Potential implementation question

Paper 3a of the June 27 meeting dealt with the accounting of premium experience variances when the group of insurance contracts is onerous and has no CSM and the application of paragraph B96(a) that requires premium experience variances to be accounted for against the CSM.

Background scenario extracted from Paper 3a of the June 27 meeting:
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. That is, death benefit is reduced by 60.

The question is:
How do experience adjustments arising from premiums received that relate to future service, affect the loss component of a contract which was onerous at inception?

Paragraph of HKFRS/IFRS 17 *Insurance Contracts*

47 An insurance contract is onerous at the date of initial recognition if the fulfilment cash flows allocated to the contract, 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. Applying paragraph 16(a), an entity shall group such contracts separately from contracts that are not onerous. To the extent that paragraph 17 applies, an entity may identify the group of onerous contracts by measuring a set of contracts rather than individual contracts. An entity shall recognise a loss 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.

48 A group of insurance contracts becomes onerous (or more onerous) on subsequent measurement if the following amounts exceed the carrying amount of the contractual service margin:
(a) unfavourable changes in the fulfilment cash flows allocated to the group arising from changes in estimates of future cash flows relating to future service; and
(b) for a group of insurance contracts with direct participation features, the entity’s share of a decrease in the fair value of the underlying items.
Applying paragraphs 44(c)(i), 45(b)(ii) and 45(c)(ii), an entity shall recognise a loss in profit or loss to the extent of that excess.

49 An entity shall establish (or increase) a loss component of the liability for remaining coverage for an onerous group depicting the losses recognised applying paragraphs 47–48. The loss component determines the amounts that are presented in profit or loss as reversals of losses on onerous groups

and are consequently excluded from the determination of insurance revenue.

50 After an entity has recognised a loss on an onerous group of insurance contracts, it shall allocate:
(a) the subsequent changes in fulfilment cash flows of the liability for remaining coverage specified in paragraph 51 on a systematic basis between:
(i) the loss component of the liability for remaining coverage; and
(ii) the liability for remaining coverage, excluding the loss component.
(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.

51 The subsequent changes in the fulfilment cash flows of the liability for remaining coverage to be allocated applying paragraph 50(a) are:
(a) estimates of the present value of future cash flows for claims and expenses released from the liability for remaining coverage because of incurred insurance service expenses;
(b) changes in the risk adjustment for non-financial risk recognised in profit or loss because of the release from risk; and
(c) insurance finance income or expenses.

52 The systematic allocation required by paragraph 50(a) shall result in the total amounts allocated to the loss component in accordance with paragraphs 48–50 being equal to zero by the end of the coverage period of a group of contracts.

41 An entity shall recognise income and expenses for the following changes in the carrying amount of the liability for remaining coverage:
(a) insurance revenue—for the reduction in the liability for remaining coverage because of services provided in the period, measured applying paragraphs B120–B124;
(b) insurance service expenses—for losses on groups of onerous contracts, and reversals of such losses (see paragraphs 47–52); and
(c) insurance finance income or expenses—for the effect of the time value of money and the effect of financial risk as specified in paragraph 87.

103 An entity shall separately disclose in the reconciliations required in paragraph 100 each of the following amounts related to insurance services, if applicable:
(a) insurance revenue.
(b) insurance service expenses, showing separately:
(i) incurred claims (excluding investment components) and other incurred insurance service expenses;
(ii) amortisation of insurance acquisition cash flows;
(iii) changes that relate to past service, ie changes in fulfilment cash flows relating to the liability for incurred claims; and
(iv) changes that relate to future service, ie losses on onerous groups of contracts and reversals of such losses.

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.

B121 Paragraph 83 requires the amount of insurance revenue recognised in a period to depict the transfer of promised services at an amount that reflects the consideration to which the entity expects to be entitled in exchange for those services. The total consideration for a group of contracts covers the following amounts:

(a) amounts related to the provision of services, comprising:

(i) insurance service expenses, excluding any amounts allocated to the loss component of the liability for remaining coverage;

(ii) the risk adjustment for non-financial risk, excluding any amounts allocated to the loss component of the liability for remaining coverage; and

(iii) the contractual service margin.

(b) amounts related to insurance acquisition cash flows.

B122 Insurance revenue for a period relating to the amounts described in paragraph B121(a) is determined as set out in paragraphs B123–B124. Insurance revenue for a period relating to the amounts described in paragraph B121(b) is determined as set out in paragraph B125.

