Ind AS 117* Insurance Contracts

What it means to Indian insurers

June 2018

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*Exposure Draft

Foreword

International Accounting Standards Board (IASB) issued International Financial Reporting Standard (IFRS) 17: Insurance Contracts in May 2017. This is a significant change for insurers across the globe, following prolonged discussions and debates, and heralds an end to the lack of comparability between the financial positions and performance of insurers in different jurisdictions and with companies in other industries. The new standard is expected to significantly enhance comparability and transparency in reporting by insurers.

Keeping in mind the same objective of enhanced transparency in financial statements prepared by the insurers in India, The Institute of Chartered Accountants of India (ICAI) issued an Exposure Draft (ED) on Indian Accounting Standard (Ind AS) 117, Insurance Contracts, which is consistent with IFRS 17.

This is a precursor to its notification under the Companies Act, 2013 by the Ministry of Corporate Affairs ('MCA').

The Insurance Regulatory and Development Authority of India (IRDAI), pursuant to circular on implementation of Ind AS dated 28 June 2017, advised insurance companies to comply with Ind AS for accounting periods beginning from 1 April 2020 onwards, with comparatives from the periods ending 31 March 2020 or thereafter. Presently, Ind AS 104: Insurance Contracts has been included in the set of notified Indian AS and is expected to be replaced by Ind AS 117 in due course.

Key highlights of ED Ind AS 117 are

- Separate presentation of underwriting and finance results will provide added transparency about the sources of profits and quality of earnings.
- Premium volumes will no longer drive the 'top line' as investment components and cash received are no longer considered to be revenue.
- Accounting for options and guarantees will be more consistent and transparent.

Accordingly, the implementation of the new standard would result in:

- Current, explicit and fair estimates of future cash flows
- Discounting rates that reflect the characteristics of the contracts' cash flows
- Risk adjustments

Actuarial computations are expected to be more complex as the standard focusses on greater granularity in contract groupings for valuation purposes. This would require both insurance entities and the regulator to take a closer look at the impact on solvency margins, pricing and risk management. For insurers, the transition to the new Insurance standard is expected to have a notable impact on the reported numbers, ratios and key performance indicators.

The impact of the new standard is likely to be more in the life insurance business as compared to the general insurance business. However, all insurers are expected to be equally impacted with changes in profit recognition and extensive new disclosure requirements.

The changes could significantly impact insurers on profitability pattern, volatility in financial results, equity levels and level of transparency about profit drivers.

Ind AS 117 may rewrite the rulebook on financial reporting by insurance companies and require insurance companies to focus on aspects such as data, people, technology solutions and investor relations. Co-ordination between functions such as finance, actuary, business and IT will be important as implementation of Ind AS 117 will require them to work as one unified team to achieve consistent reporting.

As per the new ED, insurance companies are allowed to early adopt Ind AS 117 only for the limited purposes of consolidation by their parent company. However, since the new standard is not notified yet, the consolidation by the parent company is expected to be based on Ind AS 104.

Considering the recent trend of listing and consolidation within the insurance sector in India, the implementation of Ind AS 117 is expected to be a major change programme that would be closely monitored by stock exchanges, investors and regulators. The IRDAI has formed a working committee to examine the provisions of IFRS 17 and the committee is expected to review the impacts by 30 June 2018.

Through this publication, we aim to highlight the nuances of the new insurance standard for life, general and reinsurance companies.

Rajosik Banerjee

Partner and Head

Financial Risk Management

KPMG in India

Sai Venkateshwaran

Partner and Head

Accounting Advisory Services

KPMG in India

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Introduction to Ind AS 117 and the Indian insurance landscape[1]

The Ministry of Corporate Affairs (MCA), Government of India had notified the Companies (Indian Accounting Standards) Rules, 2015 on 16 February 2015. Through its press release dated 18 January 2016, the MCA outlined the road map for implementation of Ind AS by banks, non-banking financial companies, select all India term lending and refinancing institutions and insurance entities.

With the introduction of IFRS 17 Insurance Contracts globally as a replacement for IFRS 4, the Insurance Regulatory and Development Authority of India (IRDAI) reconsidered the timelines and deferred the implementation of Ind AS 104 accounting model by two years. The deferral is aimed at reducing the burden of additional compliance and costs that would have to be undertaken by insurance companies, first upon transition to Ind AS 104 and then again on adoption of Ind AS 117 ('the standard').

However, the IRDAI vide circular IRDA/F&A/CIR/ACTS/262/12/2016 dated 30 December 2016, requires insurance companies to submit quarterly pro forma Ind AS financial statements.

The ED of the standard permits early adoption. If an entity adopts the standard earlier, it shall disclose that fact. However, insurance companies are allowed to early adopt the new insurance standard only for the limited purpose of consolidation by the parent company.

This standard requires all insurance contracts to be accounted for in a consistent manner, benefiting both investors and insurance companies. Ind AS 117 is expected to enhance transparency of reported profits through separate presentation of income from underwriting and investment.

Key principles of the new insurance standard are:

- Contracts that are insurance (and those that are not) are clearly identified.
- Components in the contract (including options and guarantees) are separated and valued, given certain conditions are fulfilled.
- Contracts are grouped into annual profitable and non-profitable cohorts (onerous contracts) for valuation.
- Current assumptions should be applied to risk-adjusted cash flows to value contracts, and unearned profit remains in the liability until it is recognised.
- Profit is recognised as insurance coverage is provided and the entity is released from risk.
- Insurance revenue, insurance expenses and financing income and expenses are presented separately.
- A higher level of disclosure to enable users to understand and compare insurance companies in a better way.

1. Insurance Contracts First Impressions IFRS 17, KPMG's Global IFRS insurance contracts leadership team , KPMG International Standards Group, July 2017

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Overview of the new insurance standard - Ind AS 117[2]

Scope and definitions

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Combination and separation

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Level of aggregation and recognitition

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Measurement models

General model	Premium allocation approach	Variable fee approach
Non participating insurance contracts	Contracts with coverage period less than a year	Direct participating contracts

Presentation and disclosure

Figure 1: Overview of Ind AS 117

The new standard prescribes three measurement models as elaborated under:

General Measurement Model (Building Block Approach)	On initial recognition the liability for insurance contracts is measured as a sum of: • Contractual service margin • Fulfilment cash flows which comprise: - Estimates of future cash flows; - Adjustment to reflect the time value of money i.e. discounting - Risk adjustment for non-financial risk.
Premium Allocation Approach (PAA)	Simplified measurement model for contracts with coverage period of one year or less.
Variable Fee Approach (VFA)	Applicable for direct participation contracts which modifies treatment of contractual service margin as provided under the general measurement model.

Variant of General Model

Figure 2: Measurement model

The core principles underlying these measurement models are expected to result in major financial transformation for insurers and provide better insights into the financial results for analysts and users.

2. Exposure Draft Indian Accounting Standard (Ind AS) 117, Accounting Standards Board The Institute of Chartered Accountants of India, February 12, 2018; Insurance Contracts First Impressions IFRS 17, KPMG's Global IFRS insurance contracts leadership team, KPMG International Standards Group, July 2017

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Scope

The new insurance standard applies to:

1. Insurance contracts;
2. All reinsurance contracts it issues and holds; and
3. Investment contracts with discretionary participation features it issues, provided the entity also issues insurance contracts.

Insurance contract is a contract under which:

- One party - the **issuer**
- Accepts **significant insurance risk** from
- Another party - the **policyholder**
- By agreeing to **compensate** the policyholder if a specified uncertain future event - the **insured event** adversely affects the policyholder.

Insurance risk is a risk other than financial risk, transferred from the holder of a contract to the issuer.

The standard is silent on the level of significance of insurance risk. However, it does mention that risk will be considered as significant if and only if an insured event could cause the issuer to pay additional amounts that are significant in any single scenario, excluding scenarios that have no commercial substance.

Reinsurance contract is a type of insurance contract that is issued by an entity (the reinsurer) to compensate another entity (the cedant) for claims arising from insurance contracts issued by the cedant. Even if a reinsurance contract does not expose the issuer to the possibility of a significant loss, that contract is deemed to transfer significant insurance risk if it transfers to the reinsurer substantially all the insurance risk relating to the reinsured portions of the underlying insurance contracts.

Investment contract with discretionary participation features is a financial instrument that provides a particular investor with the contractual right to receive, as a supplement to an amount not subject to the discretion of the issuer, additional amounts:

a. That are expected to be a significant portion of the total contractual benefits;

b. The timing or amount of which are contractually at the discretion of the issuer; and

c. That are contractually based on:

- The returns on a specified pool of contracts or a specified type of contract
- Realised and/or unrealised investment returns on a specified pool of assets held by the issuer or
- The profit or loss of the entity or fund that issues the contract.

Since these contracts do not transfer insurance risk, they do not meet the definition of insurance contract. These contracts are covered by Ind AS 117 only if they are issued by an entity which also issues insurance contracts. The benefit of treating such contracts as insurance contracts is to ensure consistency because they typically share similar characteristics as that of insurance contracts.

