4th Capacity Building Seminar on IFRS 17
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Onerous Contracts

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Agenda

- What are Onerous Contracts?
- How to identify a group of onerous contracts?
- Measurement of group of Onerous contracts
  - Initial Measurement
  - Subsequent Measurement
- Practical challenges / other considerations

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What are Onerous contracts?

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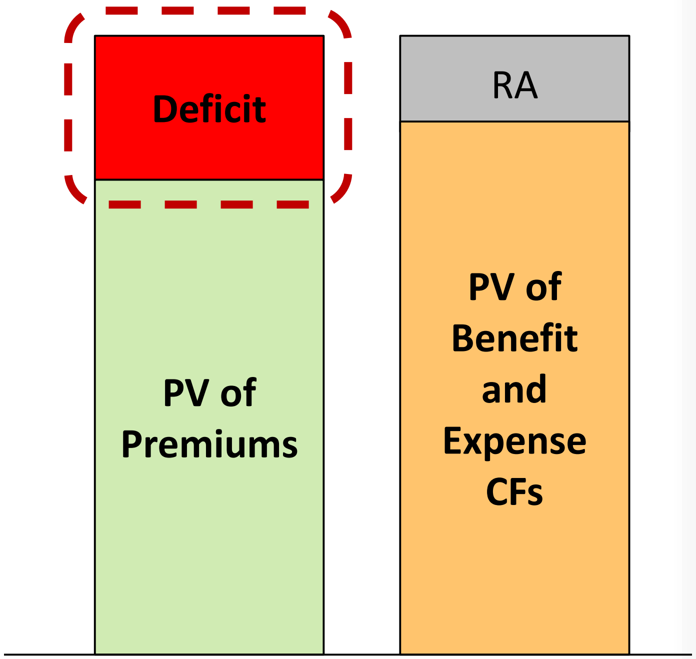
Group of contracts which are either:

- **Loss making at initial recognition**: Full deficit recognized as loss immediately.
- **Become Loss making during the lifetime of the contract** (i.e. **subsequent measurement**):

  Unfavorable changes in FCF reducing CSM to be zero and resulting in further deficit.

Note contract has to be ***loss making as per IFRS 17 measurement requirements***.



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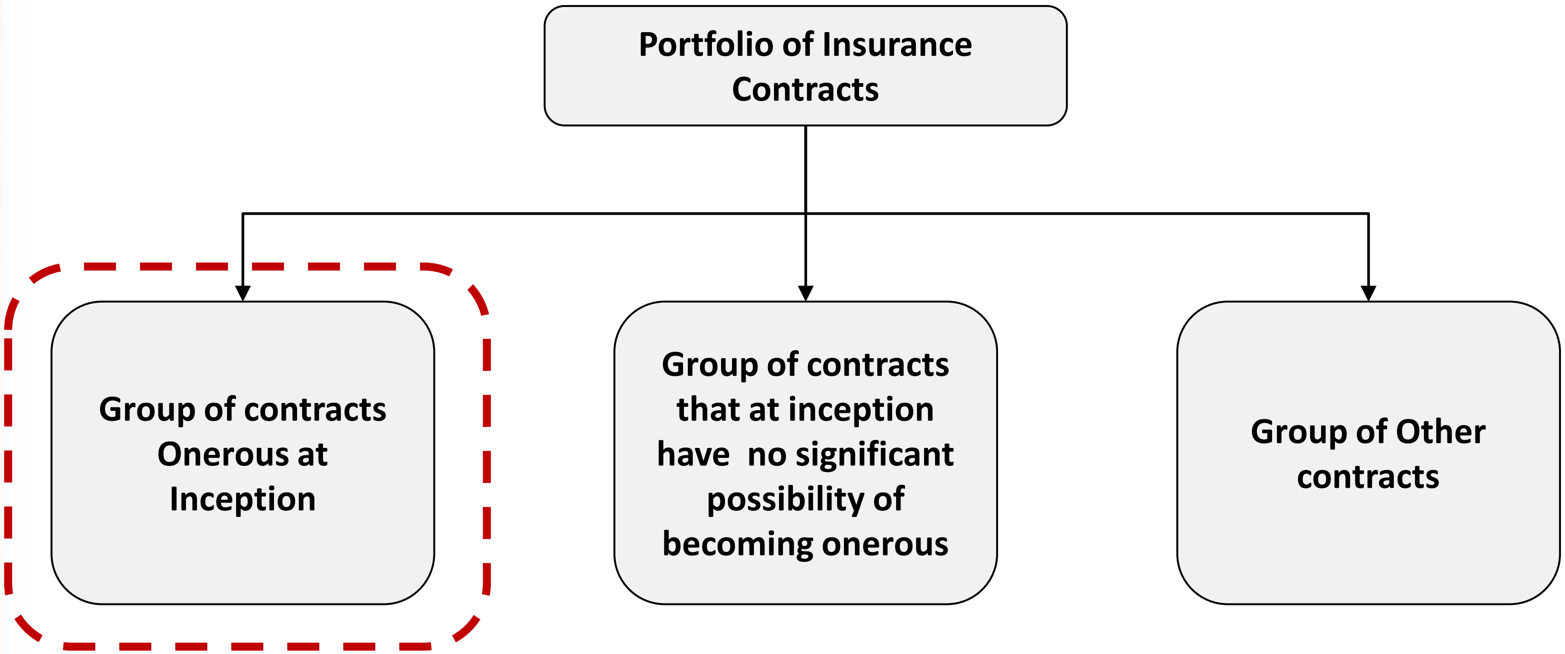
Level of aggregation required

