IFRS 17: Loss components – Part 1 of 3: Why do loss components need to be amortised?

[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, James Thorpe, Joanna Stansfield, Kruti Malde, Natalia Mirin (Deputy Chair), Richard Dyble, Rob Walton, Timothy Berry, Weihe Qin and Wijdan Yousuf (Chair).]

Introductory remarks

The primary aim of this topic is to draw the reader's attention to the various possibilities that exist in respect of amortising loss components. In the interests of length and readability, the discussion has been presented in three parts.

Part 1 (this article) explains what the purpose of amortising loss components is. A strong understanding of this makes the rest of the discussion intuitively obvious and fruitful.

Part 2 takes Part 1 as given and outlines three possible amortisation methods that companies could consider as part of their methodology. For each method, it notes some of the obvious technical and operational consequences.

Part 3 builds on Part 2 and leads the discussion into more advanced and specific considerations.

1. Overview

For direct business written, IFRS 17 requires an asymmetric treatment of profitable and onerous groups of contracts. For profitable groups, entities are required to spread the recognition of profits (i.e. the CSM) over the lifetime of the group of contracts based on a measure of service provided. However, for loss-making groups, losses must be recognised in the P&L immediately; it is not possible to set up a 'negative CSM' and spread the recognition of the losses over the coverage period.

The basic mechanics for such loss-making business are as follows:

- At initial recognition, the entity will need to establish a "loss component of the liability for remaining coverage" and simultaneously record this amount in the insurance service expense line of the P&L (this is how an immediate hit arises in the P&L).
- At subsequent measurement, the entity will need to amortise that loss component balance over the lifetime of the group of contracts such that there is a 'zero' loss component by the end of the coverage period. At each reporting period, the amount by which the loss component balance has been amortised will also appear in the insurance service expense line as 'reversals of losses'. This same amount will also reduce insurance revenue to reflect the amount of expected cash out flows that can be 'supported' by the premiums.
- Over the lifetime of the group of contracts, the total sum of the P&L entries relating to the loss component (i.e. the establishment and the subsequent reversals) will be equal to zero.

In this article, we attempt to answer one question that arises from the description supplied above.

2. Why do we need to amortise loss components?

Or, more appropriately, why is this question important? The amortisation of loss components is taken to be one of the more technical and difficult topics under IFRS 17. At the same time, the underlying principle at play is quite simple. Why this apparent discrepancy?

One possible reason could be an insufficient understanding of what the purpose is. Indeed, once a P&L hit has been recognized on day 1, why does the loss component balance need to be amortised at all?

Let's begin with an extract of paragraph 49 on of the Standard:

"…The loss component determines the amounts that are presented in profit or loss as reversals of losses on onerous groups and are consequently excluded from the determination of insurance revenue."

At first glance, this paragraph appears to be an unintelligible string of jargon. What are 'reversals of losses'? What is the connection between loss components and revenue?

Paragraph 50 continues:

"After an entity has recognised a loss…it shall allocate: …subsequent changes in fulfilment cash flows specified in paragraph 51 on a systematic basis between: i) the loss component of the liability for remaining coverage; and ii) the liability for remaining coverage, excluding the loss component."

This paragraph fares no better for a less familiar reader. Why do certain items need to be systematically allocated to the loss component?

To answer these questions, let's look at a simple example.

3. Example 1

Consider a two-year term insurance contract where:

- An annual premium of £1 is payable at the start of each year (total premiums = £2)
- Expected claims and expenses of £30 and £70 are paid at the end of each year respectively (total outflows = £100)
- The risk adjustment and the impact of discounting are negligible so can be ignored.
- Actual experience is exactly in line with that expected

This gives us the following fulfilment cash flows:

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

As one would expect, the contract is identified by the entity as onerous at initial recognition and a loss component balance of £98 is established.

Let's now look at how the insurance service result (i.e. the profit and loss statement) might be populated for such a contract **if the mechanism of the systematic allocation and the reversals/amortisation 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 about Example 1

- At initial recognition, the entity records a £98 loss in the P&L because of the establishment of the loss component.
- Once the day 1 loss is recognised, zero profits/losses are reported in subsequent years and this is also consistent with expectations.
- The total insurance service result at the end of two years shows a loss of £98 and is in line with what we expect it to be.
- This was all achieved without having to worry about amortising the loss component and considering any of the systematic allocation requirements of IFRS 17.

If that is the case, what is the fundamental problem? Why are loss components a technical topic at all?

Problems that arise from Example 1

There are two fundamental problems with the results presented here:

1) The total reported insurance revenue over the two years is £100. This does not make sense. How can the total revenue be £100 when the company only received total premiums of just £2? Not only is this difficult to make sense of, this also contradicts the requirements of paragraphs 83, B120 and B123.

2) The total reported insurance service expenses over the two years is £198. This does not make sense either. How can the total insurance service expense be £198 when the company only incurred total actual claims and maintenance expenses of £100? This also contradicts the definition of insurance service expenses as per paragraph 103.

