and different from how the business is organised and from the economics of the contracts, because there is no contractual link between a cohort of contracts and any subset of the portfolio of underlying items, i.e., a cohort of policyholders does not have any right on any subset of the portfolio of underlying items. As a consequence, the accounting ignores the economic consequences of the contractual terms and does not reflect reality.
- 15 In addition, the annual cohorts requirement does not provide relevant information 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 fungible across generations of policyholders so that profitability is not determinable on a cohort-by-cohort basis.
- 16 Those opposing the application of the annual cohorts to intergenerationally-mutualised contracts consider that the information about the judgement used by entities in allocating profits to different cohorts and between entity and policyholders will not provide useful insights. In particular, these stakeholders hold the view that, in the context of contracts with discretionary participation features, paragraphs 24 (for the share of the policyholders) and 45(b) (for the variable fee) of IFRS 17 will require an allocation of the fair value gains or loss of the underlying items to each generation of contracts. The resulting amounts therefore reflect the unrealised fair value gains at the valuation date, that periodically fluctuate depending on financial markets. As a consequence, the allocation has no predictive value because it only reflects the fair value at a point in time, without providing any insights about the future. Furthermore, it has no confirmatory value since the allocation is discretionary and contingent on the amount of fair value gains at the valuation date which changes at each closing date. Please also refer to paragraph 37 about the discretion of management in this regard.
- 17 Some stakeholders differentiate between normal judgement and additional judgement made applying cohorts. In particular, the judgement needed to measure new contracts during the period is the “normal judgement” required by IFRS 17. The marginal or stand-alone valuation of the new contracts and the subsequent valuation after the injection of the new business in the portfolio provide a measurement of the mutualisation effects between in-force portfolio and new business at issue. This operation requires additional judgement and is operationally challenging, as it would have to be replicated for each annual cohort present in the portfolio. Therefore, tracking of the profitability of each single cohort over time within the in-force portfolio requires judgment additional to the one used for the valuation of new business, resulting in segregating financial profit into the different cohorts. The only way that this is possible is to derive additional drivers of allocation that create an accounting reality that is different from the economics of the contracts, thereby, impairing reliability and comparability.
- 18 In paragraph 23 below, an allocation mechanism proposed by a German stakeholder to deal practically with the annual cohort requirement is described. Some stakeholders from other jurisdictions consider that such mechanism is not applicable to the features of their contracts and, in particular, they believe that it:
 - (a) may lead to results that are not comparable;
 - (b) may rely too heavily on allocation methods which would not be reliable;

- (c) does not solve the concerns around the cohorts providing misleading or artificial information; and
 - (d) the assessment by local auditors is still in progress at this stage.
- 19 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 contract or cohort level but rather at a higher level. Therefore, the allocation described above would distort the profitability results.

- 20 Some stakeholders also note that an allocation on a cohort-by-cohort basis is not objectively determinable because cash flows are fungible across generations of policyholders, including future policyholders. They consider that when management changes its expectations, the entity is unable without undue judgement and complexity to allocate in a rational manner the changes in the fulfilment cash flows to determine the CSM of each annual cohort. They disagree that the information about management expectations would be useful.

EFRAG notes the following aspects or views of some stakeholders that contribute positively to relevance of IFRS 17 requirements

- 21 Management exercises discretion in deciding how to allocate profits (and therefore cash flows per paragraph B67 of IFRS 17) to (i) different cohorts and (ii) between the entity and the policyholders (either current or future). Those who support the use of annual cohorts to intergenerationally-mutualised contracts consider that resulting information will provide useful insights about management expectations about the development of the business and help users hold management to account based on those expectations. Therefore, such information is not arbitrary. In addition, to satisfy (ii) above an entity would be required to exercise the same judgement to measure new contracts recognised in the period even if the entity was not required to apply the annual cohorts requirement; as such this is not adding complexity.
- 22 Some stakeholders have observed that the Standard does not explicitly require preparers to trace and track assets or the related returns to specific cohorts, in order to calculate the CSM of the cohort under the VFA. This is true even if the Standard requires the updating of the fulfilment cashflows of the annual cohorts. Since the policyholders share equally in the returns, an allocation of different level of asset return of an annual cohort 20x1 compared to the asset return assigned to cohort 20x2 would indeed not reflect the economic reality. IFRS 17 does not provide guidance how the impact of the asset returns on the variable fee should be incorporated, but the use of such tracking of assets to a specific group (as defined by IFRS 17) is, in those stakeholders' view, an interpretation, not a requirement.
- 23 Some propose a practical approach to implement the annual cohort requirement to these contracts. They consider that the annual cohort can be seen as one additional granularity requirement that has to be added to and included in the measurement approach. For subsequent measurement, neither the effects of mutualisation nor the required cohort split can be determined directly but need to be derived by using reasonable and consistent allocation algorithms. The following approach has been proposed to practically achieve the required annual cohort split and to separate mutualisation effects after initial recognition:
- (a) Stochastic cash flows for subsequent measurement are determined at a higher granularity level than groups of contracts.
 - (b) The adjustments to the CSM are determined at the level at which mutualisation occurs.
 - (c) An amount of CSM is then allocated to each group of contracts.

(d) The CSM release is determined at a group of contracts level allowing for annual cohorts.

Thus, the task is to develop an appropriate allocation procedure.

- 24 The majority of the feedback received from the audit profession indicated that such information can be audited.

Contracts that do not require the use of annual cohorts (paragraphs BC138 and BC139G)

- 25 The IASB, in the Basis for Conclusions on IFRS 17, acknowledges that, for contracts that fully share risks, the groups together will give the same results as a single combined risk-sharing portfolio, and therefore the IASB considered whether IFRS 17 should give an exception to the requirement to restrict groups to include only contracts issued within one year. However, the IASB concluded that setting the boundary for such an exception would add complexity to IFRS 17 and create the risk that the boundary would not be robust or appropriate in all circumstances. Hence, IFRS 17 does not include such an exception.

- 26 Nonetheless, the IASB, in the Basis for Conclusions in IFRS 17, notes 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 (optional non-application of the annual cohorts in paragraphs BC138 and BC139G of IFRS 17), although in practice this possibility seems to be very small.

- 27 The contents of the Basis for Conclusions are outside the scope of this assessment. Nevertheless, EFRAG notes that there has been a significant debate on the possible role of the simplification in paragraph BC138 of IFRS 17 (as issued in May 2017) in solving, to some extent, the issue of annual cohorts. The contents of BC138 have been further clarified by the IASB in paragraph BC139G of the Amendments issued in June 2020. EFRAG understands that in the jurisdictions (except Denmark) that have reported most of the issues of annual cohorts, preparers assess that the practical expedient that may be created by paragraphs BC138 or BC139G of IFRS 17, because the need to verify that the accounting outcome with and without cohorts is the same reduces the practical relevance of the intended relief.

Annual cohorts as a rules-based practical simplification

- 28 EFRAG notes that in order to meet the reporting objectives of IFRS 17, the annual cohorts requirement has been retained, at the end of the long development process of IFRS 17, and without being exposed for comments in an IASB due process document, as a practical simplification on a conventional basis. Such a convention derives from the difficulties for the IASB to develop a relevant and robust principles-based approach. Up to 2016, the unit of account for subsequent measurement was the individual contract. As a matter of fact, subsequently, the IASB introduced a principles-based approach to identifying groups that would allow to depict trends in profitability (according to some, this would result in a loss of information). This was pursued in the 2013 ED; however, such an approach was rejected as stakeholders considered that it would be unduly burdensome. The annual cohorts requirement is, therefore, a practical simplification missing a principles-based approach but meeting the objectives of the level of aggregation. Such a simplification appears to be rules-based, i.e., it does not aim at providing an approximation of a principles-based grouping approach.

*Averaging of profits across generations and across contracts with
different profitability*

EFRAG notes the following aspects or views of some stakeholders that contribute negatively to relevance of IFRS 17 requirements

- 29 There is no profitability at annual cohort level to be reported in a meaningful way as the profitability is assessed at a portfolio level, consistently with the contractual and economic characteristics of the contracts.
- 30 The annual cohorts requirement provides useful information about trends only when profitability can be measured objectively at cohort level. This condition is not met for contracts with intergenerational risk-sharing because the entity exercises discretion as to the timing and amount of the cash flows to policyholders, which means that profitability changes whenever management exercises its discretion. Such changes in discretionary expectations cannot be objectively allocated to the cohorts. If expected profits and changes in expectations cannot be allocated univocally to the cohorts, then the requirement only provides artificial information about profitability. These stakeholders do not agree with the view and arguments in paragraph 34 that not applying annual cohorts would leave room to judgemental or even opportunistic allocation of profit or loss at the expense of future periods.

EFRAG notes the following aspects or views of some stakeholders that contribute positively to relevance of IFRS 17 requirements

- 31 Some believe that the conventional use of annual cohorts would avoid an indefinite re-averaging of the CSM of a group. If the annual cohorts were not to be applied, the resulting portfolio would consist of maximum three groups that would last for the entire life of the portfolio. The CSM of each group would average the profitability of all contracts in the group over the life of the portfolio and this would impair the recognition of profits of the contracts over the duration of those contracts (i.e., one of the three objectives of IFRS 17). Furthermore, the contracts placed in any of the profitability groups could be significantly more or less profitable than other contracts in that group and the continuing profitability of some contracts would absorb the subsequent adverse changes in expectations that make some contracts onerous. As a result, the information about trends in profitability of each separate annual cohort in the date of issuance of the contracts would be lost and onerous contracts would not necessarily be identified and reported as such (i.e., other two objectives of IFRS 17).
- 32 Put otherwise, profitability trends cannot be assessed when there is continuous re-averaging of the CSM. While the policyholders may contractually share specified risks as policyholders in a certain proportion with shareholders, this does not necessarily mean that the profit generated by the contracts over multiple years will be similar or comparable and therefore the averaging of the CSM generated by different generations of contracts results in an unacceptable loss of information.
- 33 These stakeholders also consider that some of the profits reported will be at the expense of future profits or even create losses in the future, in particular in the prolonged nil interest environment – which represents a loss to shareholders.
- 34 For these stakeholders, not applying annual cohorts would give management the discretion when profit arise to a certain extent which could leave room for a judgemental or even opportunistic allocation of profit or loss at the expense of future periods. They believe that this would enable entities to potentially defer the recognition of losses that are in onerous portfolios.