IFRS 17 requires dividing contracts into **minimum of 3 groups** for **all measurement purposes**:



Identifying Group of contracts onerous at Inception

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1 Determine level at which onerousness should be tested i.e. contract level or higher level?

2 Perform test of Onerousness at that level

Para 17 of IFRS 17 Standard allows:

- Testing onerousness for a **set of contracts** provided **reasonable and supportable information** exists to conclude that a set of contracts will all be in the same group

- Else, test onerousness by **considering individual contracts**.

Determining level at which onerousness should be tested

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- What is reasonable and supportable information?

  - Business plan of Company
  - Pricing models / structures

- Practical cases where contract level assessment may need to be considered:

  - Age / term combinations priced differently (e.g. band break-points)
  - Low cost channels subsidizing contracts sold through high cost distribution channels (Cross-subsidy)
  - Smoothing of premium rates for certain ages / terms
  - Loss leader pricing for some variants

- Should materiality argument be considered in deciding the level of testing?

Performing test of Onerousness

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Contract is Onerous if FCF at initial recognition is net outflow i.e.

FCF at initial recognition > 0

Note that the test is performed:

- Using IFRS 17 assumptions and measurement model which may differ from pricing assumptions and methodology (for e.g. yield curve differences, contract boundaries etc.).
- Without taking any reinsurance credit.

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Case Study

A contract is issued with the following information and a coverage period of 3 years:

Particulars	Initial Recognition (INR)	Year 1 (INR)	Year 2 (INR)	Year 3 (INR)
Premiums Received (BOP)		1000	1000	
Payout (Benefits + Expenses) (EOP)		800	500	1000
Discount rate assumed	5%			
Risk Adjustment assumed (BOP)		240	160	80

BOP – Beginning of Period, EOP – End of Period

- No lapses assumed.
- All other amounts, including the investment component are ignored, for simplicity

** The numbers are for representative purposes only and may have been rounded for presentation. We have wanted to stress on the calculation methodology.*

Initial Recognition/Measurement

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Particulars	Initial Recognition
Estimates of the present value of future cash inflows	-1,952
Estimates of the present value of future cash outflows	2,079
Estimates of the present value of future cash flows	127
Risk adjustment for non-financial risk	240
Fulfilment Cash Flows	**367**
Contractual Service Margin	**-**
Insurance Contract Liability	**367**

- FCF of INR 367 > 0, **Contract is Onerous**
- Loss of INR 367 **recognized immediately in the P&L** under Insurance Service Expense Line
- Create **Loss Component (LC) of INR 367** and track in future

Subsequent Measurement (Year 1)

