PAPER 5

To: Hong Kong Insurance Implementation Support Group ("HKIISG")

From: Douglas Mason & Sai-Cheong Foong

Date: 10 April 2019

Subject: HKIISG cover note – coverage units for groups of contracts with multiple services

1. Background

During the January 2019 HKIISG meeting, AIA presented Paper 3 'CSM Calculation' covering a proposed method for determining coverage units for groups of contracts with multiple services.

As noted in the HKIISG minutes (found here) there were mixed industry views on the paper including:

- There was some support for the paper given its operational simplification and easy of understanding.
- Some questions on whether the approach was in-line with the Standard, specifically whether the CSM is a proxy for services provided and the notional unbundling of the components.
- Alternative approaches were mentioned as being in development.

The actions/conclusion from the January 2019 HKIISG were for more clarification and justification of the approach to be given.

This cover note provides detail of developments on the paper since the January 2019 submission and the attaching papers provides the updated submission for discussion at the HKIISG.

2. Developments

The submission paper has been expanded and clarified since the January submission to include more specific examples of the approach and to clarify the facts and circumstances in which it would apply.

It should be noted that the proposed approach is just one way in which to determined coverage units for groups of contracts with multiple services and does not prohibit or restrict other approaches. Indeed the IFRS 17 Standard is principles based and does not prescribe particular approaches or techniques that should be used.

Alternative approaches
During the January 2019 HKIISG, some members highlighted alternative approaches that were being explored. AIA welcome any additional insights on such approaches but notes that, to date, there are not known solutions that have been operationalised.

Notional unbundling of the components
Some of the concerns raised during the January 2019 HKIISG noted that the IASB had not intended for the CSM to be componentised and further that the approach represented a separation of contracts. The approach set out in the attached paper has been presented to the IASB (one board member and two staff members) in discussions with AIA on 3rd April 2019 during which they could find no issues or challenges to the proposed approach. To be clear, the attached paper is almost identical to that shared with the IASB and discussed in detail. The IASB had no concerns with the determination of the coverage units at the level of services provided

and then aggregating these to the group of contracts level for the circumstances set out in the paper i.e. where cash flows are independently identifiable and measurable.

Whether the CSM is a proxy for services provided
Additional comments raised by some members during the January 2019 HKIISG were surrounding why the CSM could be used as a proxy given the May 2018 TRG paper which stated that the "level of profitability in a contract does not affect the services provided by the contract.". The minutes from the HKIISG also noted that the CSM was unlikely to be an appropriate proxy unless it can be demonstrated otherwise. AIA view that the expanded paper and specifically the examples provided demonstrate circumstances whereby the CSM is a reasonable proxy for the services provided. In particular, for the examples provided the approach demonstrates that the CSM pattern is the same as that for standalone contracts providing the same services – in such examples the approach therefore provides a reasonable proxy.

3. Conclusion

In conclusion to the above, AIA submit the revised and expanded paper in conjunction with this cover note for HKIISG discussion as:

- The IASB (one board member and two staff members) had no concerns with the attached approach. The concerns raised by others on the not being in line with the Standard are viewed as being addressed;
- There remains no known viable alternative solutions to explore. This approach is just one viable approach.
- The issue remains pervasive across the industry and AIA believe that this is a practical solution that others may wish to adopt.

Implementation question – coverage units for groups of contracts with multiple services

Potential implementation question

1. IFRS17.B119 requires that an amount of the Contractual Service Margin ("CSM") for a group of insurance contracts is recognised 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 period.
    (b) allocating the CSM at the end of the period (before recognising 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) recognising in profit or loss the amount allocated to coverage units provided in the period.

2. In calculating the CSM for groups of contracts, that group may include multiple service patterns. For example, any given group of contracts may include one or more of the following:
    (a) Death cover;
    (b) Accident cover;
    (c) Critical illness cover;
    (d) Hospitalisation cover;
    (e) Investment related services;
    (f) Etc.