Recognition of profits during the coverage period

EFRAG notes the following aspects or views of some stakeholders that contribute negatively to relevance of IFRS 17 requirements

- 35 The attribution of fair value returns on assets to a specific annual cohort will be arbitrary and misleading as it would provide a reporting that is inconsistent with the contractual and business model characteristics of the mutualised contracts. For contracts with intergenerational mutualisation, the application of the annual cohorts requirement, while being operationally complex, would not provide additional useful information to users, as no specific annual generation of contracts has rights and obligations over a slice of the underlying items.
- 36 This is consistent with feedback received by EFRAG during the due process of IFRS 17 Amendments, i.e.:
- (a) Some users specialising in insurance entities consider the annual cohorts requirement as an unnecessary complexity for contracts managed under the mutualised model as described above.
 - (b) Some actuaries consider that the three reporting objectives of the level of aggregation requirements in IFRS 17 can alternatively be obtained through additional disclosures in the notes rather than through an overly complex, costly, judgemental, and potentially arbitrary accounting process.
- 37 It has been noted that the fair value gains do not relate to a specific generation (or annual cohort). In fact, in Continental Europe the contractual discretionary participation benefits are determined based on realised gains. The insurer's share in the underlying items depends on the decision to realise fair value gains, which is discretionary. This implies that the entity can revise discretionarily its share of the fair value gains by deciding to hold or sell the underlying items. The entity's profit share therefore depends on the accumulated unrealised gains from the pool of underlying items and management's decision to hold or sell. It is therefore not contingent on the date when the contracts were underwritten.

EFRAG notes the following aspects or views of some stakeholders that contribute positively to relevance of IFRS 17 requirements

- 38 As mentioned in paragraph 22, proponents of annual cohorts note that there is no requirement in IFRS 17 on how to allocate fair value gains to specific cohorts and, missing contractual indications on how to do so, judgement² is required to determine an allocation that provides useful information. Arguments against annual cohorts are based, they say, on an assumption that specific underlying items have to be allocated to each annual cohort based on an interpretation of the Standard. Further, it is important to recognise that where for instance financial guarantees impact the CSM (either in full or partially when the risk is shared with policyholders) this may have a significant impact on the estimated profitability of a group and therefore the variable fee and the CSM. Annual cohorts would allow to capture this without necessarily adding complexities relating to tracking of assets.
- 39 The fact that the entity expects to spread the policyholders' share of the fair value returns to policyholders over a longer period, i.e., the duration of the entire portfolio, is reflected in the application of the requirements of paragraph B68 of IFRS 17 to reflect the effect of sharing of risks on the CSM or the related groups. However, the sharing of risks between policyholders does not mean that the entity should not recognise its share over the life of the annual cohort of contracts to which the fair

² For example, an IASB Staff paper for the February 2020 meeting illustrates an allocation of an equal rate of return on CSM of each annual cohorts reflecting the contractual rights of policyholders.

value returns relate. These stakeholders consider that the allocation over a longer period has no impact on the entity's profitability. Therefore, they consider that the purpose of the annual cohorts is not about recognising or disclosing the policyholders' share of returns but about the shareholder's profit, i.e., the CSM that is recognised as revenue.

- 40 Some stakeholders observe that annual cohorts prevent the continued recognition of the CSM after the related cohorts have been derecognised. However, this is not always the case as paragraph 76 of IFRS 17 deals with this on derecognition of insurance contracts. Furthermore, the bigger concern is whether the allocation of the CSM to profit or loss is at an appropriate rate.
- 41 In addition, some stakeholders observe that the absence of annual cohorts in a mutualised portfolio would require a judgemental allocation of the CSM to insurance revenue while the recognised insurance revenue would be relevant if annual cohorts are applied.

Value relevance of using annual cohorts when the cash flows are fixed and the entity's exposure is not small

EFRAG notes the following aspects or views of some stakeholders that contribute negatively to relevance of IFRS 17 requirements

- 42 Some stakeholders have proposed to the IASB to exempt from the requirement to apply annual cohorts contracts whose fixed cash flows (including guarantees) are either shared amongst policyholders, or small. They believe that for this target population there would be high costs of implementation of the requirements and no benefits in terms of relevance. Some stakeholders have proposed that requiring the contracts to fall under the VFA will mean that the value relevance of annual cohorts will be small as other fixed cash flows are expected to be small.
- 43 Some consider the importance of guarantees in savings contracts has been overemphasised in the debate on the annual cohort requirement. They consider that as such amounts may be paid out of policyholders' profit sharing and thus, reduce the amount available for the discretionary allocation to policyholders in other groups. Therefore, such guarantees affect the entity's share in the underlying items only to the extent that the fair value returns from the underlying items are insufficient to pay off the cost of guarantees.

EFRAG notes the following aspects or views of some stakeholders that contribute positively to relevance of IFRS 17 requirements

- 44 The benefits of the information provided by the annual cohorts requirement are particularly high for contracts (a) that include features such as in the money financial guarantees on the returns from underlying items and/or other cash flows that do not vary with returns on underlying items (for example, insurance claims); and (b) where the cost/benefits profile of the information provided by the annual cohorts requirement is less favourable for contracts that either do not share the effect of changes in those features between the entity and policyholders or where the effect of changes does not result in the entity's share being small. Consequently, for some stakeholders, only for a very limited population of contracts, the costs and benefits of the requirement are more finely balanced. They also observe that this population is much smaller than what other stakeholders have suggested (because these insurance contracts do not always fully share all risk categories – technical risk, financial risk and expense risk, only a subset of those risks to various degrees); while annual cohorts generally provide useful and relevant information. These stakeholders believe that the risk of the loss of useful information if the Standard were to provide an exemption from the annual cohorts requirement is too great.

CASH-FLOW MATCHED CONTRACTS

EFRAG notes the following aspects or views of some stakeholders that contribute negatively to relevance of IFRS 17 requirements

- 45 Those that oppose annual cohorts for cash-flow matched contracts argue that insurers do not manage their business on an annual cohort basis and such measurement would lead to excessive granularity, complexity and costs (one-off and increasing on-going costs as the number of cohorts becomes larger over time). Furthermore, it would not generate useful information in particular when these contracts have been priced consistently with obtaining a stable margin that is sufficient to compensate for any negative deviation in, for example, longevity risk.
- 46 They are concerned that a group of contracts as defined by IFRS 17 would typically encompass a small number of contracts and that this would create more variability in the adjustments in the CSM and increase the scope for “onerous” cohorts, while the used actuarial assumptions would on the contrary encompass a level of compensation between cohorts. For example, senior cohorts have a reduced number of policies compared to policyholders with a more similar age over time, resulting in a sample of contracts that is not representative of the expected behaviour of the global insured population. Adjusting the CSM on a cohort-by-cohort basis would thereby result in more volatility. The concern is more pronounced for those contracts that relate to more senior cohorts. This would mean that the underwriting results may not portray the performance of the product, especially when there are senior cohorts.
- 47 Stakeholders that are concerned by the application of annual cohorts to the cash-flow matched contracts, report the following issues:
- (a) there is no profitability at annual cohort level to be reported in a meaningful way, as the profitability is assessed at a portfolio level, consistently with the contractual and economic characteristics of this product;
 - (b) the annual cohorts requirement is burdensome and operationally complex. The objective of providing useful information about cash-flow matched contracts could be reached through other means;
 - (c) the prohibition to include contracts issued more than one year apart in the same accounting group would distort the reported result of those contracts;
 - (d) the annual cohorts requirement provides useful information about trends only when profitability can be measured objectively at cohort level. If expected profits and changes in expectations cannot be allocated unequivocally to the cohorts, then the requirement only provides artificial information about profitability.
- 48 They further refer to the following illustration of business management practice and regulatory framework regarding the cash-flow matched contracts:
- (a) under cash-flow matching techniques, insurers group contracts issued more than one year apart. The groups are mainly defined considering the aggregation of homogenous insurance and financial risks. The related pool of assets is regulated and managed in a separated way from the rest of the company. The optimisation of the asset and liability management mechanism and the underlying cash flows require that the size of these groups of assets and policies to be big enough. The objective of these techniques is to ensure that the expected cash flows to be paid to policyholders match the future proceeds arising from the financial assets held by insurers (mainly fixed-debt instruments), in terms of timing, amount and currency;

- (b) calculations are prescribed by regulation and require monitoring the matching of the cash flows in monthly buckets until the extinction of the in-force group of contracts. There are also compulsory quarterly reviews to ensure there is not a mismatch. By applying these techniques, there is an intergenerational risk sharing among policyholders, in particular longevity and financial risks, which is also the basis on which the pricing of these contracts is based and on how the internal actuarial statistical models used to estimate expected cash flows are built;
- (c) the management of the in-force contracts is consistent with how the contracts are grouped under the cash-flow matching. Indeed, the above referred cash-flow matching techniques are currently not only used for managerial and prudential purposes but also with an accounting perspective as financial reporting does not require to group contracts differently;
- (d) Although cash-flow matched contracts are economically matched and have specific backing portfolios of debt instruments supporting the cash flows to be paid to policyholders, they do not seem to be eligible to be measured under the variable fee approach (VFA), as the policy contractually does not specify, in all cases, the financial assets on which the guaranteed profitability is based³. This is not a requirement to apply cashflow matching techniques;
- (e) The supporting investments are managed on a pool basis and companies do rebalance their position to be matched in terms of duration and yield to be paid to the policyholder but only when necessary to address a mismatch which is very infrequent. Furthermore, as mentioned above, when contemplating guaranteed benefits, the variation in the market value of the assets may not have a significant impact on the benefits expected to be paid to the policyholders. In particular, only in the case of surrenders before the maturity date, the policyholder would receive the fair value of the underlying assets. This leads to companies assuming basically only default risk and reinvestment risk if there are deviations from expected duration (i.e., longevity risk);
- (f) The contracts mentioned above have been granted a particular treatment under the prudential regime of Solvency II, using a matching adjustment when measuring the insurance contracts that permits insurers to adjust the risk-free rate term structure to avoid volatility in the Solvency II own funds. To be eligible for the matching adjustment, insurers must have in place robust and sound cash-flow matching techniques, which reinforces the adequacy of these techniques (due to higher number of requirements to manage assets covering liabilities compared to the ones applicable to other insurance businesses) to manage groups of contracts, and at the same time provide evidence that are generally accepted at European level. Therefore, there is no profitability at annual cohort level to be reported in a meaningful way as the profitability is assessed at a portfolio level, consistently with the contractual and economic characteristics of this product. Although cash-flow matched contracts are economically matched and have specific backing portfolios of debt instruments supporting the cash flows to be paid to policyholders, they seem not to be eligible to be measured under the variable fee approach (VFA), as the policy contractually does not specify in all cases the financial assets on which the guaranteed profitability is based. This is not a requirement to apply cash flow matching techniques.