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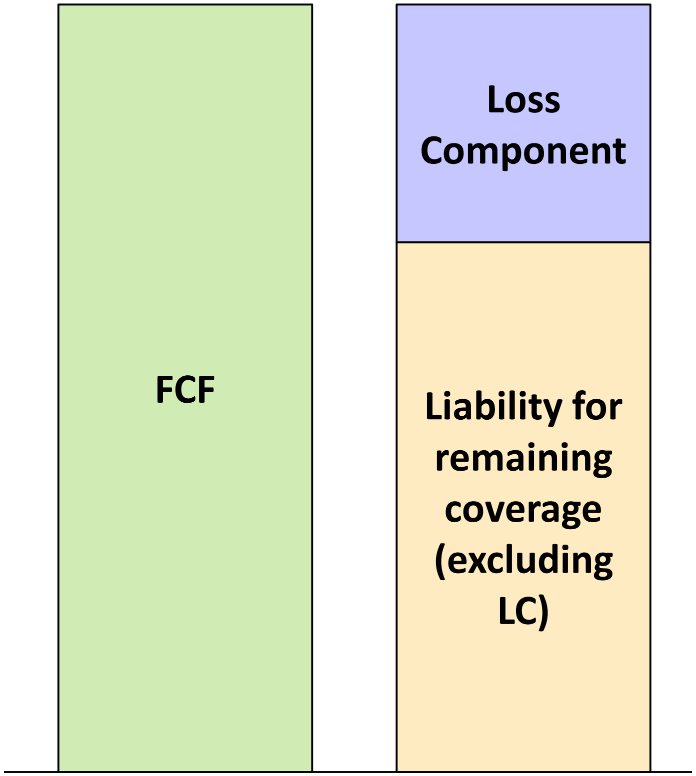
Roll forward of ICL from Initial Recognition to Year 1

In Year 1, all events occur as expected on Initial Recognition.

Particulars	Estimates of the present value of future cash flows	Risk adjustment for non-financial risk	Contractual Service Margin	Insurance Contract Liability
Opening Balance	-	-	-	-
Changes related to future service: New Contracts	127	240	-	367
Cash inflows	1,000	-	-	1,000
Insurance finance expense	56	-	-	56
Changes related to current service	-	-80	-	-80
Cash Outflows	-800	-	-	-800
Closing Balance	**383**	**160**	**-**	**543**

- FCF of **INR 367 has flown from Initial Recognition**
- Insurance finance expense of **INR 56 is calculated as 5%*(1000+127)**
- Release of RA of **INR 80, as it is released evenly**

Loss Component Tracking



Following changes in FCF are allocated between LC and remaining liability:

- Expected payment for claims and expenses during the period
- Release of Risk Adjustment during the period
- Insurance finance income or expenses component of FCF

Allocation is done in a systematic manner.

For the purposes of the example, the Systematic Allocation Ratio (SAR) is **Opening LC / Opening FCF**

Loss Component Tracking (Year 1)

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Roll forward of Loss Component from Initial Recognition to Year 1

Particulars	Liability for remaining coverage, excluding LC	Loss component	Liability for incurred claims	Insurance Contract Liability
Opening Balance	**-**	**-**	**-**	**-**
Cash inflows	1,000	-	-	1,000
Insurance service expenses: Loss on onerous contracts	-	367	-	367
Insurance finance expense	41	15	-	56
Insurance Revenue	-644	-	-	-644
Insurance service expenses: Incurred expenses	-	-236	800	564
Cash Outflows	-	-	-800	-800
Closing Balance	**397**	**146**	**-**	**543**

- The SAR for Year 1 is calculated as **Opening LC / Opening FCF including cashflows at time 1** i.e. (367/367+1000) = **26.84%**
- Amount allocated to LC = **corresponding FCF change * SAR**