Scope exclusion

Ind AS 117 does not apply to:

1. Warranties provided by a manufacturer, dealer or retailer in connection with the sale of its goods or services to a customer
2. Employers' assets and liabilities from employee benefit plans and retirement benefit obligations reported by defined benefit retirement plans
3. Contractual rights or contractual obligations contingent on the future use of, or the right to use, a non-financial item
4. Residual value guarantees provided by a manufacturer, dealer or retailer and a lessee's residual value guarantees when they are embedded in a lease
5. Financial guarantee contracts, unless the issuer has previously asserted explicitly that it regards such contracts as insurance contracts and has utilised accounting applicable to insurance contracts
6. Contingent consideration payable or receivable in a business combination
7. Insurance contracts in which the entity is the policyholder, unless those contracts are reinsurance contracts held.

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- Significance of insurance risk is to be assessed on a contract by contract basis.
- Present value basis to be used to assess significant insurance risk i.e. , for fixed death benefit, any contractual terms that delay timely reimbursement to the policyholder can eliminate significant insurance risk.
- Investment contracts with discretionary participation features (DPF) is covered under Ind AS 117 provided the entity also issues insurance contracts.

Combination and separation of components from an insurance contract

A set or series of insurance contracts entered by an entity with the same or a related counterparty may achieve, or be designed to achieve, an overall commercial effect.

An insurance contract may contain one or more components that would be within the scope of another standard if they were separate contracts e.g. unit linked.

The standard provides three different instances where the component would have to be accounted separately from that of an insurance contract:

a. Embedded derivatives

b. Distinct investment component

c. Distinct goods or non-insurance services provided to a policyholder e.g. asset management or custody services

The remaining insurance contract would have to be accounted as per Ind AS 117 and further separation is not allowed. The following figure depicts the separation of an insurance contract and its respective accounting under other standards.

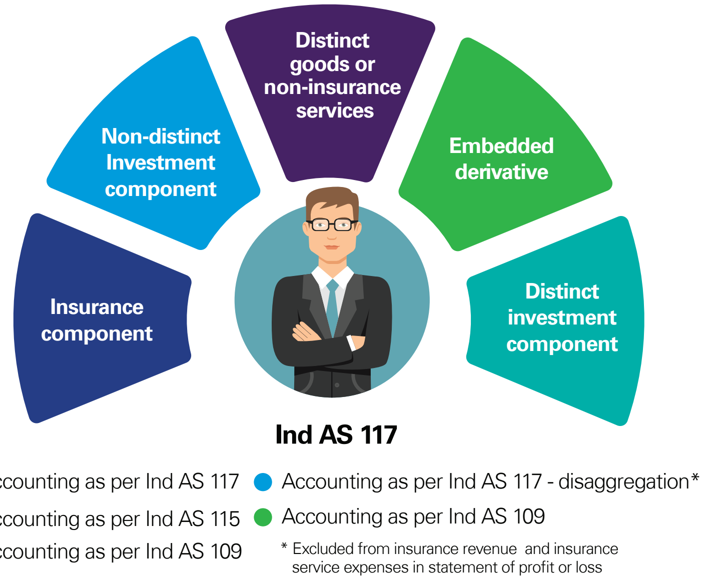

Figure 3: Separation of components

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- Investment contract is distinct only if the investment component and the insurance component are not highly inter-related and a contract with comparable terms is sold, or could be sold, separately in the same market or jurisdiction.
- Goods or non-insurance services promised to a policyholder are distinct if the policyholder can benefit from the goods or services either on their own or together with other resources readily available to the policyholder.
- The entity would not be permitted to further separate the insurance contract apart from the components specifically defined above.

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Level of aggregation

Entities are required to group the insurance contracts at the commencement since it determines the level at which the insurers would apply the recognition, measurement, presentation and disclosure guidance.

In this regard, the entity identifies portfolio of insurance contracts which would comprise contracts subject to similar risks and managed together e.g. annuities, term insurance, endowment assurance

Each portfolio is further divided at contract inception into a minimum of

a. Group of contracts that are onerous at initial recognition, if any;

b. Group of contracts that at initial recognition have no significant possibility of becoming onerous subsequently, if any; and

c. Group of the remaining contracts in the portfolio, if any.

An entity is not allowed to include contracts issued more than one year apart within the same group. Therefore, each portfolio would be disaggregated into annual cohorts or cohorts consisting of periods of less than one year.

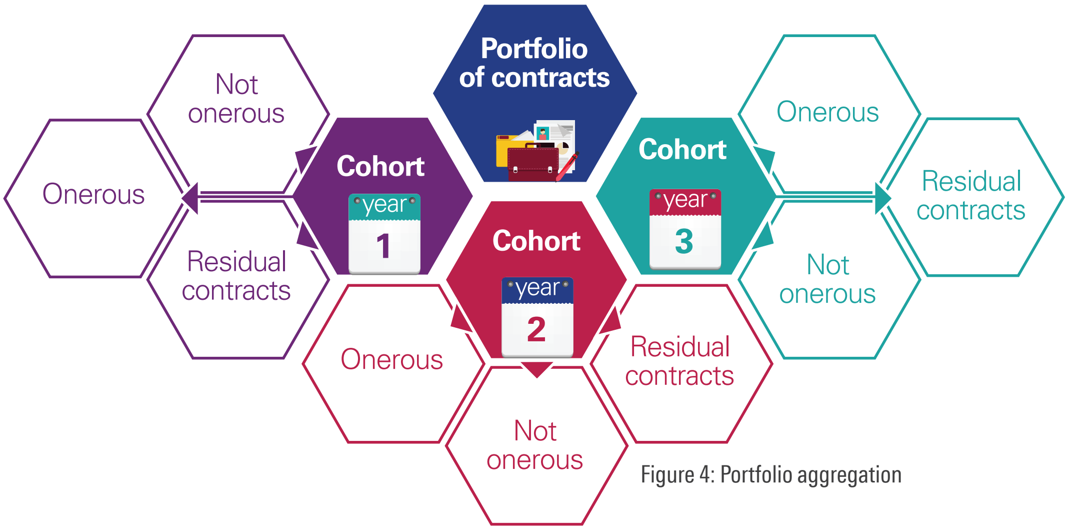

Figure 4: Portfolio aggregation

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- The term 'portfolio' under Ind AS 117 is used for various purposes, such as defining insurance acquisition cash flows and a group of insurance contracts. Consistent application of defined portfolio is required for various purposes.
- Management judgement is required to identify insurance and investment contracts with similar risk. Once it has been identified, further judgement would be required to determine if it can be aggregated and measured collectively.
- An entity may choose to divide a portfolio into more groups if the entity's internal reporting provides information at a more detailed level to make such sub-divisions.
- Aggregation of contracts based on profitability is likely to result in more granularity in contract groupings for valuation purposes.

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Timing of recognition

An entity recognises a group of insurance contracts it issues from the earliest of the following:

a. The beginning of the coverage period of the group of contracts;

b. The date when the first payment from a policyholder in the group becomes due; and

c. For a group of onerous contracts, when the group becomes onerous.

For contracts with no contractual due date, the first payment is deemed to be due from the date it is received. A group of insurance contracts includes only those contracts which are issued by the reporting date.

Determination of timing of recognition of insurance contracts is important to determine:

- Contractual service margin since fulfilment cash flows are measured as at initial recognition;
- Discounting rates used as an input to measurement model.

Contract boundary

The contract boundary distinguishes the future cash flows that relate to existing insurance contracts from those that relate to future insurance contracts. The identification of contract boundaries is important under Ind AS 117 as the measurement of a group of insurance contracts is dependent on the cash flows falling within the contract boundary.

The intent of this requirement is to include only those cashflows in the measurement of the contract which is binding on the company. When an entity has practical ability to reassess the risks of an existing insurance contract but is restricted from repricing the contract to reflect this reassessment, the contract still binds the entity and its related cash flows lie within the existing contract's boundary. However, if the restriction has no commercial substance, then the contract does not bind the entity. For example, health insurance contracts may permit an entity to re-price a contract on the basis of general market experience e.g. morbidity experience. In this case the contract boundary may not extend beyond the next reassessment date.

Measurement models

The measurement model defined by Ind AS 117 outlines a thorough and coherent framework that provides information regarding many different features of insurance contracts and the way in which the issuers of insurance contracts earn income from them.

The standard prescribes three measurement approaches of insurance contracts:

Measurement models

01 General model

Default model under the standard

It is based on the following building blocks:
- Fulfillment cash flows comprising of estimates of future cash flows, adjustment to reflect time value of money and risk adjustment for non-financial risks
- Contractual service margin representing unearned profit from the contract

If the net cash flows result in no contractual service margin, loss is recognised immediately

02 Premium allocation model

Optional simplified model for insurance contracts

Many non-life insurance products would fall under this category

Applicable for contracts wherein measurement of liability under PAA will not differ materially from the measurement under general model or applicable for contracts with coverage period of one year or less.

03 Variable fee model

Applicable to direct participating contracts

The changes in fulfillment cash flows arising from time value of money and financial risks is considered as part of variable fee for future services and recognised through contractual service margin

No interest accretion is required since the CSM is remeasured for changes in financial risks

Figure 5: Measurement models

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General model

Under the general model, the liability of a group of insurance contracts is made up of the following components.

1. The fulfilment cash flows, which represent the risk-adjusted present value of the entity's rights and obligations to the policyholders, comprising:
    - Estimates of future cash flows;
    - Discounting; and
    - Risk adjustment for non-financial risk.
2. The contractual service margin (CSM), which represents the unearned profit the entity will recognise as it provides services over the coverage period.

