Viewpoint: Level of aggregation

What is 'level of aggregation' and why does it matter?

The term 'level of aggregation' (or 'unit of account'), has been used by the International Accounting Standards Board (IASB) in its work on the forthcoming insurance contracts standard ('the standard') to describe the level (or levels) at which an entity aggregates its contracts when applying the measurement and presentation principles. Different units of account may be used when applying different measurement and presentation principles. Although the concept of 'level of aggregation' may seem somewhat technical and esoteric, it is one of the key drivers of profit recognition in the new model. The extent to which contracts are aggregated may have a significant impact on the statement of comprehensive income of an insurance entity and on its systems, processes and data.

> "When applying the standard, an entity will be permitted to aggregate contracts,provided that the approach would meet the objective to measuring individual insurance contracts."

What has the IASB decided?

The objective of the standard is to provide principles for the measurement of an individual insurance contract. This does not mean that the estimations of cash flows need to be performed for each contract individually. Estimates can be made on an aggregated level, for example for the acquisition costs, which would be included in the fulfilment cash flows if they are directly attributable to a portfolio of contracts. Nor does it mean that the benefits from pooling risks are ignored. Even though the proposed new model does not specify the 'level of aggregation' for the risk adjustment ('RA')[1] calculation, it requires consideration of diversification of risk at an entity level.

When applying the standard, an entity will be permitted to aggregate contracts, provided that the approach would meet the objectives for measuring individual insurance contracts. Both this objective, and the permitted aggregation, are similar to those contained in IFRS 15 *Revenue from Contracts with Customers*.

At contract inception, entities will be permitted to group insurance contracts that have similar profitability and cash flows that respond in a similar way to key risk drivers[2] for the following purposes:

- Recognizing losses for onerous contracts: a loss would be recognized only when the Contractual Service Margin (CSM)[3] is negative for the group of contracts.
- Allocating the CSM: in addition to similar profitability and cash flows requirements, contracts will also need to have coverage periods that are expected to end at a similar time.

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1 RA is the third building block of the insurance liability measurement model, which represents the compensation that an entity would require for the risk related to timing and amount of the future cash flows.

2 It is expected that the IASB will provide examples of key risk drivers, based on examples in IFRS 15, which includes such factors as geographical region, type of contract or contract duration.

3 The CSM is the fourth building block of the insurance liability measurement model, which at recognition equals the net unearned profit. The CSM should be allocated over the life of the contracts as the service is provided.

“The extent to which contracts may be aggregated at inception will have an impact on the reported results.”

The IASB decided not to relax the grouping requirements if an entity is constrained by regulation from pricing for risks, such as ‘gender neutral’ pricing.

Some participating contracts that qualify for the variable fee approach[4] will be subject to mutualization, meaning that losses on onerous contracts are borne in whole, or in part, by other policyholders, and not by the shareholders. If the IASB allow onerous contracts subject to mutualization to be included in the same grouping as profitable contracts, then they will not be subject to the grouping requirements mentioned earlier.

The IASB’s requirements regarding grouping contracts would apply at inception, after which they would not be revisited. There is no requirement that the aggregation approach needs to be adopted consistently for all the contracts.

What are the implications of these decisions?

Insurance entities will need to decide how to apply the standard’s measurement and presentation principles to their insurance contracts. The expected future cash flows and CSM can be measured on either:

- an individual contract basis, using average assumptions for cash flows, or
- an aggregated basis, where permitted.

When determining appropriate groupings for contract aggregation, the key determinants are expected to include:

- Whether the contract cash flows respond in a similar way to key risk drivers at inception. In practice this will mean that contracts within same product types could not be measured as part of the same group.
- The principle that the CSM must be recognized over the coverage period, and in particular, that when the coverage period of each contract has ended, the CSM relating to that contract should be fully recognized.
- For non-participating contracts, the requirement to accrete interest on the CSM using the discount rates that applied when the contract was initially recognized. In practice, this will mean that all non-participating contracts in a group must have similar inception dates.[5] Once groupings that meet these requirements have been determined, the requirement that all contracts in a group must have similar profitability would be considered and applied.