Profit and Loss for Year 1

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Particulars	Amount
Insurance Revenue	**644**
-Release of CSM	*-*
-Release of RA	*59*
-Expected Claims and Expenses at the beginning of the period	*585*
-Insurance Contract Acquisition Cashflows	*-*
Insurance Service Expenses	**-931**
-Actual Claims	*-800*
-Incurred Claims and Benefits	*-*
-Insurance Contract Acquisition Cashflows	*-*
-Loss on Onerous Contracts	*-367*
-Reversal of Loss	*236*
Insurance Service Result (A)	**-287**
Investment Income	**-**
Insurance Finance Income/(Expenses)	**-56**
-Liability for Remaining Coverage	*-41*
-Financing Component of LC	*-15*
Insurance Finance Result (B)	**-56**
Profit/Loss for the year (A+B)	**-343**

Case Study – Flow of Scenarios

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Onerous Contracts

Year 1 – Same as illustrated above

Year 2 and 3
Scenario A
Contract turns profit making

Year 2 and 3
Scenario B
Contract becomes more onerous

Scenario A : Contract becomes profitable

The expectation of future cash outgo in Year 3 changes from INR 1000 to INR 750

Particulars	Initial Recognition (INR)	Year 1 (INR)	Year 2 (INR)	Year 3 (INR)
Premiums Received (BOP)		1000	1000	
Payout (Benefits + Expenses) (EOP)		800	500	750
Discount rate assumed	5%			
Risk Adjustment assumed (BOP)		240	160	80

BOP – Beginning of Period, EOP – End of Period

- Changes in FCF due to improvements in future service cashflows, first reduce the amount of the LC and after LC becomes 0, a CSM is created.

Subsequent Measurement (Year 2 – Scenario A)

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Roll forward of ICL from Year 1 to Year 2

In Year 2, expectation of cash outflow which will happen in Year 3 is revised to INR 750 instead of INR 1000 expected originally.

Particulars	Estimates of the present value of future cash flows	Risk adjustment for non-financial risk	Contractual Service Margin	Insurance Contract Liability
Opening Balance	**383**	**160**	**-**	**543**
Changes related to future service: New Contracts	-	-	-	-
Cash inflows	1,000	-	-	1,000
Insurance finance expense	69	-	-	69
Changes related to future service: change in assumptions	-238		229	-9
Changes related to current service	-	-80	-	-80
Cash Outflows	-500	-	-	-500
Closing Balance	**714**	**160**	**229**	**1024**

- It can be seen that the **improvements in FCF are INR 238**, out of which INR 9 has been allocated to the LC to reduce it to 0 and the remaining **INR 229 has enabled us to create a CSM.**

Loss Component Tracking (Year 2 – Scenario A)

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Roll forward of Loss Component from Year 1 to Year 2

Particulars	Liability for remaining coverage, excluding LC	Loss component	Liability for incurred claims	Insurance Contract Liability
Opening Balance	**397**	**146**	**-**	**543**
Cash inflows	1,000	-	-	1,000
Insurance finance expense	51	19	-	69
Insurance Revenue	-424	-	-	-424
Insurance service expenses: Incurred expenses	-	-156	500	344
Insurance service expenses: Reversal of loss on Onerous Contracts	-	-9	-	-9
Cash Outflows	-	-	-500	-500
Closing Balance	**1024**	**-**	**-**	**1024**

- The **SAR for Year 2** is calculated as **Opening LC / Opening FCF at time 2** i.e. (146/543) = **26.84%.**
- It can be seen that the **improvements in FCF are INR 238**, out of which **INR 9 has been allocated to the LC to reduce it to 0** and the remaining **INR 229 has enabled us to create a CSM.**

Subsequent Measurement (Year 3 – Scenario A)

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Roll forward of ICL from Year 2 to Year 3

In Year 3, all events occur as expected in Year 2.

Particulars	Estimates of the present value of future cash flows	Risk adjustment for non-financial risk	Contractual Service Margin	Insurance Contract Liability
Opening Balance	**714**	**80**	**229**	**1024**
Changes related to future service: New Contracts	-	-	-	-
Cash inflows	-	-	-	-
Insurance finance expense	36	-	11	47
Changes related to current service	-	-80	-241	-321
Cash Outflows	-750	-	-	-750
Closing Balance	**-**	**-**	**-**	**-**

