IFRS 17: Loss components – Part 2 of 3: Comparing various methods of amortising loss components

[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 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 (this article) 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. How should loss components be amortised?

The Standard sets out some basic requirements when it comes to amortising loss components. However, beyond this, IFRS 17 does not ultimately prescribe an approach. What are these requirements?

Paragraph 50 requires that the loss component be amortised on a systematic basis. In other words, entities cannot arbitrarily amortise loss components by amounts of their choosing; there must be a systematic, formulaic approach by which this must happen. But what must the components of that formula be?

Paragraph 51 states this; the systematic amortisation must have a connection with certain items that will be recognised in the P&L in a given reporting period. Namely: the release of the expected claims, expenses and risk adjustment in the insurance revenue line, as well as amounts released in the insurance finance income and expenses (IFIE) line. For the rest of this article, these items (to be systematically allocated) will collectively be referred to as *'allocatables'.*

How will these requirements be applied in practice? We will now consider three possible methods. Each method is, to the working party's belief, technically compliant as these are 'systematic' approaches that avoid arbitrariness.

2. Example 1 – Method used in IFRS 17 Illustrative Example 8

We use a slight variation of the example used in Part 1 of this topic. Here:

- An annual premium of £1 is payable at the start of each year (total premiums = £2)
- Expected claims of £30 and £50 are paid at the end of each year respectively (total claims = £80)
- Expected expenses of £8 are incurred at the end of each year (total expenses = £16)
- The risk adjustment at inception is £4 (released evenly each year)
- Interest rates are 0%
- Actual experience is exactly in line with that expected

This gives us the following fulfilment cash flows at initial recognition and subsequent measurement:

	Time		
	0	**1**	**2**
PV of premiums	-£2	-£1	£0
PV of claims	£80	£50	£0
PV of expenses	£16	£8	£0
Risk adjustment	£4	£2	£0
Fulfilment cash flows	**£98**	**£59**	**£0**

The contract is onerous at initial recognition and consequently the entity will establish a loss component and recognize a loss in the P&L of £98.

How should this loss component be amortised?

Based on the method used in IFRS 17 Illustrative Example 8, the formula used to determine the systematic allocation ratio (SAR) to amortise the loss component will be:

$$SAR = \frac{loss\ component\ at\ the\ beginning\ of\ the\ reporting\ period}{PV\ of\ cash\ outflows + risk\ adjustment\ balance}$$

This can then be used to complete the required computations:

	Year 1	**Year 2**
SAR	$= \frac{£98}{£80 + £16 + £4}$ $= 98\%$	$= \frac{£58.8}{£50 + £8 + £2}$ $= 98\%$

	Year 1	**Year 2**
Opening loss component	***£98***	***£58.8***
Systematic allocation of expected claims release	= £30 x 98% x -1 = **-£29.4**	= £50 x 98% x -1 = **-£49**
Systematic allocation of expected expenses released	= £8 x 98% x -1 = **-£7.84**	= £8 x 98% x -1 = **-£7.84**
Systematic allocation of risk adjustment released	= £2 x 98% x -1 = **£1.96**	= £2 x 98% x -1 = **£1.96**
Closing loss component	***£58.8***	***£0***

Observations about Example 1

- It is not a coincidence that the SAR in years 1 and 2 is 98%. In the absence of any assumption updates or experience variances relating to future service, this method results in a stable proportion of future *allocatables* being systematically allocated to the loss component. However, in the real world, the fact that assumption updates or experience variances relating to future service are virtually guaranteed to occur means that it will be almost impossible for the systematic allocation ratio to be the same from period to period for the same group of contracts.

- On a practical note, this method will require additional calculations to determine the systematic allocation ratio. Whilst these ratios do not need to be stored for future use, the fact that they need to be recalculated at each reporting period and then applied to the *allocatables* means that this is a computationally intensive process.

- Whilst for BBA contracts it might be easier (but not easy) to identify the PV of cash outflows separately from the PV of cash inflows, for VFA contracts (like unit-linked business), cash outflows like investment expenses may be implicit (i.e. netted off) as part of the AMC projections and not necessarily modelled separately. It is important to note that non-distinct investment components (NDIC) must not be included as part of the cash outflows (as they do not form part of revenue) which means that the computations will become much more difficult.

- There are divergent opinions on whether the PV of cash outflows (for the denominator of the SAR) must be measured at locked-in rates or current interest rates for BBA contracts. Both methods are possible and can be demonstrated to meet the requirements of the Standard. This point was discussed in this article (click here).

