<u>Paper 3 –Submission Paper: CSM calculation</u>

Potential implementation question

1. In composing the contractual service margin (CSM) for groups of contracts, any given group may include contracts that have multiple service patterns and/or cover multiple currencies. For example, any given CSM group may include:
   a) Death cover,
   b) Critical illness cover,
   c) Hospitalisation cover,
   d) Multiple currencies….

2. Where multiple services exist within a group, insurers would determine blended discount rates and coverage units with which to calculate the initial and subsequent CSM. As there is no universally agreed approach for blending them, there are several concerns in having blended assumptions:
   a) Leads to divergent practices which may not reflect the underlying economics and pricing of the products.
   b) Leads to operational complexity and challenges in determining the blending and
   c) Restricts the more granular detailed analysis of the CSM breakdown.

3. Therefore, we propose to determine the CSM at a more granular level than CSM group level, being at the level of the individual service pattern, and then aggregating to the CSM at the group level.

4. More specifically we propose to determine each CSM service component separately and amortize each component CSM based on the services provided. Each component CSM would be determined on a standalone basis and aggregated to the CSM at the group level in order to meet the requirements of IFRS 17.

5. This approach has the advantage of ease of implementation and reconciliation as the sum of the parts produces the total. Furthermore, such an approach leads to no loss of information or accuracy and allows detailed analytics to be performed.

6. For groups of contracts with multiple services, do members of HKIISG view it appropriate to determine the CSM for the group at the individual service pattern level and aggregating it to get the CSM at the group level?

<u>Hypothetical example of proposed method</u>

7. Consider the simple example below which reflects a contract containing a base life insurance product and a medical rider.

Item	Basic policy	Rider
Type	Life insurance	Medical reimbursement without annual limit
Coverage Unit	Death Benefit = sum assured ("SA") + Account Value ("AV")	Surgical Benefits * Number of policies ("NOP")
Coverage period	Whole life	YRT
Initial CSM	5,000	15,000

<u>Assumptions:</u>

- The rider is a common medical product offered in HK market, providing reimbursement per confinement on surgery, room and board etc. For simplicity, it is assumed that the 'number of policies is a reasonable proxy for coverage unit.
- The policyholder is aged 85 and the coverage period is 15 years in this illustration.

CSM release:

Time	Coverage Unit Basic	Coverage Unit Rider	Coverage Unit Aggregate	Proposed approach Basic	Proposed approach Rider	Proposed approach Aggregate
0	10,000	3,000	13,000	190	1,304	1,495
1	10,000	2,900	12,900	190	1,261	1,451
2	10,000	2,800	12,800	190	1,217	1,408
3	10,500	2,700	13,200	200	1,174	1,374
4	11,000	2,600	13,600	209	1,130	1,340
5	12,000	2,500	14,500	228	1,087	1,315
6	13,000	2,400	15,400	247	1,043	1,291
7	14,200	2,300	16,500	270	1,000	1,270
8	15,500	2,200	17,700	295	957	1,251
9	17,000	2,100	19,100	323	913	1,236
10	18,600	2,000	20,600	354	870	1,223
11	20,300	1,900	22,200	386	826	1,212
12	22,100	1,800	23,900	420	783	1,203
13	24,000	1,700	25,700	456	739	1,196
14	26,200	1,600	27,800	498	696	1,194
15	28,500	-	28,500	542	-	542
Total	N/A	N/A	N/A	5,000	15,000	20,000

Notes: Proposed approach is determined at individual service level and aggregated.

Paragraphs of HKFRS/IFRS 17 Insurance Contracts & TRG discussions

IFRS 17 paragraph B119

An amount of contractual service margin for a group of insurance contracts is recognized in profit or loss in each period to reflect the services provided under the group of insurance contracts in that period. The amount is determined by:

(a) Identifying the coverage units in the group. The number of coverage units in a group is the quantity of coverage provided by the contracts in the group, determined by considering for each contract the quantity of the benefits provided under a contract and its expected coverage duration.
(b) Allocating the contractual services margin at the end of the period (before recognizing any amounts in profit or loss to reflect the services provided in the period) equally to each coverage unit provided in the current period and expected to be provided in the future.
(c) Recognizing in profit or loss the amount allocated to coverage units provided in the period.

