

NFRS 17

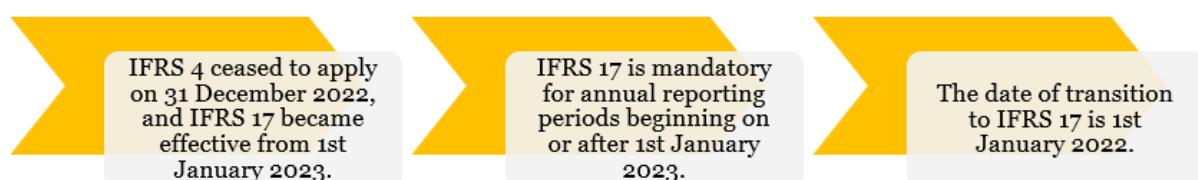
Insurance Contracts: Synopsis



NFRS 17- Insurance Contracts: Synopsis

Introduction

The International Accounting Standards Board initially issued International Financial Reporting Standard 4- Insurance Contracts in March 2004, which was subsequently replaced by IFRS 17. IFRS 17 came into effect globally for annual reporting periods beginning on or after 1 January 2023, bringing major changes to how insurers report financial performance worldwide. While it was initially issued in May 2017, its implementation was deferred to 2023 to allow companies time to adapt to its complex requirements, aiming for greater consistency and comparability in insurance accounting.



In Nepal, IFRS 17 was adopted as NFRS 17 and became effective from 16 July 2024 (1st Shrawan 2081 B.S.). The original effective date of 16 July 2023 was deferred by the Accounting Standards Board of Nepal and the Institute of Chartered Accountants of Nepal to provide insurers with additional time to prepare for the complex implementation requirements of the standard. Shikhar Insurance Company Limited became the first insurer in Nepal to prepare and publish its financial statements in compliance with NFRS 17 for the first quarter of the current fiscal year 2082/83.

NFRS 4 Vs NFRS 17: Major Difference

Basis	NFRS 4	NFRS 17
Measurement Model	Multiple local GAAP models allowed; measurement was often done based on historical cost	Several measurement models such as General Measurement model, Variable fee approach, Premium Allocation approach have been introduced.
Contractual Service Margin	No concept of CSM	CSM is introduced to defer profit recognition over the coverage period.
Discounting	Discounting of liabilities was optional	Discounting of cashflows is mandatory.
Risk Adjustment for Non- Financial Risk	No standard approach for adjusting the risk.	Requires a risk adjustment reflecting the compensation an entity requires for bearing non-financial risk.
Revenue and Expense Recognition	Premiums often recognized as revenue when received; claims as expenses when paid.	Revenue is recognized based on the services provided , with CSM amortization

		reflecting the insurance coverage provided over time.
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Disclosures	Limited Disclosure	Extensive disclosures on assumptions, cash flows, risk adjustment, CSM etc.
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Further, NFRS 17 came into implementation to address the various inconsistencies and key factors that NFRS 4 failed to govern. The adoption of NFRS 17 brings significant changes:

- **Enhanced Transparency:** NFRS 17 requires detailed disclosures about the components of insurance liabilities, such as expected cash flows, risk adjustments, and the contractual service margin (CSM), enabling better understanding of an insurer's financial position.
- **Global Comparability:** By standardizing accounting practices, NFRS 17 facilitates comparisons across insurers globally, addressing the inconsistencies prevalent under NFRS 4.
- **Operational Complexity:** The standard necessitates upgrades to systems, processes, and actuarial models, posing implementation challenges for insurers.
- **Second-Order Effects:** NFRS 17 may trigger changes in tax regulations, prudential requirements, and stakeholder expectations, requiring insurers to adapt strategically.

Scope of NFRS 17

NFRS 17 applies to:

- Insurance contracts, including reinsurance contracts, it issues
- Reinsurance contracts it holds
- Investment contracts with discretionary participation features it issues, provided the entity also issues insurance contracts

Entity doesn't apply NFRS 17 to:

- Warranties
- Employee benefit plans
- Residual value guarantees
- Contingent consideration of acquirer in a business contracts
- Financial guarantee contracts
- Policyholder insurance contracts
- Credit card contracts

Measurement Models

NFRS 17 introduces three primary measurement models to account for insurance contracts:

General Measurement Model

General Measurement Model under NFRS 17 is the default measurement model used to measure insurance contracts. GMM measures insurance contract liabilities by combining current estimates of future cash flows, time value of money and compensation for uncertainty and unearned profit.

