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Onerous Contracts

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Overview of Loss Component

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- LC is a portion of the fulfillment cashflows that has not been fully funded by the expected premiums under the contract
- LC quantifies the size of the expected loss associated with a group of contracts
- LC may be first established either at Initial Recognition (IM) or during the Subsequent Measurement (SM)
- LC gets established first time at IM, when the contract is Onerous, which implies that the reserves are partially or fully funded by the insurer
- LC gets established first time during the SM, due to unfavorable future experience, depleting the CSM of originally profitable group of contracts

Mechanics of Onerous Contracts

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Initial Recognition:

- Need to establish the LC on the BS and simultaneously recognize the same in the insurance service expense line of the P&L.

Subsequent Measurement:

- Need to amortize the LC balance over the lifetime of the group of contracts.
  - Paragraph 50 requires that the loss component be amortised on a systematic basis.
  - The systematic amortisation must be related on a P&L items - the release of the expected claims, expenses and risk adjustment
- At each reporting period, the amortized amount will appear as “reversal of losses” in the insurance service expense line.
- The same amount will also reduce the insurance revenue to reflect the amount of cash outflows that can be supported by the premiums.
- The total sum of P&L entries relating to the LC (ie., establishment and subsequent reversals) will be equal to zero.

Case 1 – Without Amortization

Cashflows and P&L Statement:

- Consider a two-year term insurance contract with the following fulfilment cashflows

Cash flow	Year 1	Year 2	Total
Premium	£1	£1	**£2**
Claims / expenses	-£30	-£70	**-£100**

- Following is the insurance service result / P&L statement, if the mechanism of the systematic allocation and the reversals/amortization of loss components did not exist.

	Year 1		Year 2	Total
	Inception	End of year		
Insurance revenue	**£0**	**£30**	**£70**	**£100**
Release of expected claims and maintenance expenses	-	£30	£70	£100
Release of CSM	-	-	-	-
Insurance service expenses	**-£98**	**-£30**	**-£70**	**-£198**
Establishment of loss component	-£98	-	-	-£98
Actual incurred claims and maintenance expenses	-	-£30	-£70	-£100
Insurance service result Insurance revenue less insurance service expenses	**-£98**	**£0**	**-£0**	**-£98**

Observations

- At IR, Loss -98 recognized
- Zero P&L reported in later years
- The total insurance service results is equal to LC established

Problems

- **The total insurance revenue is 100 for 2 years when the company only received £2.**

- **The total insurance expenses is also overestimated to -198, when incurred total actual claims and maintenance expenses of £100**

Case 2 – With Amortization

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P&L Statement:

- Working with the same onerous contract from case 1, following is the profit and loss statement, in line with the IFRS 17 requirements, incorporating the mechanisms of the systematic allocation and the reversals of loss components.

Row		Year 1		Year 2	Total
		Inception	End of year		
1	**Insurance revenue = (2) + (3) + (4)**	**£0**	**£0.6**	**£1.4**	**£2**
2	Release of expected claims and maintenance expenses	-	£30	£70	£100
3	Less amounts allocated to loss component (determined by the systematic allocation ratio; see calculation notes (a) and (b) below)	-	-£29.4	-£68.6	-£98
4	Release of CSM	-	-	-	-
5	**Insurance service expenses = (6) + (7) + (8)**	**-£98**	**-£0.6**	**-£1.4**	**-£100**
6	Establishment of loss component	-£98	-	-	-£98
7	Reversal of loss component (equal and opposite of items in row 3)	-	£29.4	£68.6	£98
8	Actual incurred claims and maintenance expenses	-	-£30	-£70	-£100
9	**Insurance service result** Insurance revenue less insurance service expenses	**-£98**	**£0**	**£0**	**-£98**
10	**Loss component balance (<u>shown for information only, this does not appear in P&L</u>)** (cumulative balance of items in row 6 and 7)	**-£98**	**-£68.6**	**£0**	**-**

Observations

- At IR, Loss -98 recognized
- Zero P&L reported in later years
- The total insurance service results is equal to LC established
- **The total insurance revenue is £2 for 2 years which is inline with insurance revenue definition**
- **The total reported insurance service expense is £100 and is now exactly equal to the actual claims and expenses incurred over the lifetime of the contract.**

Three Possible Methods of Amortization

Method 1:

- LC Amortization Ratio = (Loss Component at the beginning of the period)

  (PV of Cash outflows + RA Balance)

To address assumption updates one possible modification is :

- LC Amortization Ratio = (Adjusted Opening Balance of Loss Component)

  (Revised PV of Cash outflows + Revised RA Balance)

Method 2

- Allocate 100% of the expected claims, expenses, RA released during the period to the loss component.

Method 3

- Set the amortization ratio equal to the CSM amortization ratio based on Coverage Units

Considerations for Amortisation

- The loss component balance at transition does not affect companies' shareholder equity. However, companies will need to weigh up the pros and cons on whether to select an amortisation methodology that maximises or minimises the loss component balance at transition

- **Minimizing** the loss component balance at transition will maximise the likelihood of being able to reverse these balances out entirely and recognizing CSMs after transition (if favourable updates occur). This could be desirable because of the 'stabilising' nature of the CSM and the ability to spread and recognise a stream of profits in the future.

- On the other hand, **maximising** the loss component balance at transition might be deemed more acceptable as favourable basis updates can be recognised immediately in full without having to set up a CSM and defer their recognition.

THANK YOU

Reference:

Article: Why do loss components need to be amortised, published on 6 November 2019

https://www.actuaries.org.uk/practice-areas/life/research-working-parties/ifrs-17-contractual-service-margin-csm

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