3. Example 2 – Set the systematic allocation ratio to 100% as default

We use the same contract from Example 1. Under this method, instead of (re)calculating the systematic allocation ratio based on the formula described in Example 1, the entity could simply allocate 100% of the *allocatables* to the loss component. In a reporting period where 100% of the sum of the *allocatables* is higher than the residual loss component, the method falls back to the method in Example 1 so as to avoid creating a CSM.

	Year 1	Year 2
SAR	100%	$= \frac{£58}{£50 + £8 + £2}$ $= 96.67\%$

	Year 1	Year 2
Opening loss component	***£98***	***£58***
Systematic allocation of expected claims release	= £30 x 100% x -1 = **-£30**	= £50 x 96.67% x -1 = **-£48.33**
Systematic allocation of expected expenses released	= £8 x 100% x -1 = **-£8**	= £8 x 96.67% x -1 = **-£7.73**
Systematic allocation of risk adjustment released	= £2 x 100% x -1 = **£2**	= £2 x 96.67% x -1 = **£1.93**
Closing loss component	***£58***	***£0***

Observations about Example 2

- It amortises the loss component as quickly as possible and consequently increases the likelihood of a CSM being established (subject, of course, to future favourable assumption updates or experience variances relating to future service). There are differing views in the working party as to whether this is commercially desirable or not: slowing down the amortisation of the loss component means that favourable basis updates can be recognized immediately (and more often) without having to set up a CSM (which results in a deferral of recognition of those profits). On the other hand, the CSM reduces P&L volatility which could be seen as more desirable.

- Operationally this is a less computationally intensive and an easier to follow calculation – however it does not avoid complexity entirely as it will still be necessary to apply the method in Example 1 at some point in coverage period of the group of contracts.

- The key disadvantage of this approach is that it results in the smallest amount of revenue in a given reporting period compared to all other methods. Specifically, revenue in a given period will be equal to the amount released for insurance acquisition cash flows. If the insurance acquisition cash flows are zero or small, then the revenue reported is zero or close to zero. This is an important consideration for developing future KPIs.

4. Example 3 – Set the systematic allocation ratio to be equal to the CSM amortisation ratio

We use the same contract from Example 1. In this context, the CSM amortisation ratio simply means the ratio determined by coverage units. The fact that a loss component cannot exist simultaneously with a CSM for the same group of contracts is irrelevant as coverage units can be determined without a CSM.

Under this method, the systematic allocation ratio will be set to be equal to the CSM amortisation ratio.

Like example 2, in a reporting period where the 100% of the sum of the *allocatables* is higher than the residual loss component, this method will also need to fall back to the method in Example 1 so as to avoid creating a CSM.

However, there is one peculiarity that emerges in this method that wasn't possible in the previous two.

Let's assume the CSM amortisation ratios and SAR are determined to be as follows.

	Year 1	**Year 2**
CSM amortisation ratio	50%	100%

	Year 1	**Year 2**
SAR	50% (equal to the CSM amortisation ratio above)	$= \frac{£78}{£50 + £8 + £2}$ $= 130\%$

	Year 1	**Year 2**
Opening loss component	***£98***	***£78***
Systematic allocation of expected claims release	= £30 x 50% x -1 = **-£15**	= £50 x 130% x -1 = **-£65**
Systematic allocation of expected expenses released	= £8 x 50% x -1 = **-£4**	= £8 x 130% x -1 = **-£10.4**
Systematic allocation of risk adjustment released	= £2 x 50% x -1 = **£1**	= £2 x 130% x -1 = **£2.6**
Closing loss component	***£78***	***£0***

Observations about Example 3

- This is an operational simplification as it might be that the entity amortises the insurance acquisition cash flow balances with the same ratio as well.
- As with example two, this is less computationally intensive and an easier to follow calculation – noting again that it does not avoid complexity entirely as it will still be necessary to apply the method in Example 1 at some point in coverage period of the group of contracts.
- In the reporting period where the SAR is greater than 100%, this could result in 'negative' revenue. However, as noted above, this possibility is not unique to this method rather it is just made more obvious. This is also an important consideration for developing future KPIs.

One question is now made possible to ask: can the systematic allocation ratio be greater than 100%? This is explored in Part 3.

5. Conclusion

- Whilst many companies will find it tempting to use the method used in IFRS 17 Illustrative Examples, this article has attempted to show that many other practical and sensible methods are available that should be carefully considered before being rejected. This article just explores three possible methods.

- 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.

[END]