EFRAG notes the following aspects or views of some stakeholders that contribute positively to relevance of IFRS 17 requirements

- 49 Those that disagree that there should be an exemption for this type of contracts point out that while these contracts may pool risks similarly to other insurance contracts (including across several issuance years), the cash flows of these contracts do not impact the cash flows of others as meant by paragraphs B67 to B71 as described in paragraphs 9 and 10 above.
- 50 Annual cohorts are necessary to realise the reporting objectives of the level of aggregation of IFRS 17 and in particular to depict the trends in profitability. Furthermore, IFRS 17 allows those changes in fulfilment cash flows that relate to future services to adjust CSM rather than profit or loss for example such as estimates around mortality. EFRAG notes that such changes could be positive or negative and that the impact could be more significant for those senior groups where the CSM has been allocated to profit or loss for a longer period than a group of contracts issued recently. However, this is no different to other changes in estimates for example about useful life or residual value for property, plant and equipment, where an update that adjusts previous estimates could have a sudden impact on profit in loss in the year of change.
- 51 Furthermore, where the results always reflect unjustified optimism by management, this could be very useful for users to evaluate the pricing and other decisions. Supporters of annual cohorts also point out that the CSM of these contracts is not impacted by returns on assets and concerns around the costs of allocating assets to cohorts and the related actions are an issue of internal requirements and not by IFRS 17.
- 52 In paragraphs 21 and 22 above, it was explained why those supporting cohorts believe the perception of the extent of the operational burden of annual cohorts in combination with others, may depend on an interpretation of the Standard rather than specific requirements. For contracts under the general model, there is no update of the CSM for changes in the fair values of the related assets and such changes are recognised as part of the financial result.
- 53 Furthermore, stakeholders that support the use of annual cohorts observe that pooling of risks and cash-flows with the business intent of matching assets and liabilities when relevant cash outflows become due (e.g., following the occurrence of insured events) is a common feature to all the insurance contracts. They consider that the identification in accounting terms of a robust dividing line for the cash-flow matched contracts is not straightforward and the affected population may be too broad.
- 54 Finally, other similar long-term life or health contracts under the general model will need to apply the annual cohorts requirement. It is not clear why the operational burden for cash-flow matched contracts would be more onerous when considering that the former also:
- (a) apply asset liability management techniques including duration matching even if there is no specific regulatory recognition of this such as the matching adjustment under Solvency II; and
 - (b) pool the risks together from various issuance years.

Reliability

- 55 EFRAG has considered the reliability of the information that will be provided by applying IFRS 17. Information has the quality of reliability when it is free from material error and bias and can be depended upon by users to represent faithfully

what it either purports to represent, or could reasonably be expected to represent, and is complete within the bounds of materiality and cost.

- 56 There are a number of aspects to the notion of reliability: freedom from material error and bias, faithful representation, and completeness.

Annual cohorts

- 57 EFRAG notes that the arguments provided above about Relevance are also to a large extent valid from a Reliability perspective.

INTERGENERATIONALLY-MUTUALISED CONTRACTS

Depicting trends in profitability

EFRAG notes the following aspects or views of some stakeholders that contribute negatively to reliability of IFRS 17 requirements

- 58 The only relevant information is the trend in CSM at portfolio level, consistently with the contractual and economic characteristics of these mutualised contracts.
- 59 From a legal and economic perspective, no fair value change (nor resulting portion of CSM) is attributable to the contracts in an annual cohort. Fair value changes have to be allocated to existing cohorts only (IFRS 17 paragraph 24) but such changes may be realised later and then be attributed to future policyholders/ future cohorts where relevant.
- 60 IFRS 17 does not set any requirement about how to allocate the changes in: (i) the fair value changes of assets to the annual cohorts (for contracts under the VFA); and (ii) the entity's assumptions about its future execution of its discretion to the annual cohorts. Consequently, the CSM amount will be determined using significant judgement. Some observe that this may impair reliability and comparability and consider that in this context, creating an exemption would secure more consistency and reliability about how companies recognise revenues for contracts within the scope of the exemption (see also impacts on comparability).

EFRAG notes the following aspects or views of some stakeholders that contribute positively to reliability of IFRS 17 requirements

- 61 Profitability of new and existing insurance contracts is not static; it evolves over time as it is influenced by market parameters (e.g. new opportunities where higher profit margins are possible or increased competition resulting in lower margins). Such trend information therefore provides information to users in developing a view on the future prospects of an insurer as well as the stewardship by management. The use of cohorts results in a closed portfolio of insurance liabilities for those issued within a year. In doing so, allocation of the CSM of consecutive years provides trend information.
- 62 The one-year groups ensure that the contractual service margin is at an appropriate rate (without continuous re-averaging) over the relevant coverage period. Therefore, they consider that there would be an appropriate release of the CSM to insurance revenue in each period and over time as this would provide a faithful representation of the pattern of profit earned by the entity over time for providing insurance contract services.
- 63 The possibility to share unrealised gains with current and future policyholders (if and when insurers enter into new contracts) does not negate the existence of a CSM for the shareholders. As discussed above, factors that impact the variable fee earned by the shareholders such as guarantees or fair value returns on assets (for contracts under the VFA) or other financial factors should be reflected in the period they occur even though it may be indirectly through the CSM.

- 64 Some observe that without annual cohorts, in good periods, the reporting would penalise existing shareholders to the benefit of future shareholders, as the entity's reported profitability of a given year would not reflect the positive investment performance in that year, resulting in a distortion of future profitability and an increased risk profile for the current shareholder.

Defining an exemption to the annual cohorts requirement

EFRAG notes the following aspects or views of some stakeholders that contribute negatively to reliability of IFRS 17 requirements

- 65 A principles-based approach was considered but dismissed on the grounds of practicability. Some preparers have reported that the complexity added by the annual cohorts mechanism is not far away from the complexity due to the principles-based approach previously proposed⁴. In addition, some stakeholders have now proposed a principles-based scope for an exemption that would resolve the issue for specific types of contracts.

EFRAG notes the following aspects or views of some stakeholders that contribute positively to reliability of IFRS 17 requirements

- 66 Granting an exemption would necessarily rely on arbitrary criteria and unduly increase the complexity of the Standard. Furthermore, the complexities relating to the tracking of assets may be an interpretation not a requirement as described in paragraph 22 above.
- 67 With reference to standard-setting proposals by some stakeholders for an exemption that would potentially resolve the issue for some contracts, it has been noted that a demonstration, that this would result in better information, has not been provided.

Financial reporting not reflecting business model

EFRAG notes the following aspects or views of some stakeholders that contribute negatively to reliability of IFRS 17 requirements

- 68 The level of aggregation requirements will not reflect the level at which pricing, monitoring of profitability as well as risk management of insurance contracts is undertaken in most cases as this is generally done at a portfolio level.
- 69 When the share of returns is contractually determined jointly for all policyholders, the entity has no reason to monitor profitability and manage contracts at a lower level of aggregation. As a consequence, the allocation to annual cohorts fails to reflect appropriately the legal and economic features of such contracts.
- 70 The requirement in IFRS 17 paragraph 24 requires an arbitrary allocation to existing policyholders' future cash flows expected to be paid to future policyholders.

EFRAG notes the following aspects or views of some stakeholders that contribute positively to reliability of IFRS 17 requirements

- 71 As discussed above, the allocation of cash flows to future groups have been incorporated into IFRS 17 only to reflect the realities of a very complex contractual arrangement, i.e., intergenerational mutualisation. Simplifications of the accounting would result in the unacceptable loss of useful information such as profitability trends.

⁴ In the 2013 Exposure Draft, the IASB suggested that groups be arranged based on profitability buckets, but constituents argued that this was too onerous.

- 72 Furthermore, the tracking of CSM does not require a full tracking of profitability per cohort such that assets are allocated to specific cohorts initially and subsequently. Therefore, the implementation of the annual cohorts requirements may not be as complex as opponents of annual cohorts assert.

CASH-FLOW MATCHED CONTRACTS

Depicting trends in profitability

EFRAG notes the following aspects or views of some stakeholders that contribute negatively to reliability of IFRS 17 requirements

- 73 The stakeholders concerned about the application of annual cohorts to the cash-flow matched contracts consider that the only relevant information is the trend in CSM at portfolio level, consistently with the contractual and economic characteristics of these cash-flow matched contracts. They note the following:
- (a) cash-flow matched contracts mainly provide a long-term fixed guarantee on interest rate to policyholders that does not change over time even if the market interest rates change;
 - (b) this guaranteed interest rate credited to the policyholder is set by companies based on the observable market yield of the investment portfolio assigned for the expected duration of the benefits (life expectancy in life annuities) when the contract is underwritten;
 - (c) considering the above pricing methodology based on cash flow matching techniques, insurers earn an expected constant financial margin in these contracts that is the difference between the internal rate of return of financial assets and the guaranteed interest rate credited to the policyholder, while they are exposed to other non-financial risks (basically, deviation from the assumptions used in pricing in relation to longevity risk, to the risk margin or to operating expenses) that would determine the overall margin.

EFRAG notes the following aspects or views of some stakeholders that contribute positively to reliability of IFRS 17 requirements

- 74 One of the objectives of the level of aggregation is the trends in profitability over time. Since these contracts pool risks together, any losses would be compensated by gains from other contracts. Therefore, in the absence of annual cohorts, trends in profitability would not be faithfully represented because of the higher level of aggregation which would allow the compensation of gains with losses also with a potential significant loss of information.

Defining an exemption to the annual cohorts requirement

- 75 The stakeholders that support the application of annual cohorts to cash-flow matched contracts consider that the reasoning included in the intergenerationally-mutualised contracts (paragraph 65) is equally applicable to the cash-flow matched contracts. In addition, differently from the intergenerationally-mutualised contracts that meet the conditions in B67/71 of IFRS 17 and the criteria for the application of the VFA, it is not evident how to distinguish in accounting terms from the rest of the contracts under the general model the population to which the exemption would apply.

EFRAG notes the following aspects or views of some stakeholders that contribute negatively to reliability of IFRS 17 requirements

- 76 A principles-based approach was considered but dismissed on the grounds of practicability. Some preparers reported that the complexity added by the annual cohorts' mechanism is not far away from the complexity due to the principles-based

approach previously proposed. In addition, some stakeholders have now proposed a principles-based scope for an exemption.

EFRAG notes the following aspects or views of some stakeholders that contribute positively to reliability of IFRS 17 requirements

- 77 The same arguments as for intergenerationally-mutualised contracts described in paragraphs 66 to 67 above are valid here.