GMM comprises of four components:

1. Expected Future Cashflows

Under NFRS 17, estimates of future cash flows must be unbiased, probability-weighted averages of all expected inflows and outflows from the insurance contract (including premiums, claims, benefits, and directly attributable expenses), incorporating all reasonable and supportable information available without undue cost or effort regarding their amount, timing, and uncertainty.

2. Discounting (Time Value of Money)

Future cash flows are discounted to present value using current discount rates that reflect the time value of money, and the characteristics such as timing, currency, liquidity of the cash flows.

3. Risk Adjustment for Non-Financial Risk

This represents the compensation the insurer requires for bearing uncertainty about the amount and timing of cash flows arising from insurance risk, excluding financial risk.

4. Contractual Service Margin

The CSM is the unearned profit of the insurance contract. It ensures that no profit is recognized at initial recognition and is released systematically over the coverage period as insurance services are provided.

The liability of insurance contracts comprises the liability for remaining coverage (fulfilment cash flows for future services i.e., insured events that have not occurred) and the liability for incurred claims (fulfilment cash flows for claims and expenses already incurred but not yet paid).

Premiums received are initially recognized as different components of insurance contract liabilities. These liabilities are subsequently released to income over time as insurance services are provided. Financial components such as the unwinding of interest, are adjusted accordingly at the time of revenue recognition. However, claims are recognized as an expense as and when incurred. On initial recognition if the cash outflow exceeds the cash inflow, then such contract is onerous contract. The loss is recognized immediately.

Variable Fee Approach

The Variable Fee Approach is a measurement model applied specifically to insurance contracts with direct participation features. Direct participating contracts create an obligation to pay the policyholder an amount equal to the fair value of the underlying items, less a variable fee for future services. A contract is said to be direct participating contract if all of the following conditions are met:

- The contractual terms specify that the policyholder participates in a share of a clearly identified pool of underlying items.

- The entity expects to pay to the policyholder an amount equal to a substantial share of the fair value returns on the underlying items and
- The entity expects a substantial proportion of the change in the amounts to be paid to the policyholder to vary with the change in fair value of the underlying items.

VFA comprises of two components:

1. Fulfilment cashflows

Fulfilment cashflows are measured similarly to the GMM and includes expected future cashflows discounted using current rates and a risk adjustment for non-financial risk.

2. Contractual Service Margin

CSM represents the insurer's variable fee rather than a fixed unearned profit. Changes in the insurer's share of fair value of the underlying items is adjusted in CSM.

The policyholder is entitled to a substantial share of the returns on clearly identified underlying items, minus the insurer's variable fee for services provided. The obligation to pay the policyholder essentially equals the fair value of underlying items less the variable fee. Changes in the insurer's expected share due to financial risks adjust the CSM directly. Therefore, the liability for remaining coverage is not recognized as revenue in the same way in GMM and VFA model as it largely represents amounts that will be returned or credited to policyholders. The only element recognized as revenue from the contract is the release of the CSM over time, reflecting the insurer's earned fee/profit for providing insurance and investment-related services.

Premium Allocation Model

Premium Allocation Model is a simplified measurement model designed primarily for short term contracts, especially non -life insurance which is easier to apply and more aligned to the current accounting and reporting than the General Measurement Model in NFRS 17 making it an attractive for non-Life insurers. It provides a more straightforward alternative to General Measurement Model (GMM) for assessing obligations.

Insurance Acquisition cashflows

These are cash flows from selling, underwriting, and starting a group of insurance contracts that directly relate to a portfolio of insurance contracts.

Liability For Remaining Coverage

It represents the insurance company's responsibility to provide coverage and make payments for future events and benefits promised under existing insurance policies.

Liability For Incurred Claims

It is the insurance company's responsibility to pay claims for events that have already happened, along with any other costs or benefits owed under the policy, including services already provided or investment-related amounts.