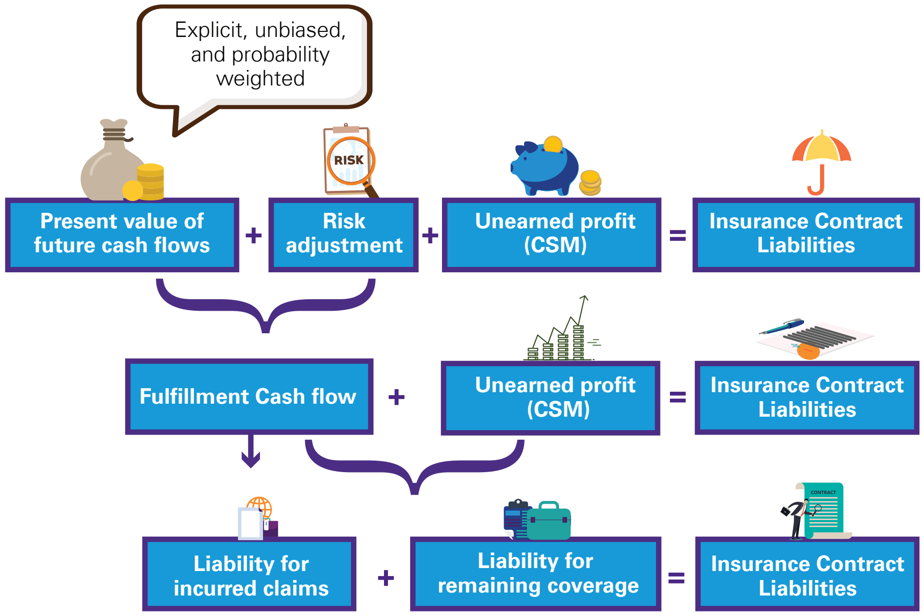


Figure 6: Overview of general model

1. Fulfilment cash flows:

A. Future cash flows

The expected present value of future cash flows is determined by:

- Developing a range of scenarios that reflects the full range of possible outcomes, in which each scenario specifies:
    - The amount and timing of the cash flows for a particular outcome; and
    - The estimated probability of the outcome; and
- applying to each scenario:
    - A discount factor to determine the present value; and
    - A weighting based on the estimated probability of the outcome.

The objective is not to develop a most likely outcome or a more-likely-than-not outcome for future cash flows.

When considering the full range of possible outcomes, the objective is to incorporate all reasonable and supportable information without undue cost or effort in an unbiased way, rather than to identify every possible scenario. Hence, it is not necessary in practice to generate explicit scenarios when determining the mean, if the resulting estimate is consistent with this objective.

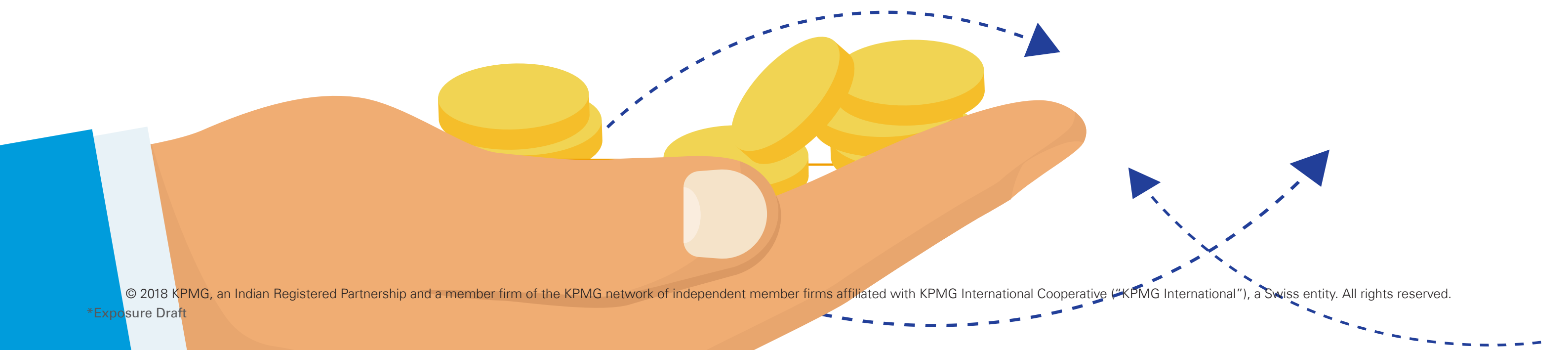
Therefore, it could be appropriate to use a small number of parameters, or relatively simple modelling, when the measurement result is within an acceptable range of precision. However, more sophisticated, stochastic modelling is likely to be needed when the cash flows and their probabilities are driven by complex underlying factors – e.g. for cash flows generated by options inter-related with the insurance coverage.

B. Discounting factor

Discounting adjusts the estimates of expected future cash flows to reflect the time value of money and the financial risks associated with those cash flows (to the extent that the financial risks are not already included in the cash flow estimates).

The discount rates applied to the estimates of expected future cash flows:

- Reflect the time value of money, the characteristics of the cash flows and the liquidity



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characteristics of the insurance contracts;

- Are consistent with observable current market prices; and
- Exclude the effects of factors that affect observable market prices used in determining the discount rate, but do not affect the future cash flows of the insurance contract.

Discount rates are determined on a basis consistent with other estimates that are used to measure the insurance contracts. For example:

- Cash flows that do not vary based on the returns on underlying items are discounted at a rate that does not reflect such variability i.e. a risk-free rate;
- Cash flows that do vary based on the returns on any financial underlying items are discounted using rates that reflect that variability (or adjusted for the effect of that variability and discounted using a rate that reflects the adjustment made);
- Nominal cash flows are discounted at a rate that includes the effect of inflation; and
- Real cash flows are discounted at a rate that excludes the effect of inflation.

C. Risk adjustment factor

Ind AS 117 does not prescribe methods for determining the risk adjustment for non- financial risk. Therefore, management judgement is necessary to determine an appropriate risk adjustment technique to use.

The risk adjustment for non-financial risk reflects:

- the degree of diversification benefit that the entity includes when determining the compensation that it requires for bearing that risk; and
- The entity's degree of risk aversion, reflected by both favourable and unfavourable outcomes.

It is important to understand that the risk adjustment for non-financial risk considers risks arising from an insurance contract other than financial risk. This includes insurance risk and other non-financial risks e.g. lapse and expense risk. Risks that do not arise from the insurance contract e.g. general operational risk are not included.

Risk adjustments for financial risk can be included in either the estimates of future cash flows or in the discount rate.

2. Contractual service margin

The final step in measuring a group of insurance contracts on initial recognition is to determine the unearned profit, represented by the CSM for profitable groups of contracts, or the loss component for groups of onerous contracts.

At each reporting date, the CSM reflects the profit in the group of insurance contracts that has not yet been recognised in profit or loss, because it relates to future service to be provided.

Therefore, the CSM is adjusted in each reporting period for an amount recognised in profit or loss to reflect the services provided under the group of insurance contracts in that period. This amount is determined by:

- Identifying the coverage units in the group;
- Allocating the CSM at the reporting date (before recognising any release to profit or loss to reflect the services provided) equally to coverage units provided in the current period and expected to be provided in the future; and
- Recognising in profit or loss the amount allocated to coverage units provided in the period.

3. Onerous contract

An onerous contract is a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it. An insurance contract is onerous at the date of initial recognition if the fulfilment cash flows, any previously recognised acquisition cash flows and any cash flows arising from the contract at the date of initial recognition in total are a net outflow. Loss is recognised in profit or loss for the net outflow for the group of onerous contracts, resulting in the carrying amount of the liability for the group being equal to the fulfilment cash flows and the contractual service margin of the group being zero.

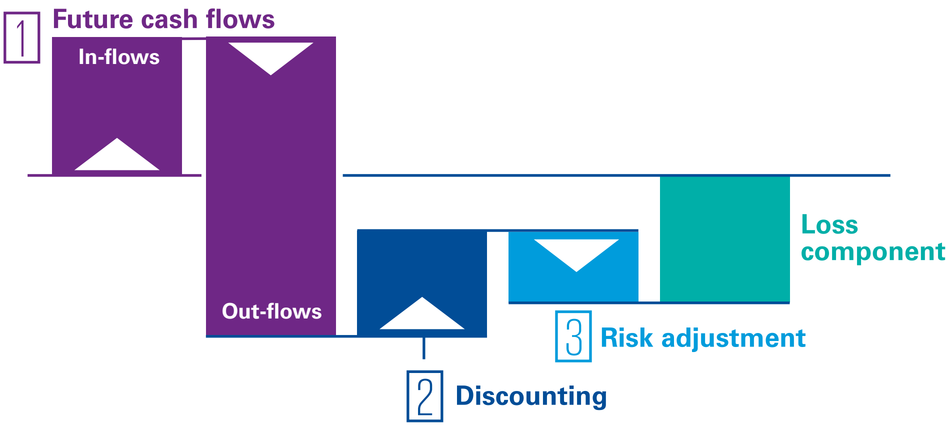

Figure 7: Initial measurement-Onerous contracts

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The loss component on onerous groups would be reversed in profit or loss as a reduction in insurance service expenses and is consequently excluded from revenue.