Financial reporting not reflecting business model

EFRAG notes the following aspects or views of some stakeholders that contribute negatively to reliability of IFRS 17 requirements

- 78 The stakeholders that are concerned about the application of annual cohorts to cash-flow matched contracts consider that the level of aggregation requirements will not reflect the level at which pricing, monitoring of profitability as well as risk management of insurance contracts is undertaken in most cases as this is generally done at a portfolio level.
- 79 They observe that when the asset returns are calculated, the entity has no reason to monitor profitability and manage contracts at a lower level of aggregation. As a consequence, they consider that the allocation to annual cohorts cannot appropriately reflect the legal and economic features of such contracts.

EFRAG notes the following aspects or views of some stakeholders that contribute positively to reliability of IFRS 17 requirements

- 80 As described in paragraph 48(b) '*calculations [for cash-flow matched contracts] are prescribed by regulation and require monitoring the matching of the cash flows in monthly buckets until the extinction of the in-force group of contracts. ...By applying these techniques, there is an intergenerational risk sharing among policyholders, in particular longevity and financial risks*'.
- 81 The use of a reporting period of one year is merely a convention to report results to the investors on regular intervals. It does not affect the ability the exercise the business model *any more than* the regulatory requirement to match cash-flows in monthly buckets.

Comparability

- 82 The notion of comparability requires that like items and events are accounted for in a consistent way through time and by different entities, and that unlike items and events should be accounted for differently.
- 83 EFRAG has considered whether IFRS 17 results in transactions that are:
- (a) economically similar being accounted for differently; or
 - (b) transactions that are economically different being accounted for as if they are similar.

Annual cohorts

- 84 EFRAG notes that, in theory, the IFRS 17 requirement to divide all the insurance contracts in groups that include contracts issued within one year reduces different application options. However, as IFRS 17 does not specify how the allocation of cash flows to annual cohorts has to be done in practice, it leaves room for different approaches.
- 85 In particular, in the context of contracts with intergenerational mutualisation the annual cohorts requirement may lead to diversity of reporting practices when:

- (a) applying paragraphs B67–B68 of IFRS 17 to determine what groups would substantially affect the cash flows of other groups;
- (b) allocating changes in the entity’s assumptions about its future execution of its discretion to the cohorts (both for indirect and direct participating contracts);
- (c) allocating the fair value changes arising from the underlying items to the cohorts (VFA contracts).

The lack of application guidance in IFRS 17 is likely to lead to inconsistent implementation and thus, undermine comparability.

- 86 However, EFRAG notes that the introduction of profitability buckets would limit the extent of averaging of profit across contracts; however, the absence of annual cohorts may allow to a certain extent the continuance of existing practices of blending of profits across periods, which may impair comparability of how profitability has changed.

CASH-FLOW MATCHED CONTRACTS

EFRAG notes the following aspects or views of some stakeholders that contribute negatively to comparability of IFRS 17 requirements

- 87 Some stakeholders concerned about the application of annual cohorts to cash-flow matched contracts consider that different reporting practices may be taken by preparers to allocate a portion of the assets belonging to the cash flow matching asset portfolio to each specific insurance contracts cohorts of the general model (e.g., this asset allocation might be needed internally in order to assess the overall performance of an insurance portfolio). These stakeholders, as mentioned before, consider that the asset management strategy is defined at a higher level of granularity (i.e., cashflow matching group), thus, the allocation at a more granular level (i.e., annual cohorts) would lead to a lack of comparability between financial statement preparers. Furthermore, they note that in case annual cohorts should be applied, this could lead to differences in the reporting disclosures versus the approach used to manage the assets and liabilities (based on the ALM framework in place).

EFRAG notes the following aspects or views of some stakeholders that contribute positively to comparability to the assessment of IFRS 17 requirements

- 88 Others disagree with this assessment as in many cases IFRS Standards require accounting on a more granular basis than that at which pricing or monitoring would occur, such as inventory, financial assets including loans or revenue. In some cases, the accounting may require management to report transactions in a different way than managed or perceived by management, e.g. risk management activities that do not meet the requirements in IAS 39 or IFRS 9. While some standards require the perspective of management such as IFRS 7 *Financial instruments: Disclosures* or IFRS 8 *Operating Segments*, these refer to disclosures rather than measurement and recognition criteria relating to transactions.

Understandability

- 89 The notion of understandability requires that the financial information provided should be readily understandable by users with a reasonable knowledge of business and economic activity and accounting, and the willingness to study the information with reasonable diligence.
- 90 Although there are a number of aspects related to the notion of ‘understandability’, EFRAG considers that most of the aspects are covered by the discussion above

about relevance, reliability and comparability. As a result, EFRAG is of the view that the main additional issue that deserves consideration is assessing whether the information resulting from the application of IFRS 17 is understandable and whether that information is unduly complex.

Annual cohorts

- 91 The disclosure on significant judgements (as per paragraph 122 of IAS 1 and paragraph 93 of IFRS 17) would, to a certain extent, enable users to understand the results of the application of B67-68 principles in IFRS 17. However, due to a lack of specific implementation guidance on how to apply annual cohorts, there is potentially no uniform way to apply annual cohorts and the results may be challenging to explain.
- 92 In addition, the level of aggregation only provides for an accounting mechanism of grouping contracts and defining the extent of offsetting of cash flows at group level, without making available to the users any specific presentation or disclosure requirements to report information at annual-cohort level.

CASH-FLOW MATCHED CONTRACTS

EFRAG notes the following aspects or views of some stakeholders that contribute negatively to understandability of IFRS 17 requirements

- 93 Preparers that are concerned about the application of annual cohorts to the cash-flow matched contracts observe that having within the unit of account (i.e. the cohort) a more reduced number of contracts, together with a different profile composition (for example, significant differences in the individual amount of the liability for remaining coverage for each policyholder) are factors that generate more variability in the adjustments in the CSM. These preparers also consider that, increasing the scope for “onerous” cohorts, when based on actuarial assumptions supporting the product there would be a compensation across cohorts. These preparers conclude that this can confuse users, as they could perceive that the company does not have a good risk management framework in place.

EFRAG notes the following aspects or views of some stakeholders that contribute positively to understandability of IFRS 17 requirements

- 94 As discussed in paragraphs 50 and 51, IFRS 17 allows changes in fulfilment cash flows that relate to future services (for example estimates around mortality) to adjust CSM rather than profit or loss. Such changes could be positive or negative and that the impact could be more significant for those senior groups where the CSM has been allocated to profit or loss for a longer period than a group of contracts issued recently. However, other changes in estimates such as updating of the useful life of an item could also have significant impacts in a specific year without making the information less reliable.
- 95 Finally, where such changes in estimates are slanted in a specific direction, this could be very useful information for users when evaluating pricing and other decisions.

Prudence

- 96 For the purpose of this endorsement advice, prudence is defined as caution in conditions of uncertainty. In some circumstances, prudence requires asymmetry in recognition such that assets or income are not overstated, and liabilities or expenses are not understated.
- 97 Prudence is different from and unrelated to prudential reporting. The former is a qualitative characteristic used in accounting standard setting and is applicable to the

financial statements of all companies. The latter refers to the reporting by individual financial institutions to regulators in order to meet the regulator's objectives (such as capital adequacy and liquidity).

Annual cohorts

Timely reporting of losses on onerous contracts

- 98 One of the key innovations of IFRS 17 is the early identification of onerous contracts, with the requirement to immediately recognise losses expected from onerous contracts at initial recognition and regular monitoring and reporting of changes expected to those losses. EFRAG considers that this feature enhances the prudence of the Standard. With reference to the intergenerational mutualisation and cash-flow matched contracts however this feature creates tension with the economic characteristics of this portion of the market, as illustrated below.

INTERGENERATIONALLY-MUTUALISED CONTRACTS

EFRAG notes the following aspects or views of some stakeholders that contribute negatively to prudence to the assessment of IFRS 17 requirements

- 99 One of the peculiarities of the contracts with intergenerational mutualisation is that, due to the transfer of cash flows from one contract to another and from one generation to another, no individual contract nor individual annual cohort may become onerous (i.e., the shareholders may have to contribute to the assets of the policyholders) until the entire mutualised population of contracts becomes onerous.
- 100 The expected profitability of contracts with intergenerational risk-sharing changes over time, depending on how management exercises its discretion as to the timing and the amount allocated to policyholders. Intergenerational sharing of risk, coupled with discretion by the insurer over the sharing of returns on underlying items between the insurer and policyholders, requires adjustments (to depict the extent to which profits from existing contracts are expected to subsidise future contracts or vice versa) to allow for changes in the fulfilment cash flows and, hence, the CSM of each annual cohort. These adjustments are, in effect, arbitrary and consequently the separate CSM of each annual cohort is not meaningful.
- 101 The annual cohorts requirement may lead to unduly consider as onerous contracts that in reality (taking into account their contractual and economic characteristics) are not, as they will benefit from a mutualisation mechanism.
- 102 In addition, the Standard reflects the impact of the intergenerational mutualisation, as a transfer of cash flows from one contract to another (paragraphs B67-B71) when determining fulfilment cash flows. Such transfers may delay the recognition of onerous contracts and this will happen irrespective of the use of annual cohorts. On the contrary, the annual cohorts requirement may result in imprudent accounting, as it forces the recognition in profit or loss of CSM that does not contractually and economically belong to existing shareholders, as it is (contractually and economically) attributable to services to be rendered to future policyholders.
- 103 As the expected profit is not determinable at cohort level, the resulting information from applying annual cohorts cannot be meaningful. Applying paragraphs B67–B68 of IFRS 17, no generation of contracts can become onerous unless the fungible discretionary cash flows in the portfolio of contracts are exhausted. So, no single cohort can become onerous unless the whole portfolio of contracts is onerous.

EFRAG notes the following aspects or views of some stakeholders that contribute positively to prudence of IFRS 17 requirements

- 104 While judgement is required in these circumstances, the objective of the adjustments is clear, and the outcome should still provide relevant information about the profitability of each annual cohort. For example, an insurer may issue new contracts that would be onerous were they not to be subsidised by returns generated on invested premiums from previous contracts. Conversely, an insurer may issue new contracts that would improve the profitability (or onerousness) of the existing portfolio. The requirements of paragraph B68 of IFRS 17 result in the effects described in the previous paragraph being reflected in the measurement of the annual cohorts, so that an annual cohort is not shown as onerous to the extent that it is subsidised by returns generated on invested premiums from previous contracts. This depicts the economic effect on the entity. However, it is often not the case that an annual cohort can be onerous only if the whole portfolio is onerous. The effects of features such as guarantees in an annual cohort may be shared with policyholders in other annual cohorts, but the entity may still bear a share of the effect. That share could cause an individual annual cohort to become onerous even if other annual cohorts in the portfolio are still profitable.
- 105 Hence, as described above in paragraph 45, except for a small population, the removal of the annual cohorts requirement would lead to an unacceptable loss of useful information. 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. It is important that the CSM reflects the impact on the variable fee of financial guarantees which may result in the CSM declining to zero or result in losses even if the shareholders do not have make a contribution to the pool of policyholder assets.
- 106 Furthermore, some have observed that annual cohorts are essential to avoid imprudent accounting and to ensure that aggregation is not so great as to render profit measures meaningless, i.e. to avoid the failure to recognise profits or losses on contracts in the appropriate periods. If annual cohorts are not applied, then it is likely that:
- (a) there will be co-mingling of different generations of contracts with different profitability, or different changes in profitability, which could result in profit being anticipated or deferred rather than being recognised as it is earned;
 - (b) these effects on the recognition of profit obfuscate the presentation of the effects of different pricing decisions at different times, resulting in a lack of accountability for such decisions and impaired ability for users of financial statements to model future profitability;
 - (c) the recognition of a loss arising from onerous insurance contracts would be delayed, potentially for many years. In every other industry, if transactions become unprofitable, losses are recognised immediately when this becomes apparent.