The incoherence of the results produced here suggests that something is missing – there must be some way of reflecting that revenue cannot be higher than the premiums received and the service expenses cannot be higher than the actual outflows.

Indeed, there is such a way.

4. Example 2

Working with the same onerous contract from example 1, let's now consider how the profit and loss statement should be populated, in line with the IFRS 17 requirements, by **using the mechanisms of the systematic allocation and the reversals of loss components**.

Before we proceed, please note that the systematic allocation method used in this example does not matter yet: this will be discussed in exhaustive detail in Part 2. For now, the reader's aim should simply be to understand why a method is required in the first place.

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 (shown for information only, this does not appear in P&L)** (cumulative balance of items in row 6 and 7)	**-£98**	**-£68.6**	**£0**	**-**

Calculation notes

It should first be noted that the systematic allocation ratio (SAR) is being recalculated at the start of each reporting period.

The ratio is being calculated by applying an extremely simplified version of a method shown in IFRS 17 Illustrative Example 8.

Consequently, in this example, the SAR to apply for year 1 is calculated as:

$$\frac{\text{loss component at beginning of year 1}}{\text{PV expected claims/expenses at start of year 1}} = \frac{£98}{£100} = 98\% = \text{year 1 SAR}$$

Similarly, the SAR to apply for year 2 is calculated as:

$$\frac{\text{loss component at beginning of year 2}}{\text{PV expected claims/expenses at start of year 2}} = \frac{£68.6}{£70} = 98\% = \text{year 2 SAR}$$

a) The amounts in row 3 have been calculated by applying the SAR applicable in that year to the release of the expected claims and maintenance expenses in revenue that year. For example:
   - £29.4 = £30 (amount released in revenue) x 98% (year 1 SAR)
   - £68.6 = £70 (amount released in revenue) x 98% (year 2 SAR)

b) The amounts in row 7 are equal and opposite of the items in row 3.

c) The amounts in row 10 are calculated as cumulative balances of the establishment of the loss component and the subsequent reversals. For example, by the end of year 1, the loss component balance of £68.6 is calculated as the starting loss component of £98 less the £29.4 amount reversed or amortised over the year.

Observations about Example 2

Compared to the results in Example 1, the results in Example 2 look much more reasonable:

- The total reported insurance revenue is £2 and is now exactly equal to the consideration/premiums received over the lifetime of the contract. This meets the requirements of paragraphs 83, B120 and B123.

- 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. This meets the definition in paragraph 103.

- The establishment of the loss component in row 6 (i.e. -£98) and the subsequent reversals of the loss component in row 7 (i.e. £68.6 + £29.4 = +£98) net off fully to equal zero by the end of the contract. This meets the requirement of paragraph 52.

More importantly, Example 2 also provides a deep insight into the nature of the systematic allocation ratio and the reversals/amortisation of the loss component:

- The systematic allocation has the impact of reducing both the insurance revenue and insurance service expenses in a period. For example, in year 1, revenue was reduced from £30 in Example 1 to just £0.6 in Example 2. Similarly, in year 2, service expenses were reduced from £70 in Example 1 to £1.4 in Example 2. This meets the requirements of paragraph 49.

- The amount by which revenue is reduced is directly dependent on the loss component (at this point it is strongly recommended the reader refers back to the extract of paragraph 49 in section 2). In this example, the systematic allocation ratio was 98% in both years. This means that only 2% of the premium received was sufficient to cover the outgo. Consequently, the reported revenue should only be 2% of the unadjusted revenue items that would have been released otherwise (i.e. the unadjusted release of claims and maintenance expenses in revenue).

- The impact of systematically allocating items to reverse/amortise of the loss component have no bottom line impact on the insurance service result in a given reported period; items that are excluded from revenue are simultaneously excluded from the service expenses to give a net impact of zero.

5. Conclusion

Several questions were raised throughout this discussion. We are now in a position to answer these.

- What are reversals of losses? This is just jargon used by IFRS 17 to describe the amortisation of the loss component. (To avoid doubt, reversals can also include favourable changes relating to future service, but this is not the focus of this article.)

- Why does the loss component need to be amortised? The amortisation of loss components is what enables the insurance service result (i.e. the profit and loss statement) to be populated in a sensible manner. If loss components were not amortised, both insurance revenue and insurance service expenses would be overstated (compare Example 1 and Example 2). The amortisation is effectively what 'fixes' this overstatement issue.

- What is the connection between loss components and insurance revenue? The amortisation of loss components requires a systematic allocation of certain items that are released in the insurance revenue line in a reporting period. Systematically allocating these items has the dual purpose of reducing the revenue (i.e. 'fixing' it for the overstatement problem) and amortising the loss component.

Part 2 builds on this foundation and attempts to answer the next logical question: how should the loss component be amortised?

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