After the recognition of loss component of liability for remaining coverage, subsequent changes in fulfilment cash flows of the liability for remaining coverage is allocated on a systematic basis between:

- Loss component of the liability for remaining coverage and
- The liability for remaining coverage, excluding the loss component.

This systematic allocation shall result in the total amounts allocated to the loss component being equal to zero by the end of the coverage period of a group of contracts. Ind AS 117 does not prescribe any methodology for systematic allocation of changes in fulfillment cash flows. However, for each period, consistent allocation methodology is to be applied.

Premium Allocation Approach

Under Premium Allocation Approach (PAA), the total carrying amount of a group of insurance contracts is made up of:

- A liability for remaining coverage, which represents the fulfilment cash flows relating to future service that will be provided under the contract in future periods and the CSM; and
- A liability for incurred claims, which represents the fulfilment cash flows related to past service for claims and expenses already incurred.

Under PAA, the general model may be simplified for certain contracts to measure the liability for remaining coverage. Generally, PAA measures the liability for remaining coverage as the amount of premiums received net of acquisition cash flows paid, less the amount of premiums and acquisition cash flows that have been recognised in profit or loss over the expired portion of the coverage period based on the passage of time.

PAA assumes that recognising the contract's premium over the coverage period provides similar information and profit patterns to those provided by recognising insurance contract revenue measured using the general model.

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Generally, PAA shares some similarities with the current accounting model for short-duration contracts. However, some of the specific guidance in Ind AS 117 introduces new practices and challenges, even for entities that currently use a similar methodology.

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General Measurement Model under Ind AS 117 is a completely new way of recognising insurance liability in the financial statements. The recognition of CSM and its amortisation over the coverage period is likely to significantly change the way profit is recognised for a long duration life insurance contract.

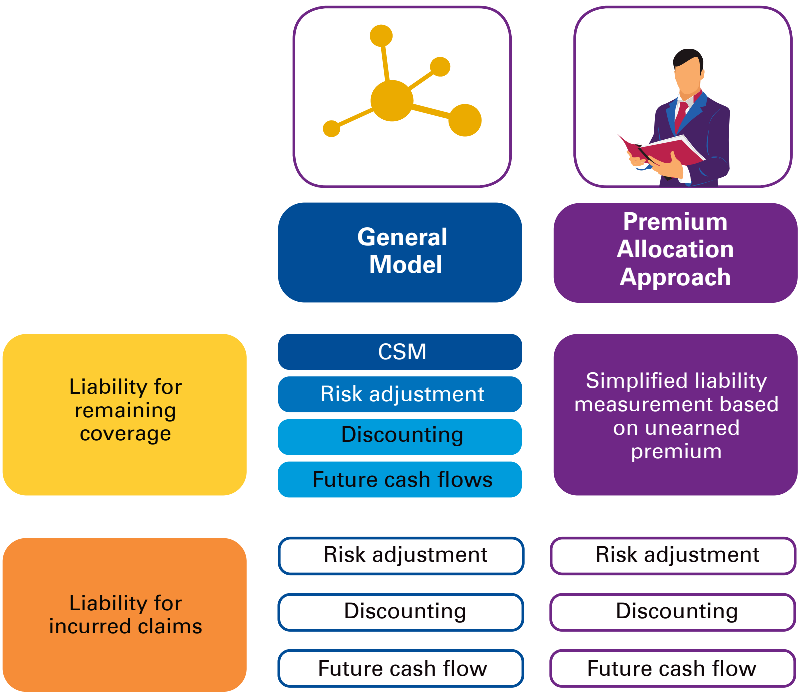

Figure 8: Comparison of general model with premium allocation approach

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Variable Fee Approach

The Variable Fee Approach (VFA) modifies the treatment of CSM under the general measurement model to accommodate direct participating contracts.

Under VFA, the general measurement model is applied on initial recognition of direct participating contracts in the same way as it is applied for contracts without direct participation features. As for subsequent measurement, differences arise within the treatment of the CSM, which includes specific modifications that reflect the specific nature of direct participating contracts.

The following table shows the primary measurement differences between the general measurement model and the variable fee approach.

	General Model	Variable Fee Approach
Changes in the fulfilment cash flows arising from time value of money and financial risks.	Recognised immediately in the statement(s) of financial performance as insurance finance income or expense.	Regarded as part of the variability of the fee for future service and recognised in the CSM.
Interest rate accreted to the CSM.	Interest rate determined on initial recognition.	No explicit interest accretion is required since the CSM is effectively remeasured when it is adjusted for changes in financial risks.

Figure 9: Comparison of general model with variable fee approach

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- Under the current accounting policies the revenue generated from ULIP contracts generally increases over time. For example, if the unit fund increases annually, then the Fund Management Charges (FMC) charged to policyholders that are based on the returns of the underlying items is expected to increase over time, as more funds are managed over time.
- Under the variable fee approach, the expected profitability of the contract i.e. the CSM includes the entity's share of cash flow expectations related to funds that are expected to be received in the future. This means that the CSM reflects the expected FMC for the funds that have not yet been received by the entity. As the CSM is recognised in profit or loss as services are provided, this might result in a larger amount of expected charges being recognised in the early periods of the contract than under current practice.

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Acquisition cost

Insurance acquisition cash flows arise from selling, underwriting and starting a group of insurance contracts. These cash flows need to be directly attributable to a portfolio of insurance contracts to which the group belongs. Such cash flows include cash flows that are not directly attributable to individual contracts or groups of insurance contracts within the portfolio. Insurance acquisition cash flows:

- Can arise internally e.g. in the sales department or externally e.g. by using external sales agents.
- Include not only the incremental costs of originating insurance contracts, but also other direct costs and a proportion of the indirect costs that are incurred in originating insurance contracts.

Under Indian GAAP, insurance companies recognise all acquisition costs as an expense when they are incurred. Under Ind AS 117, insurance acquisition cash flows are included in the measurement of the insurance liability, thereby reducing the CSM recognised on initial recognition. For short-term insurance contracts (with coverage period of less than one year), the insurer may choose to expense any insurance acquisition cash flows as and when incurred.

Under general measurement approach, an entity is required to allocate part of the premium to recover acquisition costs, so that both the costs and the related revenue are recognised over the same periods and in the same pattern, based on the passage of time.

Reinsurance contracts

The initial recognition of reinsurance contracts held would depend upon the coverage period:

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- Insurance acquisition cash flows would be allocated over the period of premium recognition.
- If the coverage period of each contract in the group on initial recognition is one year or less, then an entity may choose to recognise insurance acquisition cash flows as an expense when they are incurred.
- Recognising insurance acquisition cash flows paid as assets until the related group of insurance contracts has been recognised would mean these cash flows are not recognised immediately as an expense.

– For contracts that provide proportionate coverage at the beginning of coverage period of the group of reinsurance contracts or at initial recognition of any underlying contract whichever is later.

– In all other cases from the commencement of the coverage period of the group of reinsurance contracts held.

Measurement requirements for reinsurance contracts held and issued are slightly different. Below is the summary of measurement requirements specific to reinsurance contracts held:

– Entity shall additionally include in the estimates of the present value of the future cash flows the effect of any non-performance risk by the issuer of the reinsurance contract, including the effects of collateral and losses from disputes.

– The risk adjustment for non-financial risk transferred by the holder to the issuer should also be considered.

– For reinsurance contracts held, an entity shall recognise net cost or net gain on purchasing the group of reinsurance contracts held as part of CSM unless the net cost relates to events that occurred before the purchase of the group of reinsurance contracts, in which case, the entity shall recognise such a cost immediately in profit or loss as an expense.

– Changes in fulfilment cash flows that result from changes in the risk of non-performance by the issuer of a reinsurance contract held do not relate to future service and shall not adjust the contractual service margin.

– CSM on initial recognition for a group of reinsurance contracts represents a net cost or net gain from purchasing reinsurance.

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CSM at reporting date =

- CSM at previous reporting date
- \+ Effects of new contracts added to the group
- +/- Interest accreted on the CSM during the period
- +/- Changes in fulfilment cash flows relating to future service*
- +/- Effects of currency exchange differences on the CSM
- \- Amount of CSM recognised in profit or loss because of the services received during the period

*Unless the change results from a change in the fulfilment cash flows allocated to a group of underlying insurance contracts that does not adjust its CSM.

Figure 10: CSM subsequent measurement for a reinsurance contract

KPMG in India's insights

- Determination of coverage period is important for initial recognition. Detailed evaluation of contractual terms relating to reinsurance commission should also be considered.
- Consistent assumptions should be used for measurement of reinsurance contracts held and their underlying insurance contracts.
- Reinsurance contracts held cannot be onerous.

Insurance contracts acquired

Insurance contracts issued or reinsurance contracts held in a transfer of insurance contracts that do not form a business or in a business combination, are accounted as if they were issued by the insurer on the date of the transaction. The entity identifies the groups of contracts acquired based on the level of aggregation requirements and determines the CSM for insurance contracts issued and reinsurance contracts held (unless the PAA applies) as if it entered into the contracts at the date of the transaction.