CASH-FLOW MATCHED CONTRACTS

EFRAG notes the following aspects or views of some stakeholders that contribute negatively to prudence of IFRS 17 requirements

- 107 Those that oppose annual cohorts for these types of contracts consider that the results will lead to excessive prudence and do not reflect that natural implicit support of pooling of risk as envisaged by insurers.

- 108 These stakeholders report that, considering the pricing methodology used for cash-flow matched contracts noted in previous sections, most insurers using cash-flow matching techniques earn an expected constant financial margin in these contracts that is the difference between the internal rate of return of financial assets and the guaranteed interest rate credited to the policyholder, while they are exposed to other non-financial risks (basically, deviation from the assumptions used in pricing in relation to longevity risk, to the risk margin or to operating expenses) that would determine the overall margin.
- 109 They believe that, as a consequence, the annual cohorts requirement may lead to unduly consider as onerous contracts that in reality (taking into account their contractual and economic characteristics) are not, as they will benefit from the pooling mechanism of the overall cash-flow matched group.
- 110 Finally, they observe that as the expected profit is not determinable at cohort level, the resulting information from applying annual cohorts cannot be meaningful.
- 111 Some also consider the existence of the separate 'profitability buckets' as sufficient safeguard against concerns around re-averaging of profits.

EFRAG notes the following aspects or views of some stakeholders that contribute positively to prudence of IFRS 17 requirements

- 112 As mentioned earlier, those supporting annual cohorts consider that this is useful information for users and reflect the economics of the situation. They also note that the recognition of contracts that have become onerous is of significant importance to users. These contracts pool risks together in order to have a stable margin. This is not different from other industries, however, when there is a loss for some products, it would be recognised in profit or loss and not compensated with the gains from other products. In the absence of annual cohorts, these losses would not be visible to the users.

Appendix III on annual cohorts

Business models

INTERGENERATIONALLY-MUTUALISED CONTRACTS

EFRAG notes the following aspects or views of some stakeholders that contribute negatively to the assessment of IFRS 17 requirements

- 1 The annual cohorts requirement results in limited usefulness to users of the financial information. The splitting of amounts into groups of contracts issued not more than one year apart is seen as artificial and different to how the business is organised and from the economics of the mutualised contracts: the initial allocation of cash flows on an annual cohort basis, because there is a common underlying pool of assets (the underlying assets are not segregated by annual cohorts), has to be compensated by further artificial allocations. Consequently, the accounting ignores the economic consequences of the legal and contractual terms (e.g. the regulation requires this intergenerational sharing of risks), does not reflect reality and will not provide a relevant information to the users.
- 2 The level of aggregation requirements will not reflect the level at which pricing, monitoring of profitability as well as risk management of insurance contracts is undertaken in most cases as this is generally done at a portfolio level.
- 3 The allocation of the CSM by annual cohorts will be costly, will not correctly reflect their economics and the way they are managed for legal and contractual purposes, and thus will be of little value for the users.
- 4 EFRAG's outreach run in 2019 with European users specialising in the insurance sector have reported that a number of them on the contrary consider that the use of annual cohorts is not appropriate (e.g. the results of the mutualised business should be at a level of aggregation that is aligned with how management manages the business, annual cohorts would create volatility due to accounting mismatches).

EFRAG notes the following aspects or views of some stakeholders that contribute positively to the assessment of IFRS 17 requirements

- 5 The use of annual cohorts is needed for all insurance contracts, in order to realise the reporting objective of IFRS 17. This contributes to the relevance of the information provided and, in this way, also to the proper reporting of the performances of the business models applied. The following two arguments further explain this view.
- 6 Profitability at inception of contracts can and has changed fundamentally over time. For example, guarantees that originally may have had a fair value of zero have become significantly more costly over time given the current levels of asset returns after 2008. If annual cohorts are not applied, the information about this change in profitability would be lost.
- 7 Views among users are not all aligned: generalist users associations believe that in the absence of annual cohorts, management would be allowed too much discretion thereby avoiding showing wealth transfers which give material information for all stakeholders - shareholders, existing policyholders, regulators and potential new policyholders. They believe that, in order to obtain an understanding of how good an insurance company is, it is necessary to understand how good the management is at managing risks (i.e. underwriting decisions), balancing competing stakeholder rights and investing funds. Annual cohorts would go some way to enable this understanding. Any level of aggregation above the annual cohort will obscure visibility around the risk and earnings profile of insurance companies.

CASH-FLOW MATCHED CONTRACTS

EFRAG notes the following aspects or views of some stakeholders that contribute negatively to the assessment of IFRS 17 requirements

- 8 The level of aggregation requirements will not reflect the level at which pricing, monitoring of profitability as well as risk management of insurance contracts is undertaken in most cases as this is generally done at a portfolio level. It is also considered that for this reason, the allocation of the CSM on this basis would be costly, may not correctly reflect the economics (please refer to the discussion on relevance in Appendix II) and will therefore not provide useful information to users.
- 9 Stakeholders concerned about the application of annual cohorts to cash-flow matched contracts believe that the splitting of amounts into groups of contracts issued not more than one year apart is artificial and different to how the business is organised (i.e. based on the cash-flow matching groups) and from the economics of the mutualised contracts: the initial allocation of cash flows on an annual cohort basis, because there is a common underlying pool of assets (the underlying assets are not segregated by annual cohorts), has to be compensated by further artificial allocations. As a consequence, they believe that the accounting would ignore the economic consequences of the legal and contractual terms (e.g. the regulation requires risk-sharing within each cash flow matching group), would not reflect the reality and would not provide relevant information to the users.
- 10 These stakeholders state that mandatory application of annual cohorts with the persistent low interest rate environment, could further discourage the sale of these contracts in favour of unit-linked type of products where policyholders bear the investment risk. They see this as negative for the insured and for the European life savings insurance market.
- 11 They also consider that the internal actuarial statistical models used to estimate expected cash flows are based on asset liability management, so the requirement would increase significantly the implementation cost without increasing the quality of the information reported. Not only implementation costs will increase, but also ongoing costs, due to the duration of the contracts.

EFRAG notes the following aspects or views of some stakeholders that contribute positively to the assessment of IFRS 17 requirements

- 12 In other sectors profitability is not necessarily evaluated at the level of individual product, but rather at department level (such as home, furniture or food for retailers or per portfolio for investors), but losses reflecting where net realisable value is below cost or fair value changes on an individual instrument basis is still required for accounting purposes.

Financial stability

INTERGENERATIONALLY-MUTUALISED CONTRACTS

EFRAG notes the following aspects or views of some stakeholders that contribute negatively to the assessment of IFRS 17 requirements

- 13 Constituents that oppose the use of annual cohorts for intergenerational mutualised contracts state that that regulation of guaranteed interest rates may be part of a broader policyholder interest protection strategy or it may be introduced to ensure entities invest in financial assets that provide enough risk-adjusted yield to secure those guarantees and thus protect the resilience and financial stability of the insurance industry. In some of these cases, insurers need to include contracts

issued more than one year apart in the same group to meet the regulation, existing a substantial intergenerational risk sharing of financial and longevity risks.

Low interest rates

- 14 They also report that in a low interest rates scenario, the risk is to favour pro-cyclical reporting effects, linked to artificial allocations of cash flows to annual cohorts, rather than reflecting the entity's performance in managing risks and reporting meaningful profitability trends. For example, the insurer can aim at achieving a long-term return on the underlying items of x%. In reality, asset returns will fluctuate and may be higher or lower than the expected long-term return at any given year. Applying annual cohorts, the point-in-time returns may deviate from the expected long-term return. In economic challenging times the point-in-time return will go down or even be negative. Reflecting that point-in-time return may result in recognising losses which will never occur if the long-term expected return is finally achieved. Hence, it would result in providing to the market a performance lower than the one corresponding to the implemented long-term management strategy. This would be pro-cyclical, as the reported results would be less positive in bad times. Markets may react negatively to these lower results, perceiving a higher level of risk for the entity and making more difficult for the entity to have access to funding.
- 15 Further, their argument is that the annual cohorts requirement implies artificial allocation of fair value asset returns to cohorts by using drivers (i.e. allocation keys) to allocate financial return that arise from the overall pool into the groups. In particular splitting up the funds return among the cohorts requires judgmental drivers and or/big operational challenges, considering that there is not any technical, contractual, managerial evidence on how the assets of the fund are spread into the cohorts. These drivers are not determined on the basis of the economic characteristics of the fund (from a legal or ALM point of view there is no such a segregation) and the behaviour of the CSM of a specific cohort could depend by the driver used, rather than reflecting the contribution to real profitability of the fund.
- 16 Furthermore, in periods of financial stress the risk of reflecting a different reality for accounting than the economic substance is higher - there is a risk of showing onerous cohorts in profitability rather than the ability of the insurer to manage and mutualise its financial risk within the fund and among policyholders.

EFRAG notes the following aspects or views of some stakeholders that contribute positively to the assessment of IFRS 17 requirements

- 17 Increased transparency supports financial stability, as during a financial crisis, users would have more information to timely assess the implications of the crisis on entities' financial position and performance. This would allow to timely react and adjust their risk exposures, thus avoiding a potential cliff-effect that would occur missing such level of transparency.
- 18 Annual cohorts provide an early warning signal about the insurer's performance, making visible the changes in profitability due to pricing conditions and performance of individual annual cohorts, as well as recognising losses from onerous contracts at a more granular level. Investors will receive a signal through the disclosure of an increase of the loss component. Such an increase will tempt investors to ask questions to the management, adding to the need for corrective action and thus avoidance of any negative impact on financial stability.