- CSM of **INR 241 is released in its entirety as the contract is derecognised**

Profit and Loss for Year 2 and Year 3 – Scenario A

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	Year 2	Year 3
Particulars	**Amount**	**Amount**
Insurance Revenue	**424**	**1071**
-Release of CSM	*-*	*241*
-Release of RA	*59*	*80*
-Expected Claims and Expenses at the beginning of the period	*366*	*750*
-Insurance Contract Acquisition Cashflows	*-*	*-*
Insurance Service Expenses	**-336**	**-750**
-Actual Claims	*-500*	*-750*
-Incurred Claims and Benefits	*-*	*-*
-Insurance Contract Acquisition Cashflows	*-*	*-*
-Loss on Onerous Contracts	*-*	*-*
-Reversal of Loss	*164*	*-*
Insurance Service Result (A)	**89**	**321**
Investment Income	**-**	**-**
Insurance Finance Income/(Expenses)	**-69**	**-47**
-Liability for Remaining Coverage	*-51*	*-36*
-Financing Component of LC	*-19*	*-11*
Insurance Finance Result (B)	**-69**	**-47**
Profit/Loss for the year (A+B)	**20**	**274**

Case Study – Flow of Scenarios

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Onerous Contracts

Year 1 – Same as illustrated above

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Scenario A
Contract turns profit making

Year 2 and 3
Scenario B
Contract becomes more onerous

Changes with respect to expectations of future cashflows in year 2 – Scenario B

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The expectation of future cash outgo in Year 3 changes from INR 1000 to INR 1200

Particulars	Initial Recognition (INR)	Year 1 (INR)	Year 2 (INR)	Year 3 (INR)
Premiums Received (BOP)		1000	1000	
Payout (Benefits + Expenses) (EOP)		800	500	1200
Discount rate assumed	5%			
Risk Adjustment assumed (BOP)		240	160	80

BOP – Beginning of Period, EOP – End of Period

- Changes in FCF which lead to an increase in future service cashflows, increase the LC and such increase is recognised immediately in the P&L.

*****Reminder - Systematic Allocation Ratio (SAR) for Year 2 = (146/543) = 26.84%***

Subsequent Measurement (Year 2 – Scenario B)

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Roll forward of ICL from Year 1 to Year 2

In Year 2, expectation of cash outflow which will happen in Year 3 is revised to INR 1200 instead of INR 1000 expected originally.

Particulars	Estimates of the present value of future cash flows	Risk adjustment for non-financial risk	Contractual Service Margin	Insurance Contract Liability
Opening Balance	**383**	**160**	**-**	**543**
Changes related to future service: New Contracts	-	-	-	-
Cash inflows	1,000	-	-	1,000
Insurance finance expense	69	-	-	69
Changes related to future service: change in assumptions	190		-	190
Changes related to current service	-	-80	-	-80
Cash Outflows	-500	-	-	-500
Closing Balance	**1143**	**160**	**229**	**1223**

- It can be seen that **the increase in the FCF of INR 190** increases the LC and the same in **recognised immediately in the P&L**.

Loss Component Tracking (Year 2 – Scenario B)

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Roll forward of Loss Component from Year 1 to Year 2

Particulars	Liability for remaining coverage, excluding LC	Loss component	Liability for incurred claims	Insurance Contract Liability
Opening Balance	**397**	**146**	**-**	**543**
Cash inflows	1,000	-	-	1,000
Insurance finance expense	51	19	-	69
Insurance Revenue	-424	-	-	-424
Insurance service expenses: Incurred expenses	-	-156	500	344
Insurance service expenses: Loss on Onerous Contracts	-	190	-	190
Cash Outflows	-	-	-500	-500
Closing Balance	**1024**	**199**	**-**	**1223**

- The **SAR for Year 2 is calculated as Opening LC / Opening FCF at time 2** i.e. (146/543) = **26.84%**

Subsequent Measurement (Year 3 – Scenario B)

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Roll forward of ICL from Year 2 to Year 3

In Year 3, all events occur as expected in Year 2.