The consideration received or paid for the contracts acts as a proxy for the premiums received. However, it would exclude any consideration received or paid for any other assets and liabilities acquired in the same transaction. In a business combination, the consideration received or paid is the fair value of the contracts at that date.

KPMG in India's insights

Different accounting treatment for similar contracts depending on whether they were originally issued by the entity or acquired.

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Derecognition and modification

An entity derecognises an insurance contract when, and only when:

a. It is extinguished, i.e. when the obligation specified in the insurance contract expires or is discharged or cancelled

b. Contract is modified and subject to certain criteria

If the contract modification does not result in derecognition, it shall be accounted for as a change in estimates of fulfillment cash flows.

Contract modification is said to apply when the terms of contract are modified by way of an agreement between the parties or by way of change in regulation. The exercise of a right included in the terms of a contract is not a modification.

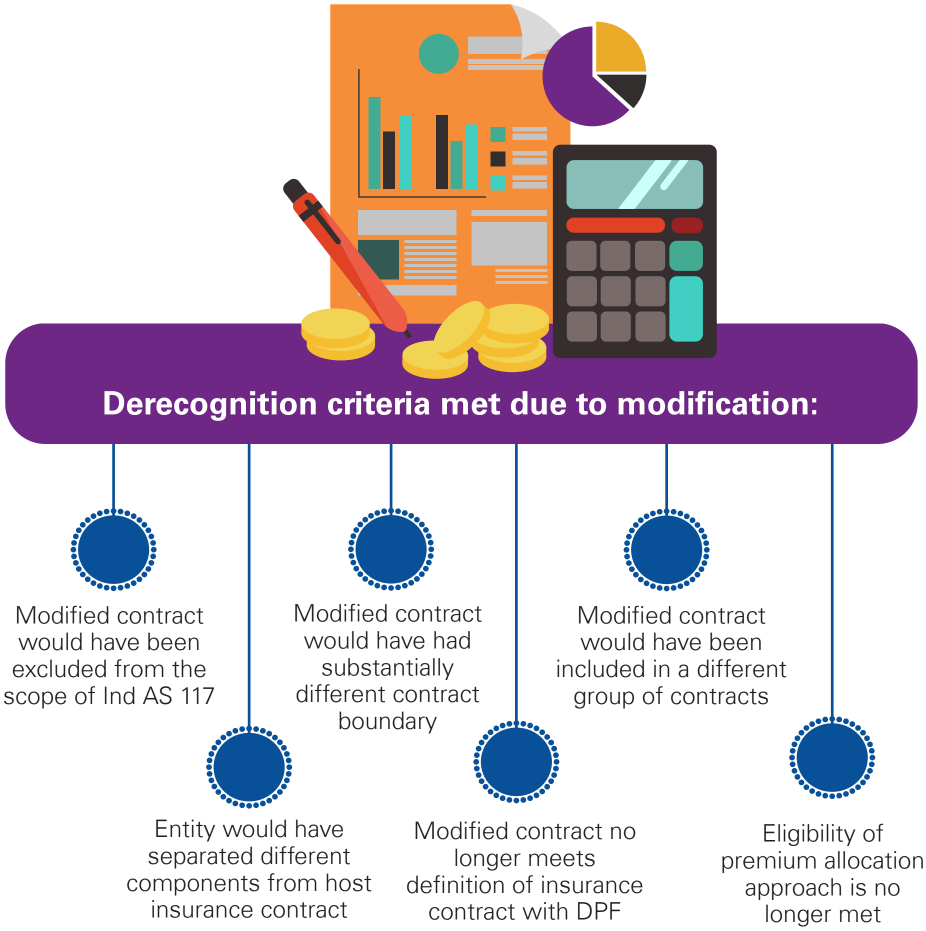

Figure 11: Derecognition criteria

KPMG in India's insights

- Derecognition as a result of a contract being transferred to a third party can result in adjustment of contractual service margin for the difference between adjustment to fulfilment cash flows and premium charged by a third party.
- Contracts derecognised from a group of contracts would not result in direct recognition of profit or loss as the change in fulfilment cash flows adjusts the CSM of the group of contracts.

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Transition requirement

Ind AS 117 has specified three broad transition arrangements for recognising the existing set of contracts.

Retrospective method is the preferred choice at the time of transition unless it is impracticable. The standard also permits use of modified retrospective and fair value approach.

Retrospective

a. Identify, recognise and measure each group of insurance contracts as if Ind AS 117 had always applied;

b. Rerecognise any existing balances that would not exist had Ind AS 117 always applied; and

c. Recognise any resulting net difference in equity.

Impracticable

Modified Retrospective Or **Fair Value Approach**

Modified Retrospective: Maximise the use of information that would have been used to apply a fully retrospective approach, but need only use information available without undue cost or effort

Fair Value Approach: Determine the contractual service margin or loss component of the liability for remaining coverage at the transition date as the difference between the fair value of a group of insurance contracts at that date and the fulfilment cash flows measured at that date

Transition will be a challenging exercise. Entities will first need to evaluate whether full retrospective application is practicable. If it is not, then they will need to go through the different choices available on the approach to apply for each relevant group of contracts. The availability of relevant information is key to these assessments.

Figure 12: Transition approaches

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Comparison between Ind AS 104 and Ind AS 117[3]

Ind AS 104	Ind AS 117
Contract classification - Investment contract or insurance contract	
Standard requires classification of contracts between insurance and investment, based on the significance of insurance risk included in the contract design. Contracts with significant risk will be considered as insurance contracts which are governed under Ind AS 104, whereas contracts with insignificant risk will be considered as investment contracts are governed under Ind AS 109. Standard does not provide any quantitative guidance for assessing the significance of insurance risk. Insurance risk is significant if, and only if, an insured event could cause an insurer to pay significant additional benefits under any scenario.	Similar to Ind AS 104 except that Ind AS 117 requires 'significant insurance risk' test would be based on present value of future potential cash flows of a particular contract not on nominal value. Contracts containing deferred payment features may fail the 'significant insurance risk' test if future potential cash flows need to be considered to compute present value.
Embedded derivative	
Ind AS 104 requires an entity to separate embedded derivatives from their host contract, measure them at fair value and include changes in their fair value in profit or loss. The standard applies to derivatives embedded in an insurance contract unless the embedded derivative is itself an insurance contract. For example - Payments under a derivative are life – contingent if they are contingent on death or contingent on survival. As an exception, an insurer need not separate, and measure at fair value, a policyholder's option to surrender an insurance contract for a fixed amount.	Similar to Ind AS 104 except that under Ind AS 117, an entity may need to assess if surrender feature in the contract will meet the definition of an embedded derivative as per Ind AS 109.

3. Exposure Draft Indian Accounting Standard (Ind AS) 117, Accounting Standards Board The Institute of Chartered Accountants of India, February 12, 2018; Insurance Contracts First Impressions IFRS 17, KPMG's Global IFRS insurance contracts leadership team , KPMG International Standards Group, July 2017

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Ind AS 104	Ind AS 117
Deferred Acquisition Cost (DAC)	
For insurance contracts, insurance companies in India usually expense acquisition costs on an accrual basis since gross premium valuation method is used for valuation of liabilities. For investment contracts, DAC may be required to be recognised and amortised as per the future revenue margins.	Measurement approach of the insurance liability under Ind AS 117 also includes insurance acquisition cash flows on initial recognition. On initial recognition, CSM is recognised net off insurance acquisition cash flows. This approach allocates the insurance acquisition cost in the same period and pattern in which revenue is recognised. Additionally, asset recoverability test or the separation of acquisition cash flows between successful and unsuccessful efforts in obtaining new business is not required under Ind AS 117. Ind AS 117 provides a policy choice for deferment of acquisition costs in case where the contract term is 12 months or less.
Unbundling of insurance contract	
Ind AS 104 requires the deposit component within an insurance contract to be unbundled and accounted for as per Ind AS 109. Standard provides guidance on circumstances where an insurer may be required, permitted or prohibited from unbundling the deposit component. **Unbundling is required if both of the following conditions are met:** 1. The insurer can measure the deposit component separately, and 2. Insurer's accounting policies do not otherwise require it to recognise all obligations arising from the deposit component. **Unbundling is permitted, but not required, if:** The insurer can measure the deposit component separately from the insurance component, but its accounting policies already require it to recognise all rights and obligations arising from the deposit component. **Unbundling is prohibited if:** The insurer cannot measure the deposit component separately	Ind AS 117 retains the principle of unbundling labeled as 'separation and disaggregation'. Key exceptions are: • Voluntarily separation is not permitted; and • Risk riders forming part and issued with the insurance contract might not be required to be unbundled. Investment components which are 'distinct' should be recorded separately and accounted as per Ind AS 109. Investment component which are non-distinct (i.e. the amount policyholders will receive from the insurer regardless of occurring of insured event) are disaggregated. Accordingly, any premiums and claims amounts related to non-distinct investment component would be recorded in the balance sheet, not in profit and loss account.
Liability Adequacy Test	
Ind AS 104 requires an insurance company to carry out a test to ensure adequacy of the insurance liabilities using current estimates of future cash flows under its insurance contracts. Adequacy of liabilities needs to be tested specially in the areas of liabilities kept for guaranteed components.	Under Ind AS 117, 'onerous contracts' recognition test needs to be applied instead of Liability Adequacy Test (LAT). 'Onerous contracts' recognition test is expected to be measured at a more granular level in comparison to LAT. This could lead to recognition of loss for certain contracts.