Some of the most important implications of the principles and guidance provided to date by the IASB on the ‘level of aggregation’ are discussed below:

Impact on reported results

If contracts are measured on an individual basis, losses on onerous contracts would be recognized immediately, but profits on profitable contracts would be recognized over their coverage period. In most of the current accounting frameworks this asymmetry between the accounting treatment of onerous and profitable contracts

[4] The variable fee approach is a method of measuring direct participating contracts, under which an entity would adjust the CSM for changes in the estimate of the variable fee for service which is the fee that represents an entity’s expected share of returns on underlying items less any expected cash flows that do not vary directly with underlying items.

[5] For participating contracts, remeasuring the shareholders’ share of the underlying items under the variable fee approach is the equivalent of remeasuring the CSM under the general model using current discount rates, and so this would not necessarily be a determinant.

does not arise, either because there is no restriction on the recognition of profits at inception, or because insurance contracts are aggregated at a higher level and a loss would be recognized at inception only if the portfolio of contracts, as a whole, was onerous.

The extent to which contracts may be aggregated at inception will, therefore, have an impact on the reported results, as illustrated in the example below. Judgment will be required to determine the level (or levels) at which aggregation is permitted. We anticipate that the standard will include guidance to assist entities when applying this judgment.

Example

	Scenario 1: no grouping			*Scenario 2: grouping*
	Contract A	**Contract B**	**Total effect**	**Group of contracts**
Expected discounted cash inflows	10	10	20	20
Expected discounted cash outflows	-6	-11	-17	-17
Fulfilment cash flows*	4	-1	3	3
CSM at inception	4	0	4	3
Loss at inception	0	-1	-1	0

* Assume the RA is immaterial

In the example above Contract A and Contract B are sold for the same premium of 10. However, different cash flows are expected because of, for example, profitability differences due to gender. As illustrated, if an entity were permitted to group Contracts A and B (Scenario 2), it would offset the losses on Contract B by gains projected for Contract A. Accordingly, a CSM of three would be released to the statement of profit or loss over time. However, accounting for the onerous contract separately (Scenario 1) as required by the IASB's proposals, would result in a loss recognized immediately in the statement of profit or loss for Contract B.

If an entity is required to recognize losses on onerous contracts at inception when adopting the standard, but was previously able to offset those losses against expected profits on other contracts, this will cause a reduction in the entity's equity on transition to the standard.

Impact on systems and processes

In adopting the final standard, entities will need to balance the benefits of aggregating large volumes of policy data, to the extent possible, against the complexity of establishing and monitoring aggregation methodologies that will comply with the new standard. Some insurers may already have actuarial valuation systems that support or have the capability to support contract-by-contract approaches. Consequently, it may be easier for those insurers to apply the new measurement requirements on a contract-by-contract basis. However, some other insurers may currently undertake policy valuations at a portfolio level or at a level of aggregation that does not align to the proposed IASB requirements. This could mean significant system, data or valuation methodology change to support the new standard, in order to capture the different assumptions on a granular level.

> "Insurance entities will need to decide how to apply the standard's measurement and presentation principles to their insurance contracts."

What actions should you consider?

Although the IASB's final decisions and guidance on 'level of aggregation' will only be known when the standard is published, insurance entities should start to consider how they might meet the considerable challenge of granularity of assumptions at the level required by the IASB, and to assess the possible impact on their reported results and systems. In particular, entities should:

— Identify the product types that might require contracts to be separated into different groupings because they have different profitability profiles and key risk drivers. For example, grouping by different profitability levels might be required for the same product as a result of the gender, age, illness history, smoking status etc. of the policyholders.

— Undertake initial investigations into the availability of required data and functionality of existing systems, and identify the likely areas of biggest impact as a result of the aggregation approach adopted.

— Identify contracts qualifying for mutualization.

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