May 2018 Transition Resource Group ("TRG")

Meeting minutes: https://www.ifrs.org/-/media/feature/meetings/2018/may/trg-for-ifrs-17/trg-for-ifrs17-meeting-summary.pdf

The following paragraphs discussed how to determine coverage units to reflect the services provided under a group of contracts?

Paragraph 33
TRG members also observed the determination of coverage units is not an accounting policy choice but involves judgment and estimates to best achieve the principle of reflecting the services provided in each period. Those judgments and estimates should be applied systematically and rationally.

Paragraph 35
In considering how to achieve the principle, TRG members observed:

a) the period in which an entity bears insurance risk is not necessarily the same as the insurance coverage period.
b) expectations of lapses of contracts are included in the determination of coverage units because they affect the expected duration of the coverage. Consistently, coverage units reflect the likelihood of insured events occurring to the extent that they affect the expected duration of coverage for contracts in the group.
c) because the objective is to reflect the insurance services provided in each period, different levels of service across periods should be reflected in the determination of coverage units.
d) determining the quantity of benefits provided under a contract requires an entity to consider the benefits expected to be received by the policyholder, not the costs of providing those benefits expected to be incurred by the entity.
e) a policyholder benefits from the entity standing ready to meet valid claims, not just from making a claim if an insured event occurs. The quantity of benefits provided therefore relates to the amounts that can be claimed by the policyholder.
f) different probabilities of an insured event occurring in different periods do not affect the benefit provided in those periods of the entity standing ready to meet valid claims for that insured event. Different probabilities of different types of insured events occurring might affect the benefit provided by the entity standing ready to meet valid claims for the different types of insured events.
g) IFRS 17 does not specify a particular method or methods to determine the quantity of benefits. Different methods may achieve the objective of reflecting the services provided in each period, depending on facts and circumstances.
h) The following methods might achieve the objective if they are reasonable proxies for the services provided under the group of insurance contracts in each period:
   (i) a straight-line allocation over the passage of time, but reflecting the number of contracts in a group.
   (ii) a method based on the maximum contractual cover in each period.
   (iii) a method based on the amount the entity expects the policyholder to be able to validly claim in each period if an insured event occurs.
   (iv) methods based on premiums. However, premiums will not be reasonable proxies when comparing serviced across periods if they are receivable in different periods to those in which insurance serviced are provided, or reflect different probabilities of claims for the same type of insured event in different periods rather than different levels of service of standing ready to meet claims. Additionally, premiums will not be reasonable proxies when comparing contracts in a group if the premiums reflect different levels of profitability in contracts. The level of profitability in a contract does not affect the services provided by the contract.
   (v) methods based on expected cash flows. However, methods that result in no allocation of the contractual service margin to periods in which the entity is standing ready to meet valid claims do not meet the objective.

Analysis of question

8. Possible ways to apply IFRS 17:
   Option A: CSM must be determined at the CSM grouping level allowing for blended assumptions and combined coverage units.
   Option B: CSM may be determined at the standalone underlying service level reflecting the individual services provided and aggregated to the CSM coverage level.

9. Option A has limitations in that the determination of blended assumptions may be challenging, the blended service pattern may not reflect the actual coverage being provided by the contract, and the ability to analyze the underlying cash flows for each coverage service is lost.

10. Option B benefits from operational ease and a more accurate calculation. There is no loss of information under this approach. Under Option B, the CSMs of the individual services are aggregated together as a proxy for the CSM of the group. As noted in the May TRG, IFRS 17 does not specify any particular approach to be used. Rather IFRS 17 requires that the outcome appropriately reflects the services being provided and suitable proxies are allowed if they achieve this objective.

11. In addition, contracts in different currencies may fall into the same CSM at the group level e.g. contracts may be issued in both HKD and USD but are otherwise be the same. Determining a suitable coverage unit and discount rate and tracking the currency impacts is complex under Option A. Option B is well suited to handle multi-currency coverages given the granular level of the calculations.

<u>Conclusion</u>

12. Option B provides a method of calculation which more accurately reflects the underlying economics of the underlying business, with no loss of information. That is, Option B allows the most appropriate reflection of the services being provided. Option B also allows improved analysis of the business.