IFRS 17: Loss components - do we calculate changes in fulfilment cash flows using current or locked-in interest rates?

[This article is one in a series of articles (which can be found here and here) published on behalf of the IFRS 17 CSM Working Party. Members are Antoon Pelsser, Asim Ghosh, Clarence Er, Huina Zhang, James Thorpe, Joanna Stansfield, Kruti Malde, Natalia Mirin (Deputy Chair), Richard Dyble, Rob Walton, Timothy Berry, Weihe Qin and Wijdan Yousuf (Chair).]

1. Overview

When a group of contracts is written on an onerous basis, or the CSM is exhausted due to adverse experience variances or assumption changes, a Loss Component (LC) is established. After being established, the LC is tracked and amortized until the end of the coverage period or until it is reversed out entirely due to positive experience variances or assumption changes and a CSM is established.

This article considers whether changes in fulfilment cashflows that adjust the LC need to be calculated using locked in or current interest rate basis for non-participating contracts valued through the General Model (GM) approach. It does not cover the choice of systematic allocation approach for the LC run off; this will be covered in a separate, future article.

2. Background

IFRS17.47 states that: *"An insurance contract is onerous at the date of initial recognition if the fulfilment cash flows allocated to the contract, any previously recognised insurance acquisition cash flows and any cash flows arising from the contract at the date of initial recognition in total are a net outflow…"*

The requirements for onerous contracts under IFRS 17 are described in paragraphs 47 to 52. The key points to note are:

- IFRS17.47 – requires for a group of onerous contracts to recognise the net outflow, i.e. the LC, in profit and loss at initial recognition.
- IFRS17.48 – sets out when a LC may arise in subsequent measurement and that it would need to be recognised in profit and loss.

In practice the two paragraphs stated above set out the fact that a LC is recognised in profit and loss at the point when it has arisen.

- IFRS17.49 – sets out the requirement of reversal of losses on onerous groups have to be excluded from insurance contract revenue. In practice, each year the insurance contract revenue is reduced by the amount of LC reduction allocated to that year, to avoid an overstatement of revenue. Note that the same equal and opposite amount of LC reversal is allocated to the insurance service expense to avoid the loss being recognised twice.
- IFRS17.50 to IFRS17.52 set out that on subsequent measurement changes to the liability for remaining coverage due to passage of time are allocated to the LC on a systematic basis, i.e.

reduce it gradually to ensure the LC runs down to zero at the end of the coverage period. From these paragraphs we understand that all changes in estimates of future cashflows are solely allocated to the LC until it is reduced to zero or a CSM is re-established.

The Standard is explicit in requiring the use of locked in discount rates, defined at inception, for the adjustments to the CSM. However, there is no such explicit requirement for the LC. The LC is a running total that is required to be tracked and reduced to zero by the end of the coverage period.

There are several views in the market however the two more dominant positions are:

1. The LC balance will be adjusted by changes in fulfilment cash flows on a locked-in interest rate basis;

2. The LC balance will be adjusted by changes in fulfilment cash flows on a current interest rate basis.

There are pros and cons of choosing each option. For example, an advantage of the locked in basis is that there is no need to set out a justification for choice of locked in rates that would be used should a CSM be re-established. In this case locked in interest rates that have been used since the contract inception for tracking the LC will continue to be used for the CSM.

On the other hand, companies that use the current interest rates for tracking the LC, will be able to reconcile easier the LC to the current difference between income and outgo fulfilment cashflows, as these would be calculated on the current interest rates basis.

In either case, the way the LC is tracked, adjusted and reduced to zero by the end of the coverage period will need to be clearly specified in the methodology used by the company.

3. Worked examples

The examples below show the tracking of a LC, including adjustment for changes in fulfilment cashflows, under both methods on a 3-year policy. The only change since the policy inception is a change in interest rates from initially assumed 5% to a reviewed basis of 3% at the start of year 2.

We have:

- 3-year policy
- Single premium: 10,000
- Claims: year 1 – 1,000; year 2- 1,000; year 3 – 10,000
- Inception discount rate: 5%
- At the start of year 2 assumptions are reviewed and discount rates are set at 3% going forward
- A LC systematic allocation ratio used in this example is (LC at SoP) / (PV of Claims @ SoP), i.e. LC is reduced in line with liability for remaining coverage (LRC). Note, this is just a simple example of a systematic allocation and various other approaches could be used.

Base scenario

Year	1	2	3
PV of Claims @ 5%	10,498	10,023	9,524
Change in PV of Claims @ 5%	- 475	- 499	- 9,524
LC at Inception	- 498		
Example systematic allocation	-4.74%	-4.74%	-4.74%
LC at SoP	- 498	- 475	- 452
Change in FCF: Systematic allocation	23	24	452
Change in due to discount rate chage allocated to LC: Systematic allocation	-	-	-
LC at EoP	- 475	- 452	-

The base scenario assumes 5% discount rates will apply until the end of the contract.

Year 2 scenario when current rates methodology is selected for a LC run-off

If current rates are used for the LC run-off, the view of the run-off changes from year 2 onwards from the Base scenario we have seen above. Discount rate reduced to 3%, current rates are used for LC systematic allocation and changes to FCF calculation.

Year	2	3	
PV of Claims @ 3%	10,397	9,709	
Change in PV of Claims @ 3%	- 688	- 9,709	
LC Carried forward	- 475		
Example systematic allocation	-4.57%	-4.75%	Note 1
LC at SoP	- 475	- 461	
Change in FCF: Systematic allocation	31	461	
Change in due to discount rate chage allocated to LC: Systematic allocation	- 17	-	Note 2
LC at EoP	- 461	-	

1. Systematic allocation proportion changes due to the change in the discount rate and additionally in year 2 due to inclusion of a Change in FCF due to the discount rate change allocated to LC on a systematic basis.
2. The change in the PV of claims purely caused by the change in discount rates is 374 = PV of Claims @ 3% of 10,397 – PV of Claims @ 5% of 10,023. Change due to discount rate change allocated to LC = 374 * (-4.57%) = 17.

In this case the change in fulfilment cashflows that is caused purely by the interest rate changes is allocated to the LC on a systematic basis as per IFRS17.51(c) and the PVs of fulfilment cashflows after the change are calculated consistently using the current discount rates assumption.

Year 2 scenario when the locked in rates methodology is selected for a LC run-off

If locked in rates are selected in the methodology for establishment and tracking a LC, there will be no changes in to the run-off view in the base scenario table above even if the discount rate assumption changes at the start of year 2. The entire change in fulfilment cashflows that is caused by the discount rate change in year 2 will affect the insurance finance income and expense in the P&L or OCI but will not affect the LC run-off.

4. Conclusions

In summary, the key points about a LC and changes in fulfilment cashflows are as follows:

- LC is a running total, which affects the profit and loss account at outset and is tracked until it is exhausted.
- Locked in or current rates are proposed by different market participants for LC run off and tracking.
- Changes in fulfilment cashflows that affect the LC need to be calculated on a basis that is consistent with the methodology overall. If the locked in basis is selected in the methodology, all changes in fulfilment cashflows that adjust the LC have to be calculated using locked in interest rates. If the current basis is selected in the methodology, all changes that adjust the LC need to be calculated on the current rates basis.
- A systematic allocation ratio used above is an example only and may not necessarily be suitable for your business. A number of approaches to systematic allocation to LC are being discussed and tested by the industry.
- If a LC is reversed and a CSM is established, locked in rates would be used for the CSM as would be applicable at the contract inception date.

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