Low interest rates

- 19 There is a concern about the impact of guarantees given the low interest rate environment which increases the reinvestment rate risk for insurers. The use of

annual cohorts would reflect the impact of these on the CSM for shareholders and could act as an early warning system before shareholders have to contribute to the pool of assets of the policyholders.

- 20 Some consider that there is no linkage between applying annual cohorts and pro-cyclicality as transparency is the best way to avoid pro-cyclicality, as it allows to investors to anticipate their reaction and in this way prevents cliff-effects, and capital availability drives underwriting capacity and this is determined by Solvency II rather than IFRS 17. Furthermore, there is no evidence of an adverse effect on business competitiveness and financial stability due to the annual cohort requirement despite such concerns.

CASH-FLOW MATCHED CONTRACTS

EFRAG notes the following aspects or views of some stakeholders that contribute negatively to the assessment of IFRS 17 requirements

- 21 In some cases, insurers need to include contracts issued more than one year apart in the same group to reflect the pooling of risk such as longevity risks to avoid unjustified impacts on profitability that may cause groundless concerns in equity markets about the insurers.
- 22 Stakeholders concerned by the application of annual cohorts to cash-flow matched contracts believe that this circumstance, in conjunction with the persistent low interest rate environment, could lead to discouraging the sale of this type of insurance business in favour of unit-linked type of products where policyholders bear the investment risk.

EFRAG notes the following aspects or views of some stakeholders that contribute positively to the assessment of IFRS 17 requirements

- 23 It is not clear why these contracts should be excluded from the annual cohorts requirement compared to others where insurers may follow similar techniques voluntarily without any regulatory capital benefit. Furthermore, where supply of products or the price of those products are reconsidered due to accounting reflecting the economics, this will enhance the resilience of the financial system.

Social guarantees

INTERGENERATIONALLY-MUTUALISED CONTRACTS

EFRAG notes the following aspects or views of some stakeholders that contribute negatively to the assessment of IFRS 17 requirements

- 24 There is a risk of introducing accounting treatments which may directly influence the way the insurance coverage system is organised and possibly reduce the current and accepted level of mutualisation. The way insurers organise mutualised populations is a highly sensitive feature of insurance markets since it reflects and also shapes up a level of “social/societal” understanding of what is covered by insurance and what is left to the direct responsibility of the individual (natural or moral person). The scope of mutualised populations and the terms and conditions offered to them by insurers are the outcome of very long-term evolutions and decisions reflecting fundamental choices made at the level of the society as a whole (explicitly via regulations, semi-explicitly when practices reflect or influence changes in behaviour). In many cases, the strategy of insurers is heavily influenced by a prevailing insurance environment (or culture) the evolution of which requires extensive debates. The depiction of mutualised populations for accounting purposes may lead to unintended changes in the way insurers cover insurance risks.

- 25 The intergenerational mutualisation results in a transfer of wealth across generations (e.g., it allows to increase the return allocated to the future generations by reducing the returns accumulated from investing funds provided by old and existing generations). This is an essential element of the purpose of this product family, as this business model has been designed and is regulated in a way that it provides to the community a stable stream of revenues from savings over a number of years. The use of annual cohorts may distort the reported performance, as the management performance for this type of products can only be assessed along the multi-year mutualisation period and, as such, allowing to report profits in a given year on the basis of the point-in-time positive investment result would result in overstating the reported profit for that year.

EFRAG notes the following aspects or views of some stakeholders that contribute positively to the assessment of IFRS 17 requirements

- 26 Those that support the use of annual cohorts to all the insurance contracts do not share the views above. They in particular consider that annual cohorts provide useful and transparent information about the trend in profitability with appropriate granularity.
- 27 The analysis in paragraph 88 above is also valid here.

Low interest rates

EFRAG notes the following aspects or views of some stakeholders that contribute negatively to the assessment of IFRS 17 requirements

- 28 In the context of contracts with intergenerational risk sharing, applying paragraph B67–B68 of IFRS 17, no cohort can become onerous unless the fungible cash flows across contracts in the portfolio are exhausted. As a consequence, with or without applying the annual cohorts requirement, a loss for onerous contracts is recognised whenever the portfolio is onerous.

EFRAG notes the following aspects or views of some stakeholders that contribute positively to the assessment of IFRS 17 requirements

- 29 From a macroeconomic point of view, private life insurance supplement benefits provided by governments, relieving them of some of the burden of meeting financial security needs. In this sense, the ability of insurance entities to continue to provide stable returns on and protect the invested capital of life insurance products over the saving horizon of the policyholders, plays a role as well in enhancing the level of social guarantees existing in a given jurisdiction. In this context, low interest rates constitute a challenge, as they may negatively impact the ability to get sufficient investment returns to meet the obligations deriving from financial guarantees embedded in life insurance contracts.
- 30 Supporters of annual cohorts observe that information about the effect of financial guarantees is particularly important in low interest rate environments for reasons discussed in paragraphs 33 to 34 under the section on Appendix II. They acknowledge that for some insurance contracts with substantial intergenerational sharing of risks, it is likely to be rare for the effect of financial guarantees and other cash flows that do not vary with returns on underlying items to cause an annual cohort to become onerous. However, it is exactly that rarity that makes the information particularly useful to users of financial statements when such an event occurs. Accordingly, they disagree with the view of some stakeholders that the rarity of such an event reduces the usefulness of the information that results from applying the annual cohorts requirement to such contracts.

- 31 Therefore, they conclude 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 relatively small, the removal of the annual cohorts requirement would lead to an unacceptable loss of useful information. 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.

CASH-FLOW MATCHED CONTRACTS

EFRAG notes the following aspects or views of some stakeholders that contribute negatively to the assessment of IFRS 17 requirements

- 32 If companies need to apply compulsory annual cohorts, such type of guaranteed interest rates (or the products to which this guarantee is attached) may disappear or give rise to equity impacts that may in turn affect those companies offering them.
- 33 Constituents that oppose the use of annual cohorts for cash-flow matched contracts state that regulation of guaranteed interest rates may be part of a broader policyholder interest protection strategy or it may be introduced to ensure entities invest in financial assets that provide enough risk-adjusted yield to secure those guarantees and thus protect the resilience and financial stability of the insurance industry. They further consider that in some of these cases, insurers need to include contracts issued more than one year apart in the same cash-flow matching group to meet the regulation, thereby existing a substantial risk sharing of financial and longevity risks within that cash flow matching group.

EFRAG notes the following aspects or views of some stakeholders that contribute positively to the assessment of IFRS 17 requirements

- 34 It is not clear why these contracts should be excluded from the annual cohorts requirement compared to others where insurers may follow similar techniques voluntarily without any regulatory capital benefit. Furthermore, where supply of products or the price of those products are reconsidered due to accounting reflecting the economics, this will enhance the resilience of the financial system.

Cost and benefits

INTERGENERATIONALLY-MUTUALISED CONTRACTS

EFRAG notes the following aspects or views of some stakeholders that contribute negatively to the assessment of IFRS 17 requirements

- 35 For contracts with intergenerational mutualisation the annual cohorts requirement adds complexity and does not bring benefits in terms of the resulting information (reporting the profit earned from different generations would represent an artificial allocation of profits and as such would not be useful information, as this does not reflect the contractual and economic characteristics of intergenerationally-mutualised contracts).
- 36 The view that for intergenerationally-mutualised contracts the annual cohorts are essential to provide useful information to users is not shared by all the user groups. EFRAG's outreach run in 2019 with European users specialising in the insurance sector has reported that a number of them consider that the use of annual cohorts is not appropriate (e.g. the results of the mutualised business should be at a level of aggregation that is aligned with how management manages the business, annual cohorts would create volatility due to accounting mismatches).

- 37 Those users said that the resulting information of applying the annual cohorts requirement will not reflect the level at which pricing, monitoring of profitability as well as risk management of insurance contracts is undertaken in most cases as this is generally done at a portfolio level.
- 38 They also consider that when the share in the returns is contractually determined jointly for all policyholders, the entity has no reason to monitor profitability and manage contracts at a lower level of aggregation. As a consequence, the allocation to annual cohorts cannot “appropriately” reflect the legal and economic features of such contracts.
- 39 Some refer to the IASB’s acknowledgement that the costs of the annual cohort requirement might exceed the benefits for a very limited population of contracts and consider this conclusion incorrect given the size of population affected in Europe.

EFRAG notes the following aspects or views of some stakeholders that contribute positively to the assessment of IFRS 17 requirements

- 40 IFRS 17 recognises in the Basis for Conclusions of IFRS 17 that entities will incur costs to identify the contractual service margin at the annual cohort level but considers that information about higher or lower profits earned by an entity from different generations of contracts is sufficiently useful information to justify such costs.
- 41 As explained in the Basis for Conclusions of the Standard (paragraph BC139P), the IASB acknowledged that for some insurance contracts with substantial intergenerational sharing of risks, the effect of financial guarantees and other cash flows that do not vary with returns on underlying items would rarely cause an annual cohort to become onerous. The IASB has dismissed the proposal to exempt the contracts with intergenerational mutualisation as it is concluded that it is exactly that rarity that makes the information particularly useful to users of financial statements when such an event occurs.
- 42 In addition, arguments reported in the Basis for Conclusions (paragraphs BC139Q to BC139S of IFRS 17) are equally valid.

CASH-FLOW MATCHED CONTRACTS

EFRAG notes the following aspects or views of some stakeholders that contribute negatively to the assessment of IFRS 17 requirements

- 43 Increased resources will be required to allocate underlying assets to cohorts as well as costs relating to data storage and sign-off of disclosure amounts and it is considered that ALM efficiency will be lost as there will be difficulties to justify the link between certain types of investments and the contracts of a specific cohort. Furthermore, pricing and risk management techniques are done at a portfolio level and that cohorts would generate artificial variability in performance as the product is expected to provide a stable margin with no significant deviations from the longevity assumptions.

EFRAG notes the following aspects or views of some stakeholders that contribute positively to the assessment of IFRS 17 requirements

- 44 As noted previously, there is no requirement for assets of these products to be linked to annual cohorts as asset returns do not impact the CSM under the general model. Furthermore, any costs are to provide very important information to users about profitability trends of the products offered by the insurer.