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Ind AS 104	Ind AS 117
Reinsurance assets and liabilities	
Insurance liabilities/policyholder liabilities, are required to be calculated gross of reinsurance with reinsurance receivables being recognised separately as reinsurance assets. Reserving may be required gross of reinsurance with a separate recognition of reinsurance assets. Impairment test needs to be performed on the reinsurance assets on each reporting date.	The general measurement model introduces significant changes to the current practice for insurance contracts issued, which are also relevant to reinsurance contracts held such as: a. More independent fulfilment cash flow measurements b. Reinsurance gain or loss is recognised over the reinsurance coverage period c. Reinsurance asset impairment included in the measurement model
Investment contracts with DPFs	
All entities are required to apply Ind AS 104 to financial instruments with DPFs, regardless of whether they also issue insurance contracts.	Under Ind AS 117, the scope is limited to investment contracts with DPFs issued by entities that also issue insurance contracts. Investment contracts with DPFs issued by entities that do not issue insurance contracts are in the scope of Ind AS 32 Financial Instruments: Presentation, Ind AS 107 Financial Instruments: Disclosures and Ind AS 109.
New business issued and business in force comparison	
Disclosure about new business issued and business in force comparison is not required.	Ind AS 117 requires entities to disclose about: • New contracts issued during the period. This disclosure would provide insight regarding – The level of aggregation applied, into the profitability and attributes of these contracts; and – Growth of an entity's insurance business. • Entity's expectation with respect to CSM recognition in future periods. This disclosure would provide details regarding the profitability pattern expected in future periods.

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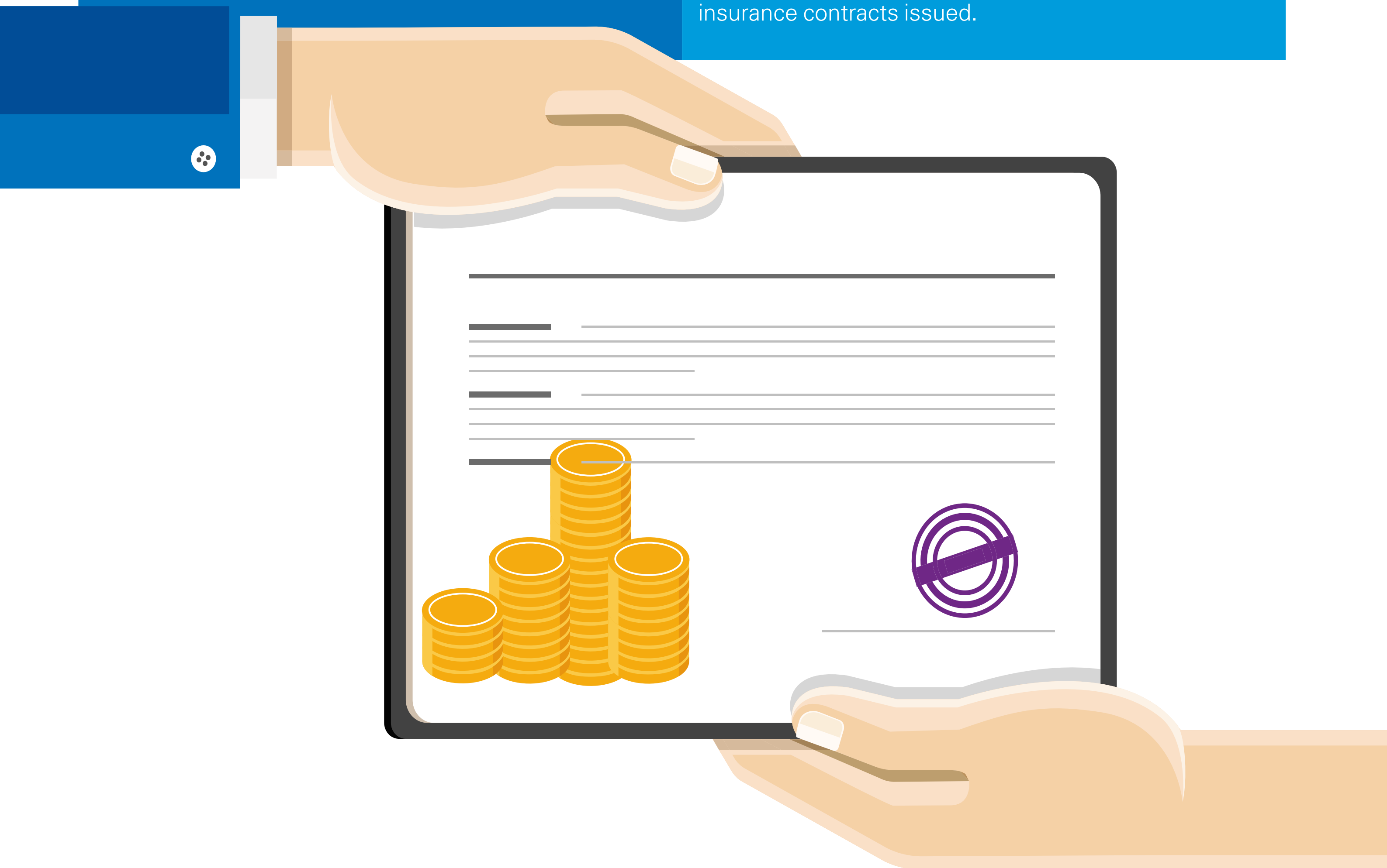
Ind AS 104	Ind AS 117
Recognition of discount rate	
Under Ind AS 104, change in insurance liability due to discount rate is recognised in profit and loss.	Under Ind AS 117, choice is available with the entity either to recognise change in discount rates in profit and loss or through Other Comprehensive Income (OCI).
Presentation	
Amounts recognised in the statement of profit or loss include: 1. Gross premium with reinsurance recoveries and reinsurance payments shown separately; 2. Investment income and net gain/loss on fair value changes and gain/loss on derecognition of financial assets at amortised cost; 3. Segregate benefits/incurred claims and change in insurance contract liabilities; Acquisition costs as an item of expense.	Amounts recognised in the statement of profit or loss and OCI are disaggregated into an insurance service result comprising insurance revenue and insurance service expenses, and insurance finance income or expense. Insurance revenue and insurance service expenses presented in profit or loss exclude any investment components - i.e. even though premiums charged may contain investment components, these investment components do not represent consideration for providing services and are not included in the insurance revenue. Income or expense from reinsurance contracts held is presented separately from expense or income from insurance contracts issued.



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Interaction with other Ind AS[4]

Ind AS 117 and Ind AS 109

Assets of insurers (and some liabilities) will be measured under the guidance of Ind AS 109, which provides classification and measurement choices such as fair value through profit and loss (FVTPL), fair value through OCI (FVOCI) or amortised cost. The implementation of Ind AS 109 and Ind AS 117 has to be in sync to reduce volatility between value of assets and liabilities. Under Ind AS 117, entities can choose to disaggregate insurance finance income or expenses between profit or loss and other comprehensive income (OCI). The accounting policy choice made by the insurer will depend on the application of the designation options under Ind AS 109. The assessment is necessary to eliminate or significantly reduce the mismatches between the measurements used for the assets held and the measurement of liability that is supported by those assets. For achieving the same, the insurer has to consider:

- The expected classification and measurement of financial assets under Ind AS 109
- The internal approach to accounting mismatches in the financial statements. For insurance companies that prefer less volatility in the profit and loss that arises between insurance liability and the assets that support it are likely to consider options that allow volatility to be presented in the OCI.

Ind AS 117 and Ind AS 115

Ind AS 117 is for insurance contracts and its application is not limited to entities that are regulated as insurers. There are instances where the risk retained by the manufacturer/ dealers/ service provider in a fixed fee service contract, meets the definition of insurance contracts. The entity may choose to account for such contracts as per Ind AS 115 if the following conditions are satisfied, this choice is irrevocable.

- The entity does not reflect an assessment of the risk associated with an individual customer in setting the price of the contract with that customer;
- The contract compensates the customer by providing services, rather than by making cash payments to the customer; and
- The insurance risk transferred by the contract arises primarily from the customer's use of services rather than from uncertainty over the cost of those services.

Ind AS 117 and Ind AS 12

While estimating the expected cash flow for existing insurance contracts, the income tax payment and receipt that an insurer does not pay or receive in a fiduciary capacity, shall be excluded. Such payment and receipt are recognised, measured and presented when applying Ind AS 12 Income Tax.

4. Exposure Draft Indian Accounting Standard (Ind AS) 117, Accounting Standards Board The Institute of Chartered Accountants of India, February 12, 2018; Insurance Contracts First Impressions IFRS 17, KPMG's Global IFRS insurance contracts leadership team , KPMG International Standards Group, July 2017

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Implementation challenges[5]

Key Impact

Business Impact

- Require adjustments to the performance management and key performance indicator framework
- Increased demand for reconciliation between multiple regulatory requirement and financial statements prepared as per Ind AS 117
- Formulate appropriate methods to explain changes in the presentation of financial results and complexity in calculation, to capital market and regulator
- Communication with investors during transitions highlighting the impact due to change in gap and related impact on business performance

Operational Impact

- Adopting actuarial modelling as per requirement of Ind AS 117 pertaining to level of aggregation, fulfilment cash flow at granular level, risk adjustment methodology and CSM.
- Model validation
- Controls to determine and place for a) financial reporting; and b) regulatory requirement

Governance

- Assess the organisational governance policy frameworks for the development, release, ongoing monitoring and use of the appropriate tools including approval, implementation, use and audit processes.
- Perform a gap analysis based on regulatory requirements and better practices.
- Draft observations on where model governance process could be improved.
- Draft recommendations on how to implement improvements.

