PAPER: 03

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Potential implementation question

IFRS 17 distinguishes contracts expected to be profitable or loss making at initial measurement date. CSM will be established for a profitable contract as a measure of unearned profit while loss component is an equivalent item when a loss is expected. This relationship between the two is illustrated by the fact that CSM will only be re-established when loss component becomes zero.

Following the above logic, the factors leading to unlocking of CSM and loss component shall be highly similar. However, according to wording of the standard, the list of changes triggering adjustment of CSM in B96 (for insurance contracts without direct participation features) is not entirely the same as the one for loss component in 50(b). 50(b) is equivalent to item (b) and (d) under B96 only. The question is, shall the other items, i.e. experience variance on premium-related cash flow and investment component (B96 (a) and (c)) be considered for adjustment of loss component?

Paragraph of HKFRS/IFRS 17 *Insurance Contracts*

50 After an entity has recognised a loss on an onerous group of insurance contracts, it shall allocate:
(b) any subsequent decrease in fulfilment cash flows allocated to the group arising from changes in estimates of future cash flows relating to future service and any subsequent increases in the entity’s share in the fair value of the underlying items solely to the loss component until that component is reduced to zero. Applying paragraphs 44(c)(ii), 45(b)(iii) and 45(c)(iii), an entity shall adjust the contractual service margin only for the excess of the decrease over the amount allocated to the loss component.

B96 For insurance contracts without direct participation features, paragraph 44(c) requires an adjustment to the contractual service margin of a group of insurance contracts for changes in fulfilment cash flows that relate to future service. These changes comprise:
(a) experience adjustments arising from premiums received in the period that relate to future service, and related cash flows such as insurance acquisition cash flows and premium-based taxes, measured at the discount rates specified in paragraph B72(c);
(b) changes in estimates of the present value of the future cash flows in the liability for remaining coverage, except those described in paragraph B97(a), measured at the discount rates specified in paragraph B72(c);
(c) differences between any investment component expected to become payable in the period and the actual investment component that becomes payable in the period, measured at the discount rates specified in paragraph B72(c); and
(d) changes in the risk adjustment for non-financial risk that relate to future service.

B120 The total insurance revenue for a group of insurance contracts is the consideration for the

contracts, ie the amount of premiums paid to the entity:
(a) adjusted for a financing effect; and
(b) excluding any investment components.

Analysis of the question

There are two ways to interpret the standard:
(1) If the wording on the standard is taken at face value, the items in question, i.e. experience variance on premium-related cash flow and investment component shall not lead to any adjustment to loss component.
In this case, there are two consequences.
First, when there is variance in premium but loss component is not adjusted, the subsequent loss ratio and then revenue calculation will not reflect the variance. This means that the future revenue does not reflect a change in premium and the requirement under B120 that revenue shall be an indicator of premium (excluding loss component) is not complied to, because there is no change in revenue after a change in premium.
Another impact is potentially diverse treatments when loss component comes down to zero which is not desirable for comparison across companies:
Example: Initial loss component at 50, Impact A of 80 is eligible for unlocking loss component, and Impact B is 100 which is not eligible for unlocking loss component but eligible for unlocking CSM.
(i) Impact A is considered first, such that a CSM of 30 is established after unlocking. The CSM will then be further increased to 130 after considering Impact B.
(ii) Impact B is considered first and there is no change to loss component. Impact A is then considered such that the CSM of 30 will be established and stay there.
(2) Another more reasonable interpretation is that the criteria of unlocking CSM and loss component shall be the same. This would mean the items in question shall be considered in loss component unlocking as well, such that the revenue will remain as a measure of premium.
Also, based on this interpretation, the same result will be reached in the above example, no matter which impact is considered first. This is also consistent with the original intention of setting up loss component, which is to keep track of the (negative) profitability of the contract and help to determine the appropriate timing of re-establishing CSM. This interpretation is recommended by us.