IFRS 17: Loss components – Part 3 of 3: Advanced considerations relating to loss component amortisation

[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 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 (this article) builds on Part 2 and leads the discussion into more advanced and specific considerations.

1. Can the systematic allocation ratio be greater than 100%?

To recap: this question arose from Example 3 in Part 2.

The simple answer is: yes, it is entirely possible for the systematic allocation ratio (SAR) to be greater than 100% in all possible approaches – Example 3 is not unique in this regard.

The detailed answer is: There are two possible scenarios under which the SAR can be greater than 100%.

Scenario 1: "Less than optimum ratios"

This scenario arises when an approach used to determine the systematic allocation ratio consistently results in a ratio that is lower than its 'optimum'.

Note that by optimum, we simply mean the ratio based on the formula described in Example 1 (i.e. based on IFRS 17 Illustrative Example 1) and we do not use it in the sense of a ratio that optimises technical/operational/financial consequences (that is a matter for an entity to conclude based on their specific circumstances).

This description explains why Example 3, and not Examples 1 and 2, resulted in a SAR greater than 100%.

In Example 3, there was a SAR of 130% in the final year as it did not amortise the loss component in the first year by the 'optimum' rate of 98%.

By contract, Example 2 will consistently result in a ratio that will be higher than the optimum (as it usually always set to be 100%) and so there is no possibility for this scenario to arise here.

Example 1, by definition, applies the 'optimum' ratio for all periods and consequently the possibility for this scenario does not arise here either.

But if this is true, under what circumstances might Example 1 or Example 2 result in a systematic allocation ratio greater than 100% (given that they both amortise the loss component at or above the optimum?)

This brings us on to the second possible scenario.

Scenario 2: Experience variances relating to future service

It is theoretically possible, though with low probability, for there to be an experience variance relating to future service that adjusts the loss component without affecting the PV of outflows or the risk adjustment.

Premium and acquisition expense variances are two such eligible items that can cause the loss component to be greater than the PV of the outflows and the risk adjustment; this can result in a systematic allocation ratio greater than 100%.

Summary

This table summarises which scenarios can apply for the three methods that were explored in Part 2.

	Scenario 1	Scenario 2
Method 1 (based on IFRS 17 Illustrative Example 8)	✘	✔
Method 2 (SAR set to 100% with one exception)	✘	✔
Method 3 (SAR set equal to CSM amortisation ratio with one exception)	✔	✔

2. Should OCI be systematically allocated to the loss component?

Paragraph 51 identifies 'insurance finance income or expenses' as an item that must be systematically allocated to the loss component. However, it identifies this in the context of the subsequent changes in fulfilment cash flows.

If an entity applies the OCI disaggregation approach for a portfolio of BBA contracts, must it systematically allocate the OCI to the loss component?

There are three considerations here.

First, it is only the OCI arising on the PV of cash outflows that can be allowed here. Allowing for the full OCI (including that arising on the PV of cash inflows) will not allow the loss component to be amortised to zero at the end of the coverage period – thus falling foul of IFRS 17 requirements. This means that operationally, entities will need to be able to identify the PV of cash outflows separately to the PV of cash inflows.

Second, systematically allocating the liability OCI to the loss component will result in an accounting mismatch compared to the asset OCI. In the most straightforward example, take a perfectly matched asset/liability position and assume that the asset OCI arising in a period is 100 (and so we know that the liability OCI arising will also be 100). If, say, 5 of the liability OCI is allocated to the loss component, then we have an OCI mismatch arising in equity: 95 liability OCI compared to 100 asset OCI.

Third, under Example 1, it was observed that the SAR was constant. Even if Example 1 were extended to allow for interest rates, it is possible for the SAR to remain constant by not allocating the OCI to the loss component. In other words, allocating the OCI to the loss component has a destabilizing effect. This is potentially not a major problem given that the SAR will change every reporting period anyway.

Ultimately companies must form their own opinions as to the considerations raised here.

3. Should the insurance acquisition cash flows be systematically allocated to the loss component?

Whilst it is entirely possible to do so, this is strictly speaking not in compliance with the Standard and consequently not explored in this article further.

IFRS 17 makes it clear that it expects to see the full value of the proportion of premiums that relate to the recovery of insurance acquisition cash flows – this requirement is not met if insurance acquisition cash flows are systematically allocated to the loss component.

4. How does the timing of assumption updates affect the systematic allocation ratio?

From a practical point of view, the method described in Example 1 is necessarily simplistic and does not reflect that entities will perform assumption updates at regular intervals.

To address this, one possible modification to the formula applied might be as follows:

$$SAR = \frac{adjusted\ opening\ loss\ component}{revised\ PV\ of\ cash\ outflows\ +\ revised\ risk\ adjustment\ balance}$$

Here:

- The adjusted opening loss component refers to the loss component after the assumption updates have been performed

- The revised PV of cash outflows and risk adjustment balance reflects the fact that the view of future cash flows and the corresponding uncertainty will have changed as a result of the assumption updates

- The ratio is not retrospectively applied from the start of the reporting year, rather only from the point at which the updates applied. For example, if the assumption updates were applied as at 30 June of a financial year running from 1 January to 31 December, then the SAR determined as at 30 June would only apply for cash flows arising between 1 July and 31 December and not retrospectively applied to cash flows between 1 January and 30 June.

The order in which the allocation is performed should be considered consistently with the order in which adjustments to the CSM are made (click here).

We separately note, for completion, the actual impact of the assumption updates will affect the loss component and the P&L as follows:

- Unfavourable assumption changes will increase the loss component and be recognized in the P&L as an immediate hit (through an "increase to the loss component" line in insurance service expenses)

- Favourable assumption changes will decrease the loss component and be recognized in the P&L as an immediate gain (through the "reversal of loss component" line in insurance service expenses). Note however that if the size of the gain is larger than the loss component, then the P&L gain recognized is capped to the value of the loss component that has now been extinguished. Any 'excess' left behind is used to establish a CSM which will then be recognized over the lifetime of the group of contracts (as per the usual requirements).

5. Conclusion

- There are several technical complications that companies must consider during implementation. Methods should be carefully considered in terms of what financial and operational implications it commits entities to – considerations for in-force business may result in completely different conclusions compared to considerations for new business. Ultimately a balance will need to be struck.

- The systematic allocation ratio can be greater than 100%. There are two scenarios where this is made possible. One relies on the concept of 'optimum' ratios, the other on the theoretical possibility of there being experience variances relating to future services that do not affect the view of future cash outflows or the risk adjustment.

- Systematically allocating OCI to the loss component is possible but comes at a price of potential accounting mismatches.

- Assumption updates can complicate the specific formulation of systematic allocation ratios as can technical choices about whether to use PV of cash outflows at locked-in or current interest rates.

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