Eligibility Criteria

There are criteria in para 53 of NFRS 17 in determining whether PAA can be applied to a group of (re) insurance contracts (group). An entity may simplify the measurement of a group of insurance contracts using the premium allocation approach if either of the conditions are met:

- The entity reasonably expects that such simplification would produce a measurement of the liability for remaining coverage for the group that would not differ materially from the one that would be produced than by applying general measurement model.
- The coverage period of each contract in the group is one year or less.

The criterion in paragraph 53(a) is not met if at the inception of the group an entity expects significant variability in the fulfilment cash flows that would affect the measurement of the liability for remaining coverage during the period before a claim is incurred. Variability in the fulfilment cash flows increases with, for example:

- the extent of future cash flows relating to any derivatives embedded in the contracts; and
- the length of the coverage period of the group of contracts.

As per para 55 of NFRS 17, Using the premium allocation approach, an entity shall measure the liability for remaining coverage as follows:

1. on initial recognition, the carrying amount of the liability is:
 - i. the premiums, if any, received at initial recognition
 - ii. minus any insurance acquisition cash flows at that date, unless the entity chooses to recognize the payments as an expense applying paragraph 59(a); and
 - iii. plus, or minus any amount arising from the derecognition at that date of
 - a. any asset for insurance acquisition cash flows applying paragraph 28C
 - b. and any other asset or liability previously recognized for cash flows related to the group of contracts as specified in paragraph B66A.
2. at the end of each subsequent reporting period, the carrying amount of the liability is the carrying amount at the start of the reporting period:
 - i. plus, the premiums received in the period;
 - ii. minus insurance acquisition cash flows; unless the entity chooses to recognize the payments as an expense applying paragraph 59(a);
 - iii. plus, any amounts relating to the amortization of insurance acquisition cash flows recognized as an expense in the reporting period; unless the entity chooses to recognize insurance acquisition cash flows as an expense applying paragraph 59 (a);
 - iv. plus, any adjustment to a financing component, applying paragraph 56;
 - v. minus the amount recognized as insurance revenue for services provided in that period (see paragraph B126); and
 - vi. Minus any investment component paid or transferred to the liability for claims incurred.

Summarized view

Initial Measurement
Add (+) Premiums
Less (-) Acquisition cashflow
Add/Less (+/-) Derecognition of any insurance asset/liability previously recognized
Liability for the remaining coverage

Subsequent Measurement
Add (+) Premiums
Less (-) Acquisition cashflow
Add/Less (+/-) Derecognition of any insurance asset/liability previously recognized
Add (+) Any adjustment to discounting
Less (-) Amount recognized as insurance revenue for coverage provided
Less (-) Investment component paid or transferred to the liability for incurred claims
Liability for remaining coverage

Comparison of GMM and PAA

Basis	GMM	PAA
Applicability	Applies to all insurance contracts unless a simplification is elected. Suitable for long-duration contract.	Mainly for short duration contract or longer ones where PAA produces a measurement of the liability for remaining coverage that does not differ materially from GMM.
Liability for Remaining Claims	<p>Insurance contract liability = Liability for Remaining Coverage + Liability for Incurred Claims</p> <p>LCR comprises:</p> <ul style="list-style-type: none"> • Present value of future cash flows- • Risk adjustment for non-financial risk • Contractual Service Margin (CSM) representing unearned profit which is explicitly calculated. 	<p>Insurance contract liability = LRC + LIC. LRC is essentially an unearned premium amount (premiums received minus insurance acquisition cash flows allocated to the period, adjusted for any onerous contracts). No explicit CSM is calculated or tracked for LRC.</p>
Recognition of profit	The Contractual Service Margin (CSM) is systematically released to profit or loss as insurance revenue over the coverage period.	Profit is recognized implicitly through the systematic recognition of insurance revenue over the coverage period. No explicit CSM is calculated or tracked separately.
Liability for incurred claims	The LIC is measured as the fulfilment cash flows for incurred claims.	The LIC is measured in the same manner as under the GMM as simplification under PAA doesn't apply to LIC.

Example of PPA

Scenario: If the Premium Paid Upfront:

Particulars	Assumption
Coverage Period	2 Years
Expense, acquisition cost and RA	0
Premium (paid immediately after the start coverage)	2,000
Claims (paid immediately after the end of five years)	2,000
Discount Rate	3%
Investment Rate	4%

On initial recognition, the liability for the remaining coverage = premiums received under the contract, less any acquisition costs paid.