B123 Applying HKFRS 15, when an entity provides services, it derecognises the performance obligation for those services and recognises revenue. Consistently, applying HKFRS 17, when an entity provides services in a period, it reduces the liability for remaining coverage for the services provided and recognises insurance revenue. The reduction in the liability for remaining coverage that gives rise to insurance revenue excludes changes in the liability that do not relate to services expected to be covered by the consideration received by the entity. Those changes are:

(a) changes that do not relate to services provided in the period, for example:

(i) changes resulting from cash inflows from premiums received;

(ii) changes that relate to investment components in the period;

(iii) changes that relate to transaction-based taxes collected on behalf of third parties (such as

premium taxes, value added taxes and goods and services taxes) (see paragraph B65(i));
(iv) insurance finance income or expenses;
(v) insurance acquisition cash flows (see paragraph B125); and
(vi) derecognition of liabilities transferred to a third party.
(b) changes that relate to services, but for which the entity does not expect consideration, ie increases and decreases in the loss component of the liability for remaining coverage (see paragraphs 47–52).

B124 Consequently, insurance revenue for the period can also be analysed as the total of the changes in the liability for remaining coverage in the period that relates to services for which the entity expects to receive consideration. Those changes are:
(a) insurance service expenses incurred in the period (measured at the amounts expected at the beginning of the period), excluding:
(i) amounts allocated to the loss component of the liability for remaining coverage applying paragraph 51(a);
(ii) repayments of investment components;
(iii) amounts that relate to transaction-based taxes collected on behalf of third parties (such as premium taxes, value added taxes and goods and services taxes) (see paragraph B65(i)); and
(iv) insurance acquisition expenses (see paragraph B125).
(b) the change in the risk adjustment for non-financial risk, excluding:
(i) changes included in insurance finance income or expenses applying paragraph 87;
(ii) changes that adjust the contractual service margin because they relate to future service applying paragraphs 44(c) and 45(c); and
(iii) amounts allocated to the loss component of the liability for remaining coverage applying paragraph 51(b).
(c) the amount of the contractual service margin recognised in profit or loss in the period, applying paragraphs 44(e) and 45(e).

B125 An entity shall determine insurance revenue related to insurance acquisition cash flows by allocating the portion of the premiums that relate to recovering those cash flows to each reporting period in a systematic way on the basis of the passage of time. An entity shall recognise the same amount as insurance service expenses.

Analysis of the question

To reach the correct analysis of the issue we need to analyse the nature of the loss component.

IFRS 17 explains that a loss component is recognised when a group of insurance contracts is onerous and this condition means that the outflows plus risk adjustment are greater than the inflows of the group of contracts. [paragraph 47]

IFRS 17 uses the carrying amount of fulfilment cash flows and CSM to apply this fundamental principle. For example, in a single premium contract all of the inflows are already known and the onerous state is tested by remeasuring the future outflows against the carrying amount of the FCF and CSM.

IFRS 17 is also clear that the loss component subsequent measurement are only reported in P&L so that they reverse promptly the loss previously recognised. [paragraph 41(b) and 103(b)(iv)]

Given these, it is logical to conclude that the loss component comprises only outflows and a portion of the risk adjustment.

The liability for remaining coverage for a group that has a loss component will include all of the expected inflows as well as the expected outflows and risk adjustment up to the total inflows and which would be accounted for as insurance service revenue in line with B120 and subsequent paragraphs. The Loss Component would not generate any insurance service revenue.

Paper 3a of the 27 June meeting describes a situation when the expected inflows compare with a lower actual receipt of inflows in a given period, which is a negative experience variance.

The accounting would need to take into account the nature of the loss component and of the liability for remaining coverage and the principles on insurance service revenue discussed above.

Utilising the illustrative example in paper 3a of the 27 June meeting, the premium variance of -30 cannot be reported directly in P&L because it would first be reported to decrease the liability for remaining coverage [paragraph B96(a)]:

Dr Liability for remaining coverage – BEL (BS) 30
Cr Loss component – BEL (BS) 30

The insurer adjusts the loss component due to the fact that the outflows not covered by inflows are now larger. The total loss component is now 50. [paragraphs 48 & 49]

Alternatively:
The -30 premium variance increases the loss component [paragraphs 48(a) and 49]. Any changes in the loss component shall be recognised in insurance service expenses [paragraph 41(b)]. If so, then the adjustment would be:

Dr Insurance service expenses (P&L) 30
Cr Loss component – BEL (BS) 30

The insurer would then look at the change in assumptions for expected cash flows and concludes that there is a positive change of 60. This is sufficient to reverse the full loss component and then create the CSM for 10. [paragraph 50(b)]

Dr Loss component – BEL (BS) 50
Cr Changes (BEL) that relate to future service (P&L), 50

i.e. losses on onerous groups of contracts and reversals of such losses, being the total loss component of 20 at recognition & subsequent increase of 30.

As noted above, the remaining changes in the expected outflows would relate to the liability for remaining coverage and they would create a CSM balance:

Dr Liability for remaining coverage – BEL (BS) 10
Cr Liability for remaining coverage – CSM (BS) 10