Particulars	Estimates of the present value of future cash flows	Risk adjustment for non-financial risk	Contractual Service Margin	Insurance Contract Liability
Opening Balance	**1143**	**80**	**-**	**1223**
Changes related to future service: New Contracts	-	-	-	-
Cash inflows	-	-	-	-
Insurance finance expense	57	-	-	57
Changes related to current service	-	-80	-	-80
Cash Outflows	-1200	-	-	-1200
Closing Balance	**-**	**-**	**-**	**-**

Loss Component Tracking (Year 3 – Scenario B)

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Roll forward of Loss Component from Year 2 to Year 3

Particulars	Liability for remaining coverage, excluding LC	Loss component	Liability for incurred claims	Insurance Contract Liability
Opening Balance	**1024**	**199**	**-**	**1223**
Cash inflows	-	-	-	-
Insurance finance expense	48	9	-	57
Insurance Revenue	-1072	-	-	-1072
Insurance service expenses: Incurred expenses	-	-208	1200	992
Insurance service expenses: Loss on Onerous Contracts	-	-	-	-
Cash Outflows	-	-	-1200	-1200
Closing Balance	**-**	**-**	**-**	**-**

- The **SAR for Year 3 is calculated as Opening LC / Opening FCF at time 3** i.e. (199/1223) = **16.29%**

Profit and Loss for Year 2 and Year 3 – Scenario B

	Year 2	Year 3
Particulars	**Amount**	**Amount**
Insurance Revenue	**424**	**1072**
-Release of CSM	*-*	*-*
-Release of RA	*59*	*67*
-Expected Claims and Expenses at the beginning of the period	*366*	*1005*
-Insurance Contract Acquisition Cashflows	*-*	*-*
Insurance Service Expenses	**-535**	**-992**
-Actual Claims	*-500*	*-1200*
-Incurred Claims and Benefits	*-*	*-*
-Insurance Contract Acquisition Cashflows	*-*	*-*
-Loss on Onerous Contracts	*-190*	*-*
-Reversal of Loss	*156*	*208*
Insurance Service Result (A)	**-110**	**80**
Investment Income	**-**	**-**
Insurance Finance Income/(Expenses)	**-69**	**-57**
-Liability for Remaining Coverage	*-51*	*-48*
-Financing Component of LC	*-19*	*-9*
Insurance Finance Result (B)	**-69**	**-57**
Profit/Loss for the year (A+B)	**-180**	**23**

Subsequent Measurement where Profitable becomes Onerous

When profitable contract becomes loss making:

- First **adjust changes in FCF through CSM**, till the **CSM becomes zero.**
- Thereafter, contracted treated as **Onerous** and **excess loss recognised in P&L** immediately.
- Establish **LC equal to the value of the remaining changes in FCF** relating to future service.

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Practical Considerations

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Particulars	Consideration
Type of products likely to be Onerous either at Inception or subsequent measurement	• Contracts profitable only after cross subsidy between channels, age / term combinations, variants etc. • Products profitable only after reinsurance credit • Lapse supported products where actual experience may have been different from expected • Term plans with higher than expected mortality experience
Determining group of Onerous contracts at transition	• Use of existing profitability metrics (traditional vs. market consistent metrics) • Need to adapt metrics to IFRS 17 requirements
Impact of yield curve changes	• General Model products profitable at inception – impact of change in yield curve on P&L and does not make group onerous • Products onerous at inception – change in yield curve may impact degree of onerousness
Understanding P&L volatility	• Difference in treatment of profitable contracts vs. loss making • Movement from Onerous to profitable and vice versa may introduce considerable volatility

Other Considerations / Points

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Particulars	Consideration
Relief available for Quota share reinsurance	• If the underlying contract is covered via a proportionate reinsurance contract, i.e. quota share treaty, the entity can take the credit of reinsurance recoveries on such onerous contracts at initial recognition or when onerous contracts are added to the group, by multiplying the % of recoveries to be received to the Loss on contracts on that date to reduce the onerousness flowing to the Profit and Loss.
Measurement for contracts with direct participation	• No change in treatment of Onerous contract • Companies to consider whether to allow impact of change in underlying in defining systematic allocation ratios
Group / subsidiary reporting	• Differences between group and subsidiary in defining the level at which onerousness should be tested / assumption to be used.
Expense allocation	• Current vs. structural cost in IFRS 17 test of onerousness?

Thank you

Any Questions?