Solution,

Liability for Remaining Coverage (LRC)

Particular	Time 0	Time 1	Time 2	Time 3	Time 4	Time 5
Balance at the start of the period(A)	-	(2,000)	(1,030)			-
Interest Accretion(B)	-	(60)	(30)	-	-	-
Amounts recognized in profit or loss	-	1,030	1,060	-	-	-
Balance at the end of the period	(2,000)	(1,030)	0	-	-	-

For $t_1 = (A+B)/2$ since it is halfway through the contract, and so, release half now to P&L (assuming uniform risk).

Unwinding of Discount

For $t_2 = (A + B) \Rightarrow$ remainder is released to P&L

Liability for Incurred Claims (LIC)

Particular	Time 0	Time 1	Time 2	Time 3	Time 4	Time 5
Balance at the Start of the period(C)	-	-	(888)	(1,830)	(1,886)	(1,942)
Interest accretion	-	-	(28)	(54)	(56)	(58)
Claims Incurred(D)	-	(888)	(916)	-	-	-
Balance at the end of the period	-	(888)	(1,830)	(1,886)	(1,942)	(2,000)

Coverage period has ended \Rightarrow balance is zero from here.

For $t_1 = \text{fulfilment cashflows of } 1776/2$ (i.e., half of the t_1 fulfilment cash flows from BBA, which related to the expired

Insurance Contract Liability (LRC+LIC)

Particular	Time 0	Time 1	Time 2	Time 3	Time 4	Time 5
Balance at the start of the period	-	(2,000)	(1,918)	(1,830)	(1,886)	(1,942)
Balance at the end of the period	(1,000)	(1,918)	(1,830)	(1,886)	(1,942)	(2,000)

Total Interest accretion (Interest expenses)

Particular	Time 0	Time 1	Time 2	Time 3	Time 4	Time 5
Interest accretion	0	(60)	(58)	(54)	(56)	(58)

Assets

Particular	Time 0	Time 1	Time 2	Time 3	Time 4	Time 5	Total
Balance at the start of the period	-	2,000	2,080	2,164	2,250	2,340	2,000
Interest accretion	-	80	84	86	90	94	434
Balance at the period end of the period	-	2,080	2,164	2,250	2,340	2,434	2,434

Statement of Profit or Loss

Particular	Time 0	Time 1	Time 2	Time 3	Time 4	Time 5	Total
Insurance Revenue(A)	-	1030	1060	-	-	-	2090
Claims incurred(B)	-	(888)	(916)	-	-	-	(1804)
Underwriting result(A-B)	-	142	144	-	-	-	286
Interest income(C)	-	80	84	86	90	94	434
Interest expenses(D)	-	(60)	(58)	(54)	(56)	(58)	(286)
Investment result(C-D)	-	20	26	32	34	36	148
Profit and loss	-	162	170	32	34	36	434

Disclosures

Following are the disclosure requirements under the Premium Allocation Approach in NFRS 17

1. Entities applying the PAA must disclose that the approach has been used and explain why the contracts qualify (e.g., coverage period of one year or less, or no material difference from the General Measurement Model).
2. Reconciliations must be presented in tabular form, separately for:
 - a) Insurance contracts issued
 - b) Reinsurance contracts held
3. Each reconciliation shows the changes during the period (opening balance to closing balance) for:
 - a) Liability for remaining coverage (LRC)
 - b) Any loss component (if the group is onerous)
 - c) Liability for incurred claims (LIC)
4. Within the reconciliations, disclose key amounts related to insurance services, including:
 - a) Insurance revenue
 - b) Insurance service expenses, broken down into:
 - i. Incurred claims and other directly attributable expenses
 - ii. Amortization of insurance acquisition cash flows
 - iii. Changes relating to past service (adjustments to fulfilment cash flows for incurred claims)
 - iv. Losses on onerous groups of contracts and any reversals of those losses
5. Disclose investment components excluded from both insurance revenue and insurance service expenses.
6. If the entity elects to expense insurance acquisition cash flows immediately (allowed when coverage \leq 1 year), disclose this accounting policy choice and the amount expensed
7. Disclose reconciliations or detailed movements are not needed for:
 - a) Present value of future cash flows
 - b) Risk adjustment for non-financial risk
 - c) Contractual service margin (CSM), since these are not calculated under PAA

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