Annex A: Annual cohorts: the issue and its pervasiveness

The issue and EFRAG's position in the comment letter to the IASB⁵

- 45 The unit of account in IFRS 17 is a group of contracts at initial recognition; the same grouping is kept for (i) the determination of the CSM, (ii) its release pattern over the coverage period of the contracts in the group and (iii) the discount rate for accretion of interest on the CSM in the general model.
- 46 First, insurers have to identify 'portfolios' of contracts that are subject to similar risks and that are managed together. The portfolios are then divided into three groups (also called profitability buckets):
- (a) onerous contracts, if any;
 - (b) contracts that at initial recognition have no significant possibility of becoming onerous subsequently, if any; and
 - (c) other contracts, if any.
- 47 Paragraph 22 of IFRS 17 requires additionally that an entity shall not include contracts issued more than one year apart in the same group ("the annual cohorts requirement").
- 48 The IASB's reporting objectives in defining the guidance on level of aggregation in IFRS 17 are the following: depicting profit trends over time, recognising profits of contracts over the duration of those contracts and timely recognising losses from onerous contracts.
- 49 EFRAG understands that in order to meet those objectives, the annual cohorts requirement has been retained as a practical simplification on a conventional basis. Such a convention derives from the difficulties to promote a principles-based approach. As a matter of fact, the IASB tried to develop a principles-based approach in identifying groups that would allow to depict profitability trends (something that the IASB considers a loss of information). However, such an approach was rejected because of feedback from stakeholders that it would be unduly burdensome. The annual cohorts requirement is, therefore, a practical simplification missing a principles-based approach but meeting the objectives of the level of aggregation.
- 50 EFRAG was informed during the due process for its comment letter on the IASB *ED/2019/4 Amendments to IFRS 17* that there are products in the European life insurance market for which the annual cohorts requirement leads to unnecessary cost, i.e., for contracts with cash flows that affect or are affected by cash flows to policyholders of other contracts. Feedback from EFRAG's constituents confirmed that the issue relates to contracts with the characteristics described in paragraphs B67 - B71 of IFRS 17 that have 'substantial' risk sharing. Most of these contracts that prevail in European jurisdictions are eligible for the variable fee approach (VFA). In some jurisdictions the issue relates to contracts eligible for the general model including contracts without the characteristics described in paragraphs B67 – B71 of IFRS 17 for which cash flow matching techniques are applied across generations. EFRAG recommended in its comment letter that the IASB consider developing an appropriate solution for such contracts, reflective of the reporting objectives of the level of aggregation requirements and of their economic characteristics.

⁵ The views expressed in the comment letter to the IASB are not valid also for the endorsement advice and they are provided in this Annex in order to facilitate the understanding of the issue by constituents for the purposes of the consultation on the DEA. **EFRAG's observations on this topic are presented in the Cover Letter to the IFRS 17 DEA.**

- 51 EFRAG in its comment letter also suggested to introduce additional disclosure requirements for contracts to which the annual cohorts would not be applied following its recommendation. In addition to the information about the reconciliations for the CSM from the opening to the closing balances (according to paragraph 101 of the Standard) and the information provided by paragraph 109 of the ED (quantitative forecasts of when the entities expect to recognise in profit or loss the CSM remaining at the end of the period), the following disclosure would enhance the information provided for contracts that are in the scope of the exemption:
- (a) qualitative disclosure describing the grouping criteria for contracts to which the annual cohorts requirement is not applied;
 - (b) disclosure on profitability trends by presenting the CSM effect of new business, derived by the quantitative information presented according to paragraph 101 of IFRS 17 for previous years (e.g. 3 in the last 3 years);
 - (c) explanation of the actuarial techniques applied for computing the CSM effect of new business joining the group as well as disclosure on the method used for assessing the profitability referred to in (b); and
 - (d) an explanation of the actuarial techniques for measuring the value of the new business and the allocation of the underlying items between the existing business and the new business.

European insurance products affected

- 52 EFRAG understands, on the basis of information obtained by stakeholders during the due process leading to the issuance of this FEA (EFRAG has not done a verification assessment of the quantitative data provided below) that the contracts under scrutiny amount to:
- (a) approximately 67% of life insurance liabilities in Austria;
 - (b) approximately 76% of the French life insurance market for direct participation contracts that also meet the characteristics of IFRS 17 paragraphs B67-B68. Estimates for French IFRS preparers are that 8% of the IFRS 4 liabilities as at end of 2019 relate to non-life insurance and 92% to life insurance. Of the latter, 81% relates to contracts under the VFA and 19% to unit-linked products with the remainder being contracts without direct participation features;
 - (c) approximately 75% of the Italian life insurance market. These contracts with discretionary participation features (known as 'Gestioni Separate') meet the characteristics of IFRS 17 paragraphs B67-B68 whereby (a) the contracts share the return of the same specified pool of underlying item; and (b) their cash flows substantially affect or are affected by cash flows to policyholders of other contracts. These contracts generally qualify for the VFA model.
 - (d) Spanish technical provisions subject to the matching adjustment on total technical life provisions is 70% and technical provisions subject to the matching adjustment on the total technical provisions is 61.5%⁶. EFRAG was informed that annual cohorts are an issue for 89% of contracts where the matching adjustment is applied. These contracts do not qualify for the VFA. They are life-time annuities that provide long-term fixed guarantee on interest rate to policyholders that does not change over time even if the market interest rates change. They are managed under cash-flow matching techniques, i.e.,

⁶ The data comes from the second quarter of 2020 and the source is the Balance Analysis Department of the General Directorate of Insurance and Pension Funds (Spanish Ministry of Economic Affairs and Digital Transformation).

the group is linked to a replicating or immunising portfolio of assets in order to avoid the exposure to financial and insurance risks, with intergenerational risk sharing of interest rate and insurance risks.

- (e) Approximately 55% of Danish guaranteed life insurance market. These contracts have discretionary participation features and meet the characteristics of IFRS 17 paragraphs B67-B68 whereby (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. Contracts are grouped so that the technical interest rate used for calculating benefits varies by no more than 1 percentage point across all contracts within the group. Any one group thus comprises contracts issued over several years, but which are homogenous with regards to the assumptions used for calculations. The company's risk margin is limited to five to ten percent of the extra profit produced by the pool of assets. These contracts are expected to qualify for the VFA. Danish life insurers will anticipate the same result regardless of whether or not they divide their groups into annual cohorts (this means that they may be eligible for the optional disapplication of the cohorts as per paragraph BC138). It is the group rather than the date of inception which determines results.

- 53 EFRAG was also informed about German life contracts with participating features with similar characteristics in Germany. EFRAG understands that the application of annual cohorts to these contracts is in general not causing concern in that jurisdiction. These contracts have similarities with the French contracts described above. They generally include a minimum interest rate guarantee as well as a profit share which depends on the returns of the insurance undertakings. The yearly profit share is generally not immediately attributed to each individual policyholder. Instead, a collective profit-sharing mechanism is established before an attribution over time of the profit share to individual policyholders. Such German contracts must return to the policyholders at least 90% of the investment profits and the technical result calculated under German GAAP. However, the entity may exercise discretion and return to policyholders' additional amounts beyond the 90% threshold. EFRAG understands that German entities do not anticipate applying paragraph BC138 or BC139G. Approximately all life and health insurance liabilities relate to these types of contracts which represents 50 to 67% of all insurance liabilities. Furthermore, approximately 12% of general insurance contracts are subject to B67-B71 of IFRS 17.
- 54 EFRAG was informed⁷ about the following characteristics of such mutualised contracts (this description would cover all the above except the Spanish contracts):
- (a) different generations of policyholders participate to the returns of a common underlying pool of assets;
 - (b) as a consequence, newly issued contracts join the existing population of beneficiaries of the total returns from the pool, so that the mutualisation mechanism lasts more than 1 year;
 - (c) the sharing of the risks among all policyholders relates to financial risk and, in some circumstances, also insurance risk, and the financial risk accounts for substantially the entire variability of the cash flows of the insurance contracts;

⁷ This information was accumulated during the due process for EFRAG's comment letter on the proposed amendments to IFRS 17 issued in September 2019.

- (d) taking into account the inter-generational mutualisation model, in substance there is no single onerous contract until the group as a whole is onerous;
- (e) in most cases in many jurisdictions these contracts are eligible to apply the variable fee approach (VFA); and
- (f) the potential loss for the insurer is generally limited to situations where the returns are not sufficient to cover guaranteed benefits.

Detailed characteristics of the French contracts

- 55 These contracts specify that the policyholders pay premiums and, in exchange, get the right to share in the returns on specified underlying items that include (i) a portfolio of similar life insurance contracts and (ii) a contractually specified pool of assets (usually the general fund of the insurer). The underlying items are contractually neither ring-fenced nor segregated at the level of individual contracts or group of contracts—in other words, no single contract or group of contracts has a right to some specific underlying items. All the contracts share in the same pool of underlying items irrespective of the date at which individual policyholders entered their contracts.
- 56 The returns from the underlying items are based on contractual and legal terms. Those terms set out a joint profit sharing (or policyholders' participation). The policyholders as a whole, not the individual policyholders, have an enforceable right to the joint profit sharing. An essential feature is that the returns from the underlying items to which the policyholders as a whole are entitled only include realised gains or losses—at any reporting date, the policyholders have no right to unrealised gains or losses on the change in the fair value of the underlying items.
- 57 The legal and contractual rights conferred to the policyholders usually include:
- (a) a collective pecuniary right: at the end of each annual period, the policyholders as a whole are entitled to a minimum share in the realised returns arising from the portfolio of insurance contracts and from the contractually specified pool of underlying assets. The insurer might also decide to pay amounts above those required by the contractual terms.
 - (b) the amount allocated to each individual policyholder is at the entity's discretion: the entity allocates and pays the participation as described above to each individual policyholder and does so within a specified time frame—eight years most of the time starting from the date at which the realised returns occur. The entity's management exercises its discretion over the amount and timing (within the confines of the aforementioned time frame) of the payments to make to each individual policyholder. Each individual policyholder has an enforceable right to payment once the insurance entity makes a decision with regard to the allocation.
 - (c) the policyholders are entitled to a minimum (i) 90 per cent of the positive 'technical' returns arising from the portfolio of insurance contracts and (ii) 85% of the realised financial returns arising from the contractually specified pool of underlying assets. The terms usually specify that the policyholders' participation is determined on accounting figures prepared in accordance with French GAAPs. Consistent with the observation in paragraph 96, this implies that the policyholders' share in the returns of the underlying items is determined on realised gains only. The joint contractual profit-share for the year needs to be allocated to individual policyholders within a time limit (most of the time: 8 years). Management exercises discretion as to the timing and the amount of the allocation to individual policyholders. This implies that, within the portfolio (of similar life insurance contracts managed together): (i)

Individual policyholders have no enforceable rights over the contractual joint profit-share until management's decision to allocate policyholders' individual share; (ii) all policyholders are eligible to the contractual joint profit-share regardless of the date when their contracts were underwritten; (iii) no single contract has preferential rights on the contractual joint profit-share as compared to the others. The insurer may allocate additional policyholders' share above the contractual minimum, reducing the entity's share accordingly.