System Impact

- More dependency on technology when implementing Ind AS 117 and Ind AS 109 is likely to transform their IT operation to outfit business goals, dynamics, accounting and regulatory pressures.

Figure 13: Impact of new insurance standard

5. Insurance Contracts First Impressions IFRS 17, KPMG's Global IFRS insurance contracts leadership team , KPMG International Standards Group, July 2017

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Financial reporting system

Ind AS 117 represents a major change from the current accounting and reporting practice for insurance contracts. Some of the key accounting and reporting changes posing significant operational challenges include accounting for onerous contracts, spreading of acquisition costs, dealing with products with embedded guarantees benefits, fulfilling additional data requirements, transition reporting on inception day, life insurance valuation method changes and interaction with Ind AS 109. The insurer needs to assess the pros and cons of disaggregation policy choice i.e. to present the insurance finance income or expense in profit or loss or disaggregate between profit or loss and OCI so that financial statement present, relevant and reliable information to the readers.

The requirement of Ind AS 117 will require a plan for the finance systems architecture aligned with the actuarial framework and supported by development of a new chart of accounts. The entity would need to capture refreshed KPIs and embed them in business as usual and in the planning/ budgeting process.

New data, systems, processes and control demands

Ind AS 117 requires insurers to maintain data at individual contract level and would require changes in the entity's own procedure such that sufficient statistically credible data is captured and available to enable an entity to measure liabilities as required by the new standard. The requirement of a new measurement model for insurance contracts requires an entity to combine the accounting, actuarial, IT and data management system. The new data and updated systems and processes will pose a challenge given the long time horizon over which many insurers operate and the legacy systems that many still use. Entities will also have to upgrade existing controls for business as usual after the transition.

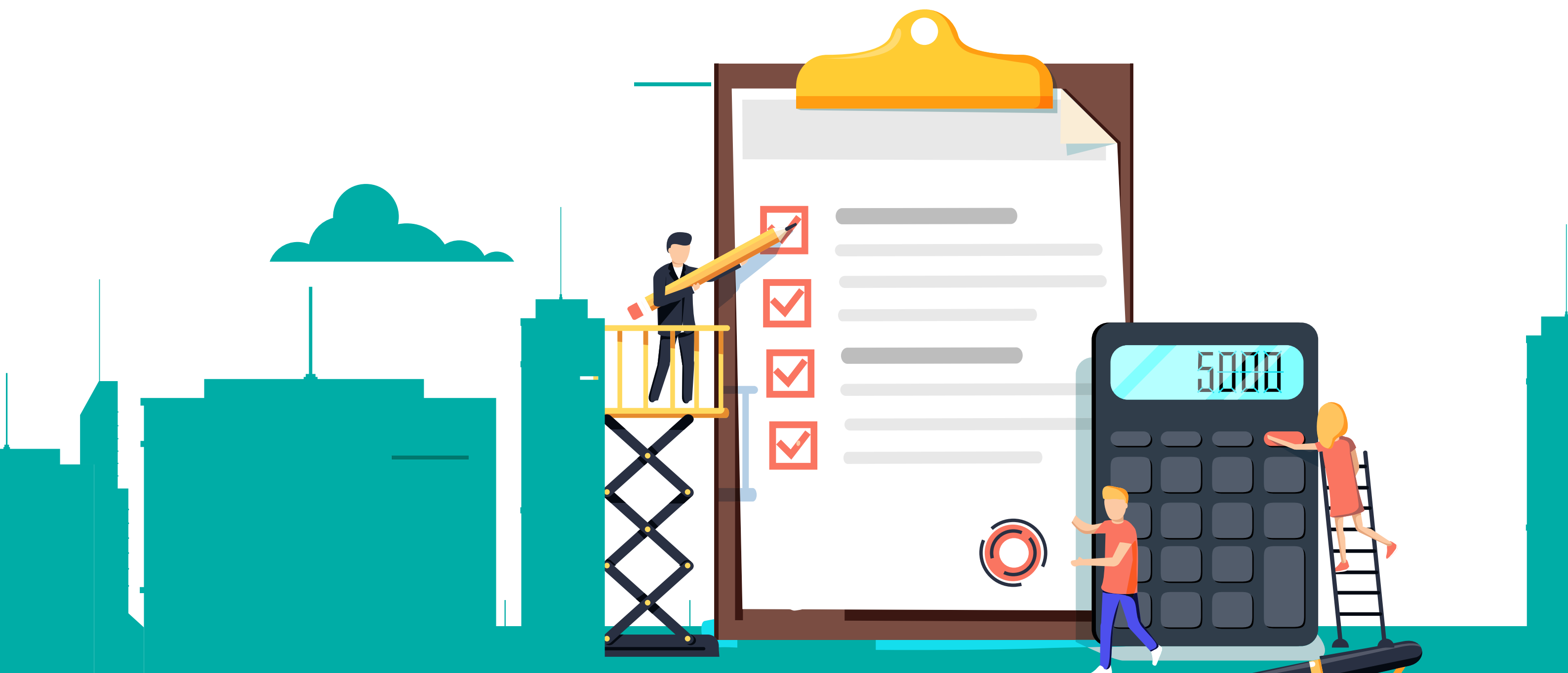
Actuarial Model

The new standard requires standardising actuarial processes and models i.e. globally consistent models, a data warehouse for analysis and reporting, centralised assumptions, controlled and documented data feeds and increased automation. The entity needs to build reusable tools and devise a methodology for data feeds and data validation.

Risk Management Framework

Ind AS 117 requires an insurer to disclose information that focusses on the insurance and financial risks (typically credit risk, liquidity risk and market risk) to enable users of its financial statements to evaluate the nature, amount, timing and uncertainty of future cash flows. In addition, insurers have to assess the information about concentration of risk and sensitivity analysis to changes in risk exposure.

To cater to these requirements, a robust risk management policy will need to be in place to identify, measure and monitor the risk factors from one period to another.



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Key issues that insurers and stakeholders need to consider as they implement Ind AS 117

Financial considerations

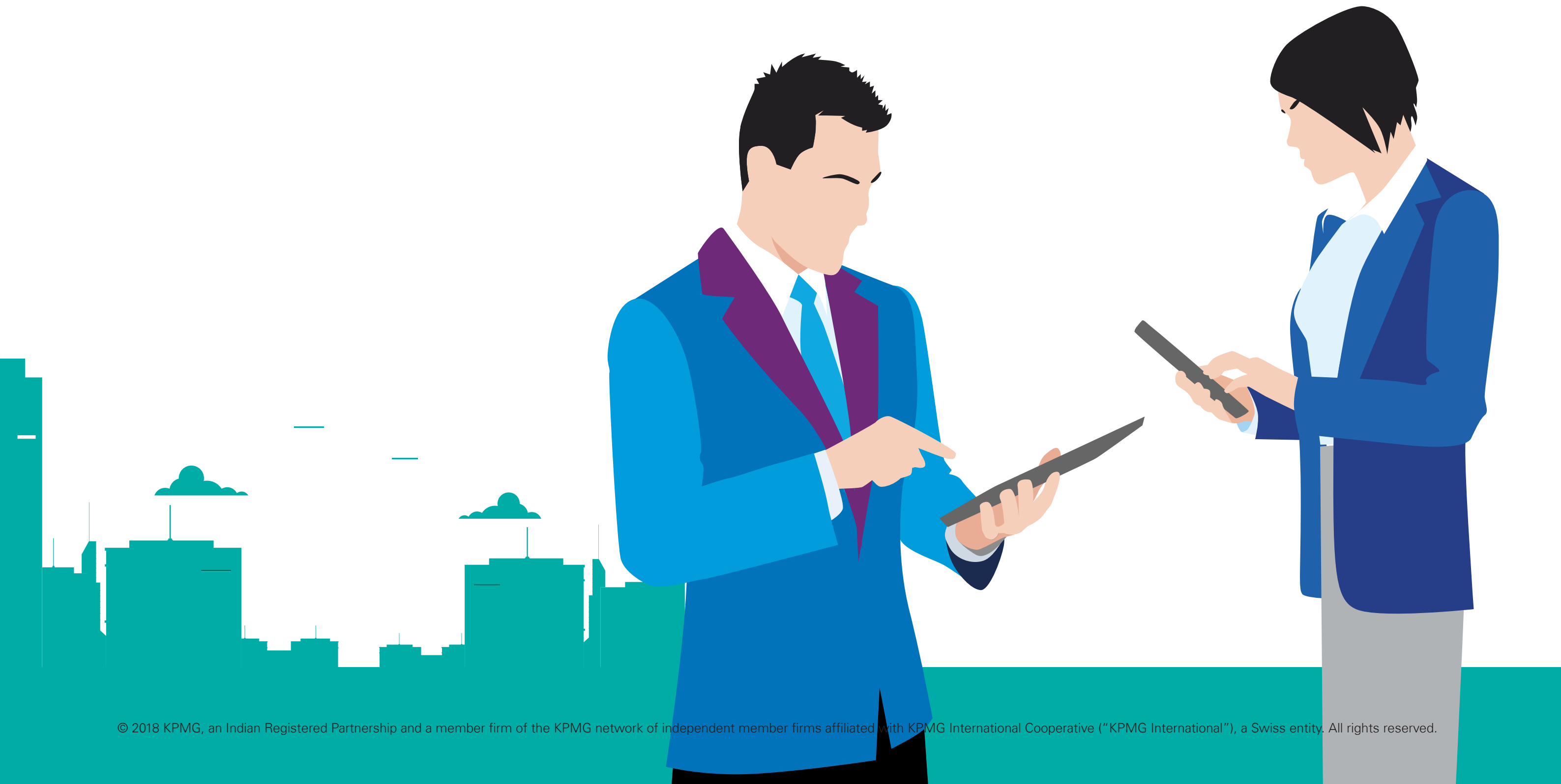
1. What options should be chosen on transition, given the impact of such options on the balance sheet?
2. How might Ind AS 117 change the way business is managed and measured in the future, including measurement of a company and executive performance?
    a. Does reported top line and bottom line need to be reinterpreted under Ind AS 117?
    b. What considerations will be relevant for measuring executive performance and remuneration? Should changes to KPIs be considered in light of Ind AS 117?
3. What would be the effect on consolidation in case where the parent company is a Bank or corporate having different Ind AS road map implementation

