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IFRS 17: THE STICKING POINT OF ANNUAL COHORTS

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On September 30, the European Financial Reporting Advisory Group (EFRAG) published its Draft Endorsement Advice on IFRS 17 Insurance contracts. Comments are requested by 29 January 2021. It concluded on a consensus basis that IFRS 17 meets the various criteria for endorsement, with the notable exception of the requirement to apply annual cohorts to intergenerationally-mutualised and cash-flow matched contracts. In this paper, we focus on this particular issue and show how annual cohorts fail to give a pertinent picture of participating life insurance business, as practiced in many continental European countries.



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The International Accounting Standards Board (IASB) has chosen a *group of contracts* as a level of aggregation to respond to several issues: pooling, which prevents individual contracts, reversal of the production cycle with the issue of mismatch between investments and provisions. On the basis of the notion of a *portfolio of insurance contracts*, the IASB defines the notion of a group of contracts in §16 of IFRS 17 as the set of insurance contracts resulting from the division of a *portfolio of insurance contracts* into contracts taken out within a period of at least one year at the most and corresponding respectively, at the time of initial recognition: - to loss-making contracts, - to contracts that have no significant possibility of subsequently becoming loss-making, - to contracts that are not in any of the above cases. Furthermore, in §22 this definition is specified with the notion of cohort, i.e. one cannot have two contracts issued more than one year apart.

This new level of aggregation leads to a double articulation around the periods of risk coverage and the issue of contracts. The aim is to record sales at a loss during the period, so that on the one hand the profits made by a generation of contracts are put and on the other hand the losses due to the Contractual Service Margin (CSM) allocation method. The general model succeeds in translating the business model: mutualization allows the use of mathematical expectations. The imperfections of mutualization are represented by the Risk Adjustment (RA). This choice of level of aggregation is consistent, in the general model, with the insurance business model by offering the insured a viable level of premium thanks to mutualization. There are operational problems with this level of aggregation, particularly when certain flows depend on non-linear mechanisms defined at higher levels. We will therefore focus more specifically on direct participatory contracts under the Variable Fee Approach (VFA) accounting model.

Life insurance contracts such as some investment contracts are well subject to IFRS 17, if there are discretionary participations and are issued by an entity that issues insurance contracts. The VFA accounting model is an adaptation of the general model to incorporate the participation and the underlying elements. Under IFRS 17 the current estimates must be market consistent. The projections are made in such a way that the business model is good and all contracts that participate in the same underlying elements are retained. The first problem that arises is that the current market consistent estimate is made based on all the participating contracts. In addition, a second problem arises, which is the management of the investments that are made in this level of aggregation (e.g. general fund). So, the projected flows depend on the underlying investments and other contracts that jointly participate in the profits of the underlying investments.

IASB has decided to keep the same level of aggregation in the general model for the VFA model while adding the possibility of allocating between the different groups of contracts, the Fulfilment Cash Flows (FCFs) determined at a high level of aggregation and allocating the variation of the underlying elements to each group. Conventionally this is good because it is not based on economic representation at the group level. But this poses some problems, particularly with regard to the evolution of the CSM, because if there is a loss at the group level, it will be recognized immediately, whereas the expected profits established are in line with the rate of transfer of the service. Furthermore, the rate of income allocation between groups is heterogeneous, and an increase in the fair value of the underlying assets will be identified more quickly if it is a group of older contracts than a group of recent contracts.



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Thus, the valuation measure of the FCF is Current Estimate Market Consistent which considers the elements. The business model for life insurance in euros practiced in France is such that there is a common management of the general assets. However, this poses a problem at the level of aggregation with the IASB's level of aggregation because the mechanics of the VFA at the level of groups of contracts fail to represent the life insurance business model correctly, leading to an arbitrary allocation. There is a collective right to general assets between policyholders and not individual policyholders. Thus the development of the CSM into VFA, which consists in identifying the fair value variations that come up against the problem of the allocation of investments or the allocation of the fair value representing neither the rights of the policyholder of the group of contracts nor the business model.

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In addition, the Current Estimate Market Consistent projects all insurance contracts participating in the same fund. The valuation is therefore at a higher level than the one recommended by the IASB, and if we change this valuation level of aggregation, we will end up with something inconsistent, i.e. we will have an arbitrary and irrelevant allocation for investors. This would also require allocating the FCF between different groups in a portfolio and once again we have an arbitrary method that is not very consistent over time because the underlying assets are artificially allocated.

So the problems of this VFA level of aggregation are multiple: first of all, there is a poor representation of the business model, furthermore, the operational implementation is complicated and expensive, since we quickly arrive at an arbitrary allocation and finally, this only leads only to an illusion of accuracy for financial statement users.

Thus, a solution seems to stand out which is to make a different level of aggregation for contracts eligible for VFA which participate in the results of the same underlying elements to be considered as a single group. This would lead to consider only one CSM for all these contracts (if they belonged in the same profitability bucket at inception). This would make it possible to avoid arbitrary allocations of FCF and bad behavior on the part of the CSM. This recommendation poses a problem for new contracts that are of interest to users of financial statements and that could not be seen with the recommended level of aggregation size. Nevertheless, some additional disclosures could be required in order to solve this issue, such as the premiums of new business booked in the group over the period, the contribution to the CSM of new business booked in the group over the period, and finally the allocation pattern of CSM income between three periods - the beginning, end and end of the period in the absence of new business.

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