- 58 For such contracts, the expected profit of the insurer stems from: (a) the difference between the contractual management fee withheld for the policyholders' account balance and the actual expenses incurred to manage the contracts; (b) the difference between the total returns from the contractually specified portfolio of assets and the total expected payments to the contracts that share into those returns.
- 59 Another key contractual feature of the French life insurance contracts is that the fair value returns from the underlying items benefit to both existing and future policyholders. In fact, since the contractual joint profit-share is calculated based on a different measurement than IFRS 17, the IFRS 17 policyholder's share in the returns that is not yet realised / allocated to the contractual joint profit-share might benefit to current as well as to future policyholders. The contractual joint profit-sharing obligation stems from realised fair value gains, which implies that unrealised fair value gains do not create an immediate right for existing policyholders. The policyholders' joint right to the unrealised fair value gain (or loss) is deferred until its realisation and ultimately benefits only to the contracts (existing and future) still in force at the time when the individual policyholder's share is attributed, which can occur as long as eight years after the realisation of the gain. This implies that: (i) existing policyholders at the time when the fair value gain on the underlying item occurs will benefit from a profit-share in the fair value gain only if their contracts do not lapse before the allocation to individual policyholder's share; (ii) future policyholders will benefit from a profit share in the fair value gain if their contracts are underwritten (and do not lapse) before the allocation to individual policyholder's share; (iii) the insurer's share will vary depending on the exit of existing contracts, or entrance of new contracts within the same portfolio.
- 60 The way those contracts share in the returns of a single pool of underlying items together with the discretion that the entity has with regard to (i) when it recovers the value of the underlying items and (ii) the amount and timing of the allocation of the policyholders' participation to each individual policyholder creates a legally/contractually-organised intergenerational mutualisation.

Detailed characteristics of the Italian contracts

- 61 These contracts combine a guaranteed interest rate with participation benefits. The yield of these contracts payable to policyholders depends on the insurer's management of a pool of assets, known as 'Gestione Separata', which is a fund that is managed separately from the insurer's general account. The assets in the Gestione Separata are fully owned by the entity and the value of policyholders' benefits is not based on the fair value of the assets assigned to the segregated fund (i.e. the fund is not 'unitised'), rather all policyholders relying on the same fund, irrespective of their generation, are assigned the higher of either a pre-determined portion of the book return of the entire fund (the same rate applies to all policyholders irrespective of their generation) or the minimum guaranteed amount. The yield of the assets assigned to the Gestione Separata fund is used as a parameter to re-value the policyholder's benefits and to re-determine the value of the technical reserves for the related insurance contracts; in addition, the rules to determine the

yield are essentially based on the realised return of the underlying fund according to a specific set of regulatory requirements.

- 62 According to the Regulation issued by the National Insurance Supervisory Authority, in the administration of the “Gestione Separata”, the insurer by law ensures equal treatment for all insured persons, avoiding disparities that are not justified by the need to safeguard the interests of all insured persons, and the balance and stability of the separately managed account. To this end, the undertaking pursues management and investment policies to ensure an equitable participation of policyholders in the financial results of the separately managed account. Based on the wording of these articles, intergenerational mutualisation and management discretion appears as two closely related concepts: the discretion in Italian jurisdiction is referred to as the discretion in managing the underlying assets (e.g., continue to hold them or realise them) to provide the policyholders with the realised average return. All policyholders benefit from these management choices, as management decisions have an effect on all contracts without distinction. Each new policyholder enters into a community that is managed jointly. The fair value returns from the underlying items belong to both existing and future policyholders. Since the contractual benefits/profit sharing is based on realised gains or losses, this implies that unrealised fair value gains or losses do not create an immediate right for existing policyholders. The policyholders’ joint right to the unrealised fair value gain is deferred until its realisation is included in the regulatory segregated fund return only to the contracts (existing and future) still in force at that time. The insurer’s share will vary depending on the development of existing portfolio, or entrance of new contracts within the same portfolio.

Detailed characteristics of the Spanish contracts

- 63 Compared to other countries, Spanish insurers mainly provide a long-term fixed guarantee on interest rate to policyholders that does not change over time even if interest rates change.
- 64 These contracts are used to promote the long-term savings of population in Spain in the form of life annuities, both immediate and deferred annuities. This guaranteed interest rate to the policyholder is fixed by companies based on the observable market yield of the investment portfolio assigned to the age of the policyholder when the contract is underwritten. That is, the pricing of each policy depends on the observable market rates when the offer is made, and an expected duration of the policy based on the age of the insured person. Only under exceptional circumstances, the policyholder will surrender. If this is the case, the surrender value will be closely linked with the market value of the underlying portfolio (i.e., insurance companies do not bear the underlying market risk in case of a surrender benefit payment).
- 65 From a simplified view, and considering the above pricing methodology, Spanish insurers earn a constant financial margin in these annuities that is the difference between the internal rate of return of financial assets (expected to be measured at FV-OCI under IFRS 9) and the guaranteed interest rate to the policyholder, while they are exposed to other non-financial risks (basically, deviation from the assumptions used in pricing in relation to longevity risk, to the risk margin or to operating expenses) that would determine the overall margin.
- 66 Under cash flow matching techniques, insurers group contracts issued more than one year apart. The groups are mainly defined considering the aggregation of homogenous insurance and financial risks. It has been around 20 years that the Spanish regulation incorporated financial immunisation and asset liability management (ALM) as methodologies for covering interest rate and spread risks for

this type of contracts. The objective of these techniques is to ensure that the expected cash flows to be paid to policyholders match the future cash flows arising from the financial assets held by insurers (mainly fixed-debt instruments), in terms of timing, amount and currency. Calculations are prescribed by regulation and require monitoring the matching of the cash flows in monthly buckets until the extinction of the in-force group of contracts. There are also compulsory quarterly reviews to ensure there is not a mismatch. The experience is borne out by the effective role that they have played in the control of the interest rate provided to the policyholder and the spread credit risk assumed by life insurance undertakings even through different macroeconomic environments (high and low interest rates, different phases in the business cycle, etc.).

- 67 Although these annuities are economically matched and have specific backing portfolios of debt instruments supporting the cash flows to be paid to policyholders, they may not be eligible to be measured under the variable fee approach (VFA), as the policy contractually does not specify in all cases the financial assets on which the guaranteed profitability is based. Furthermore, when contemplating guaranteed benefits, the variation in the market value of the assets may not have a significant impact on the benefits expected to be paid to the policyholders. In particular, only in the case of surrenders before the maturity date the policyholder would receive the fair value of the underlying assets. This leads to companies assuming basically only default risk and reinvestment risk if there are deviations from expected duration.
- 68 It is relevant to mention that Spanish annuities are designed to provide the policyholder with access to an investment guaranteed return for the premium paid for the whole life of the policyholder, covering therefore the longevity risk. The company links the surrender value to the market value of the assets in order not to incur investment risk, but not with the objective to allow the policyholder to share the market value of the investments. In fact, certain products include a penalisation over the capital gains in order to discourage surrenders and, in general, surrenders are very unusual in these products.
- 69 To sum up, based on the above descriptions, the main features of the insurance contracts to which cash-flow matching techniques are applied across generations are the following:
- (a) long-term life-saving contracts with a guaranteed interest rate which are only eligible to be measured under the general model,
 - (b) managed under cash flow matching techniques which are regulated and necessary for insurers if they want to provide a guaranteed interest rate,
 - (c) there is intergenerational risk sharing of longevity and financial risk, but
 - (d) they do not share the features described in paragraphs B67-B71 of IFRS 17, as the cash flows to be received by one policyholder are not affected by cash flows of other policyholders or contracts or affect them.
- 70 Lastly, these contracts have been granted a particular treatment under the prudential regime of Solvency II, using a matching adjustment when measuring the insurance contracts that permits insurers to adjust the risk-free rate term structure to avoid volatility in the Solvency II own funds. To be eligible for the matching adjustment, insurers must have in place robust and sound cash flow matching techniques, which reinforces the adequacy of these techniques to manage groups of contracts, and at the same time provide evidence that are generally accepted at European level.

Detailed characteristics of the Danish contracts

- 71 Danish guaranteed life insurance contracts with discretionary participation features meet the characteristics of IFRS 17 paragraphs 67 - 68 whereby (a) the contracts share the return of the same specified pool of underlying item; and (b) their cash flows substantially affect or are affected by cash flows to policyholders of other contracts.
- 72 Danish guaranteed products are contractual based, i.e. specificities vary across companies. In general, all products have the following characteristics:
- (a) Under the contracts, customers obtain a right to receive contractually binding future pension benefits. Contributions are defined (they are effectively DC contracts), and the interdependence between contributions and benefits is calculated using extremely conservative assumptions regarding interest rates, longevity, and administration costs. Currently the guaranteed interest rate may not exceed zero pct.
 - (b) Contracts are grouped so that the technical interest rate used for calculating benefits varies by no more than one pct. point across all contracts within the group. Any one group thus comprises contracts issued over several years, but which are homogenous with regards to the assumptions used for calculations.
 - (c) Contracts in a group are contractually entitled to an equal share of the surplus of the group which arises when actual return on the groups' pool of underlying assets exceeds the guaranteed technical interest rate used for calculations. The surplus, which is referred to as the "collective bonus potential", is released at the company's discretion. National rules ensure that the release of accrued bonus potential is done in a timely manner so that all contracts receive a fair share.
 - (d) The company's profit is determined as a risk margin (on technical provisions) which the company notifies to the supervisor at the beginning of the year. The risk margin may be deducted from the group investment return or from the already accrued bonus potential before allocating interest to the contracts. Although national rules do not define a limit for the company's risk margin, the contracts share of accrued bonus potential is very substantial, ranging in the 90-95 pct. area.
 - (e) The setup ensures that the company's result relies on the group as a whole, and not on any single contract.
 - (f) The company's result will only have to be affected in the event that the groups pool of underlying assets falls short of the required technical provisions for the group as a whole, i.e., no bonus potential remains.
- 73 Because of these characteristics, Danish life insurers will anticipate the same result regardless of whether or not they divide their groups into annual cohorts. It is the group rather than the date of inception which determines results.
- 74 Danish life insurance contracts with discretionary participation features are expected to qualify for the variable fee approach. Therefore, in practice, limiting the proposed scope exemption to contracts that meet the criteria in IFRS 17.B101 would, in practice, not impact the scope.
- 75 By end 2018, guaranteed products accounted for roughly 55% of Danish life insurance technical provisions. These products are highly integrated in the general understanding of life insurance in Denmark, and although unit link style products have become more prevalent in recent years, many customers value the guaranteed products highly with no intentions to transfer out of these products.