Financial accounting module 22: Onerous contracts

(The attached PDF file has better formatting.)

This posting explains onerous vs non-onerous contracts. The accounting entries for onerous contracts are covered in other postings. You are not responsible for the end-notes, which cite the text of IFRS 17.

LEVEL OF AGGREGATION OF INSURANCE CONTRACTS: ONEROUS VS NON-ONEROUS

Most accounting entries are by transaction. Premiums received, claims paid, and many acquisition cash flows are for individual insurance contracts, and the totals are the sum of the transactions.

IFRS 17 accounting entries differ two ways:

- future cash flows are estimated for portfolios of insurance contracts or groups of insurance contracts
- estimates of onerous contract losses apply to groups, not to individual contracts.

Portfolios of insurance contracts

Forming probability distributions of future cash outflows for each insurance contract is hard. Instead, insurers aggregate insurance contracts into portfolios (by line of business, region, or business unit) and form probability distributions of future cash flows for the portfolio. Expected claims and benefits are more reliably measured for portfolios of contracts than for individual contracts.[1]

The demarcation of portfolios, defined in IFRS 17 as "insurance contracts subject to similar risks and managed together,"[2] is principles-based: insurers selling products in several countries or regions or to different consumers may choose different levels of aggregation.

- Contracts in a product line often have similar risks and are in one portfolio if they are managed together.
- Contracts in different product lines often have different risks and are in different portfolios.
- Contracts sold in different regions or countries or to different markets are not managed together and are in different portfolios.

Groups of insurance contracts

Insurers separate their insurance portfolios into groups of onerous (loss-making, or unprofitable) contracts, contracts that have no significant possibility of becoming onerous, and contracts that may or may not become onerous.[3] The accounting for onerous vs non-onerous contracts differs. Within a group, non-onerous contracts offset onerous contracts, but a non-onerous group of contracts may not offset an onerous group.

We defer the analysis of onerous contracts to later chapters of this textbook; for now, onerous contracts are those that cause an accounting loss, based on the present value of future cash flows and the risk adjustment for non-financial risk.

IFRS 17 calculations are by group of insurance contracts. Some figures are computed or estimated for the portfolio of insurance contracts and allocated to the group:

- Acquisition cash flows included in the fulfilment cash flows are those directly attributable to the portfolio of insurance contracts; other acquisition cash flows are recognized immediately in profit or loss.
- The dis-aggregation of insurance finance expense between profit or loss and other comprehensive income is by portfolio of insurance contracts, since insurers are assumed to choose their asset portfolios by portfolio of insurance contracts.
- Future cash flows may be estimated by portfolio of insurance contracts and allocated to the group.

The level of aggregation affects the timing of profit or loss.

- Profits are spread over the contract period (in proportion to the coverage units in each year) for groups of non-onerous contracts.
- Losses are recognized immediately in profit or loss for groups of onerous contracts, and reversals of these losses (if the contracts become less onerous) are recognized immediately as profit.

If each insurance contract were its own group, insurers would show up-front losses on every onerous contract. If all contracts were one group, insurers would show up-front losses only if the combined group were onerous.

Each portfolios is divided into at least three groups:

- contracts that are onerous at initial recognition
- contracts that at initial recognition have no significant possibility of becoming onerous later
- the remaining contracts in the portfolio

IFRS 17 paragraph 17 explains the level of detail to assess whether contracts are onerous.

> *If an entity has reasonable and supportable information to conclude that a set of contracts will all be in the same group … it may measure the set of contracts to determine if the contracts are onerous … and assess the set of contracts to determine if the contracts have no significant possibility of becoming onerous subsequently …. If the entity does not have reasonable and supportable information to conclude that a set of contracts will all be in the same group, it shall determine the group to which contracts belong by considering individual contracts.*

- If the insurer reasonably believes that a set of contracts will be in the same group (from the three listed above), it measures if the set of contracts is onerous or might become onerous later.
- If the insurer cannot place a set of contracts in the same group, it measures the contracts individually.

