CPA
Hong Kong Institute of
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香港會計師公會

Paper 03a

Hong Kong Insurance Implementation Support Group (HKIISG)

Submission form for potential implementation question on HKFRS/IFRS 17

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 ones for loss component in 50(b).

In particular, this question would like to explore how experience adjustments arising from premiums received in the period that relate to future service is applied to the reversal of the loss component in an onerous contract.

Paragraph of HKFRS/IFRS 17 *Insurance Contracts*

Paragraph 44 - contractual service margin
For insurance contracts without direct participation features, the carrying amount of the contractual service margin of a group of contracts at the end of the reporting period equals the carrying amount at

the start of the reporting period adjusted for:
(a) …
(b) …
(c) the changes in fulfilment cash flows relating to future service as specified in paragraphs B96–B100, except to the extent that:
(i) such increases in the fulfilment cash flows exceed the carrying amount of the contractual service margin, giving rise to a loss (see paragraph 48(a)); or
(ii) such decreases in the fulfilment cash flows are allocated to the loss component of the liability for remaining coverage applying paragraph 50(b).
(d) …
(e) …

Paragraph 45 - contractual service margin
For insurance contracts with direct participation features (see paragraphs B101–B118), the carrying amount of the contractual service margin of a group of contracts at the end of the reporting period equals the carrying amount at the start of the reporting period adjusted for the amounts specified in subparagraphs (a)–(e) below. An entity is not required to identify these adjustments separately. Instead, a combined amount may be determined for some, or all, of the adjustments. The adjustments are:
(a) …
(b) the entity's share of the change in the fair value of the underlying items (see paragraph B104(b)(i)), except to the extent that:
(i) …
(ii) …
(iii) the entity's share of an increase in the fair value of the underlying items reverses the amount in (ii).
(c) the changes in fulfilment cash flows relating to future service, as specified in paragraphs B101–B118, except to the extent that:
(i) …
(ii) …
(iii) such decreases in the fulfilment cash flows are allocated to the loss component of the liability for remaining coverage applying paragraph 50(b)
(d) …
(e) …

Paragraph 50 - onerous contracts
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.

Paragraph B96 - changes in CSM for contracts without PAR
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.

Paragraph B120 - insurance revenue
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

In order to illustrate the question, an example has been provided. Please refer to the attachment.

In summary there is a contract which is onerous at initial recognition. At the end of year 1, there is a variance of premium and as a result of the variance, the death benefit is also adjusted. For the ease of illustration, no discounting, CSM amortisation and risk adjustment are assumed.

Loss component at initial recognition = -20
Variance in premium @ year 1 = -30
Variance in fulfillment of fulfillment cash flows resulting from the variance of premium @ year 1 = -60

There are two ways to interpret the standard:
View A
If the wording on the standard is taken at face value, the items in question, i.e. experience variance on premium-related cash flow shall not lead to any adjustment to loss component. The CU30 will be taken to P/L directly.
As for the CU60 variance in fulfillment cash flows, the first CU20 will be utilised to reverse the loss

component and the remaining CU40 will be used to set up CSM.

View B
Both variance in premium and the resulting death benefits are used to reverse the loss component before setting up the CSM (-20-30+60 = 10). CU10 of CSM is set up.

Interpretation:
View A leads to a result depending on timing of variances. Imagine if the variance in premium occurs when a CSM is already re-established, the variance will be considered in CSM and the ending balance of CSM will be different from the case in View A

Also under view A, the total insurance revenue is the changes in the carrying amount of the liability for remaining coverage CU160 plus the release of CSM CU40 = CU200.

And under view B, the release of CSM is CU10 so the total insurance revenue is CU170, which is consistent with the actual premium received CU70 in first year plus CU100 in the second year.

View B is a more reasonable view on the standard, in particular it produces an insurance revenue which fits the spirit underlying B120. However, to allow variance in premium to adjust loss component would require a more relaxed interpretation of paragraph 50b) on what is "…arising from changes in estimates of future cash flows relating to future service…".