Considerations beyond implementation

4. What changes might be made to the insurer's business to produce a stronger, less volatile, and growing business in a post-Ind AS 117 world as profit drivers change?
    a. How do the impacts of Ind AS 117 interact with other industry changes, including reforms to distribution arrangements, statutory schemes and regulatory oversight?
    b. What changes to the business might this project facilitate that insurers have not had the time or resources to do in isolation?
    c. As processes need to change to accommodate Ind AS 117, can this also be extended to include more data analytics capabilities, automation, machine-learning, cost savings, efficiency, more advanced modelling capabilities aligned to economic and regulatory capital requirements, and simplification?

Operational considerations

5. What communications are required for analysts and regulators during a transition and subsequently?
    a. How will regulators respond to the new standard?
    b. Are insurers prepared for the potentially greater scrutiny and challenge that may eventuate, as investors have the potential to obtain a more detailed understanding of the underlying business and a greater ability to compare businesses on a global scale?



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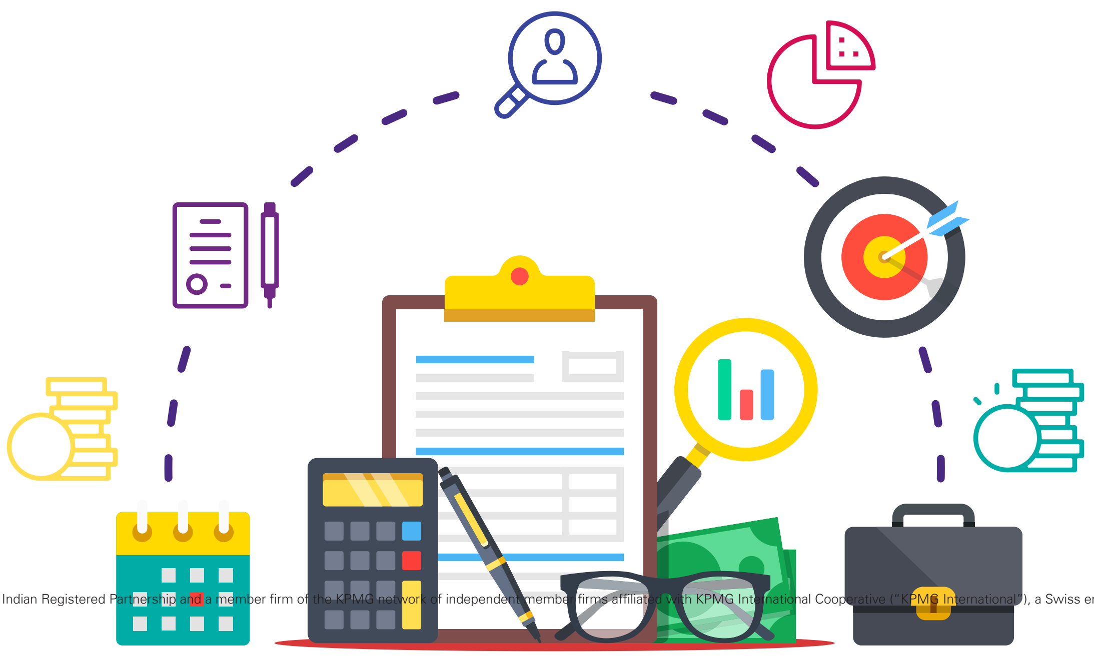
Matters for consideration

1. Ind AS 117 may change the way analysts interpret and compare insurance companies. Separation of underwriting results and investment results in the financial statement will itself give a clearer picture of the profit drivers.
2. The industry may experience significant changes in the reported top line and bottom line numbers. Premium volumes may no longer drive the 'top line' as investment components and cash received are no longer considered to be revenue. Written premiums and net margin calculations based on current revenue and cost accounting practices will be replaced by complex contract service margin (CSM) calculations based on actuarial models, risk adjustments and analysis of movements, giving possibly new insights in key performance drivers not previously disclosed. This may also have an impact on the way products are currently being priced.
3. Given the new measurement models and grouping requirement, significant system, data warehouses and valuation methodology changes will be needed to support the measurement of the insurance liabilities going forward.
4. Given that implementation of Risk Based Capital regime may be considered in India, it becomes even more important for the IRDAI and the industry to find synergies and sort out the implementation challenges well in advance. This can help reduce complexity and cost of future reporting.
5. The human talent required to operationalise Ind AS 117's requirements and translate theory into practice is significant. Accordingly, companies may have to significantly scale up their team to navigate through these challenges.
6. Ind AS 117 may trigger a second wave of activity by local tax authorities and regulators. Implementation plans need to be flexible to accommodate these second-order effects.
7. Lastly, preparing for and implementing the new standard will present challenges. It will require substantial effort, and new or upgraded systems, processes and controls. Co-ordination between functions such as Finance, Actuarial and IT will be essential, and it will be important to educate business users and investors on what to expect.



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*Exposure Draft

Glossary

Abbreviation	Definition
CSM	Contractual service margin
DAC	Deferred acquisition cost
DPF	Direct participating feature
ED	Exposure draft
FMC	Fund management charges
FVOCI	Fair value through other comprehensive income
FVTPL	Fair value through profit and loss
GPV	Gross present valuation
IASB	International Accounting Standards Board
ICAI	Institute of Chartered Accountants of India
IFRS	International Financial Reporting Standards
Ind AS	Indian Accounting Standards
IRDAI	Insurance Regulatory and Development Authority of India
IT	Information technology
LAT	Liability adequacy test
MCA	Ministry of Corporate Affairs
OCI	Other comprehensive income
P&L	Profit and loss
PAA	Premium allocation approach
RA	Risk adjusting
ULIP	Unit linked insurance plan
VFA	Variable fee approach

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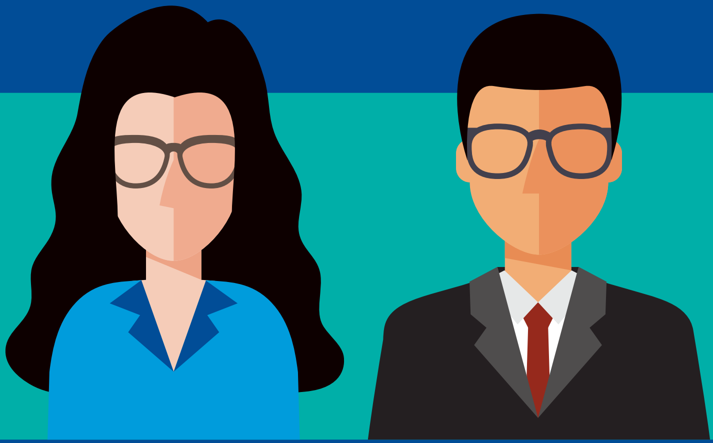

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Abhishek Agarwal
Anupriya Rajput
Anjum Tinwala
Anuj Ladha
Binay Surana
Priscilla Sundar
Sharon D'silva
Sagar Lakhani
Samrat Jha
Sourabh Mukherjee
V. Venkataramanan
Venkateswaran Narayanan

KPMG in India contacts:

Mritunjay Kapur
National Head, Markets and Strategy
Head - Technology Media and Telecom
T: +91 124 307 4797
E: mritunjay@kpmg.com

Akhilesh Tuteja
Partner and Head
Risk Consulting
T: +91 124 307 4800
E: atuteja@kpmg.com

Rajosik Banerjee
Partner and Head
Financial Risk Management
T: +91 22 3090 2707
E: rajosik@kpmg.com

Sai Venkateshwaran
Partner and Head
Accounting Advisory Services
T: +91 22 3090 2020
E: saiv@kpmg.com

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