The premium allocation approach is a simplified measurement system that bases revenue on premiums, not on fulfilment cash flows. If insurers had to measure fulfilment cash flows to determine whether contracts were onerous, the cost benefits of the premium allocation approach might be lost. IFRS 17 paragraph 18 says that if the insurer uses the premium allocation approach, it "shall assume no contracts in the portfolio are onerous at initial recognition, unless facts and circumstances indicate otherwise…"

The minimum three groups for each portfolio are the same for the general measurement model, the premium allocation approach, and the variable fee approach:

- contracts that are onerous at initial recognition
- contracts that at initial recognition have no significant possibility of becoming onerous
- the remaining contracts in the portfolio

For this division of portfolios into groups, the insurer may examine each contract separately, examine sets of contracts, or assume contracts are not onerous at initial recognition and assess whether assumptions might change, depending on the measurement model and the type of insurance contracts.

- If contracts differ, the insurer assesses them individually. Commercial contracts and whole life insurance contracts are often assessed individually.
- If contracts in a set have similar attributes, the insurer may examine the set. Insurance contracts priced by class attributes with little individual underwriting, such as motor insurance, personal property insurance, and some term life insurance, may be assessed as sets. Insurers need not collect more information for accounting allocations than they use to price the contracts,
- Contracts measured by the premium allocation approach are often assumed to be not onerous at initial recognition, and they are assessed if facts and circumstances suggest that they might be onerous. No fulfilment cash flows of the liability for remaining coverage are estimated for the measurement model, so the contracts need not be assessed as onerous or non-onerous.

Illustration: Motor insurance contracts measured with the premium allocation approach use projections about claim frequency, claim severity, and loss cost trends. The insurer assesses whether these projections might change, causing the group of contract to perhaps become onerous.

Some groups may be empty. An insurer may not expect any contracts to be onerous when the contracts are issued, though the contracts may become onerous if business conditions change. Insurers with high risk adjustments for non-financial risk may have many onerous contracts at initial recognition. Insurers with low risk adjustments may have no onerous contracts at initial recognition.

Reinsurance contracts held are not onerous or non-onerous.

- Reinsurance contracts held with a net loss for the primary insurer at initial recognition have a net gain for the reinsurer at initial recognition and are analogous to non-onerous primary insurance contracts.
- reinsurance contracts held with a net gain for the primary insurer at initial recognition have a net loss for the reinsurer at initial recognition and are analogous to onerous primary insurance contracts.

Reinsurance contracts held can not be onerous, so portfolios of reinsurance contracts held are not divided into groups. Reinsurance contracts held are not grouped with primary insurance contracts. Many insurers have a single reinsurance contract held within any portfolio.[4]

A group may not include contracts issued more than one year apart. The groups are classified by issue date, not by the date the contract is in force. The one year is any 12 month period, not necessarily a calendar year.[5]

Illustration: Life insurance contracts may stay in force many years. The groups are contracts issued in 20X1, in 20X2, and so forth (or other groups), not those in force during 20X1, during 20X2, and so forth.

The illustrations in the postings often show a single insurance contract: an onerous contract, a non-onerous contract that becomes onerous, or an onerous contract that becomes non-onerous. Actual accounting is for groups of contracts and groups that are onerous or non-onerous.

[1] See IFRS 17 paragraph 14: "…A portfolio comprises contracts subject to similar risks and managed together. Contracts within a product line would be expected to have similar risks and hence would be expected to be in the same portfolio if they are managed together. Contracts in different product lines (for example single premium fixed annuities compared with regular term life assurance) would not be expected to have similar risks and hence would be expected to be in different portfolios."

[2] See IFRS 17 Appendix A, defined terms, portfolio of insurance contracts.

[3] See IFRS 17 paragraph 16: "An entity shall divide a portfolio of insurance contracts issued into a minimum of: (a) a group of contracts that are onerous at initial recognition …; (b) a group of contracts that at initial recognition have no significant possibility of becoming onerous …; (c) a group of the remaining contracts in the portfolio …"; see also IFRS 17 *Basis for Conclusions* paragraph BC127. The demarcation of groups is also principles-based. The phrase *no significant possibility* is vague, and insurers are not able to assign statistical probabilities to future scenarios in which the insurance contracts become onerous.

[4] See IFRS 17 paragraph 61: "An entity shall divide portfolios of reinsurance contracts held applying [the same procedure as for primary insurance contracts] except that the references to onerous contracts … shall be replaced with a reference to contracts on which there is a net gain on initial recognition. For some reinsurance contracts held, [the grouping procedure] will result in a group that comprises a single contract."

[5] See IFRS 17 paragraph 22: "An entity shall not include contracts issued more than one year apart in the same group. To achieve this the entity shall, if necessary, further divide the groups …"