3. As per IFRS17.B119(a) insurers determine coverage units which consider the quantity of benefits provided. However, the multiple services that are provided within a single group of contracts may be significantly different with no common denominator and so no obvious way to combine them. For example, natural death and hospitalisation are distinct coverages and it is unclear how to determine a "blended" coverage.

4. We note that B119 requires identification of "coverage units in the group" but contains no guidance as to how to determine "blended" coverage units that apply to the group as a whole. In our proposed approach set out below we look to determine the coverage units in the group by assessing the various services provided.

5. The IASB TRG May 2018 meeting summary concluded that IFRS 17 does not specify a particular method or methods to determine the quantity of benefits in determining coverage units. It was noted that different methods may achieve the objective of reflecting the services provided in each period, depending on facts and circumstances.

6. We would therefore like to explore potential permissible approaches that could be used to determine the coverage units for groups of contracts where the constituent components provide multiple coverages. We understand that in a principle-based standard there will not be one universally agreed approach for determining the CSM pattern for groups of contracts with multiple coverages; nevertheless we believe preparers would find it helpful to explore some permissible approaches.

Proposed method: Aggregating the CSM for the individual coverages

7. For groups of contracts with multiple coverage, and specifically in scenarios where the cash flows of the service components are independently identifiable in the group of contracts, the approach we propose is to first determine an element of the CSM at the level of the individual services provided and then to aggregate the individual service CSMs to derive the CSM at the level of the group of contracts.

8. On initial recognition, the CSM for the group of contracts is the sum of the elements of the CSM for the individual components. Each of these elements is based on the corresponding, separately identifiable and measurable cash flows. The amortization of the CSM and the CSM at subsequent measurement are likewise calculated at the level of the individual components and aggregated to the level of the group of contracts.

9. The point at which the group of contracts becomes onerous and a loss is recognized would only come when the overall group becomes onerous and not when expected future cash outflows related to an individual component exceed the expected future cash inflows.

10. This proposed method is only applicable to the measurement of the CSM. There is no separation of the contract being performed rather it remains as a single contract, thereby complying with the requirements of the Standard. For example, any test for being onerous is performed at the contract level, and similarly the contract boundary assessment continues to be assessed on the contract level.

11. The current guidance on revenue recognition for insurance contracts in IFRS 17 is very high level, and so we have assessed this proposed method for consistency with IFRS 15 *Revenue from Contracts with Customers.* In such an assessment, we are taking account of the fact that the Board papers that were discussed in the January 2019 Board meeting (paper 2E, paragraphs 43-44) make reference to IFRS 15 for determining/assessing investment return services.

Alternative approaches

12. The above proposed approach is just one of a range of potential solutions. Alternative approaches include, but are not limited to, blending coverages using some form of algorithm (referred to below as 'CSM calculator'), using more homogenous groups such that multiple services do not exists in the same group, using a proxy coverage such as number of policies, or considering only the coverage unit for the predominant service.

13. Whatever approach is adopted, a key point remains that the approach must be reflective of the underlying services being provided. Our proposed approach, as demonstrated by the examples in the appendix, show that the sum of the individual service component CSMs equates to the same position as if the contracts were in different groups of contracts.

Alternative approach: Development of CSM calculator

14. It might be possible to develop algorithms for blending coverage units. However, to the best of our knowledge, no solution or agreed approach has been determined to date. The complexity of determining an algorithm, or other such blended or weighted average approach, is influenced by the fact that there a large number of different combinations of base and rider contracts and in many cases one base policy may have multiple riders attached, each with different services provided. It is not at all clear how such an algorithm could be developed and in any case finding an algorithm that works under all potential scenarios is likely to be extremely complex and may be difficult to explain to users of the financial statements.

15. It is worth observing though that a disclosure which explains that the preparer has used a complex algorithm for blending of coverages brings significant risk of mis-projection of future financials by those users thereby limiting its usefulness, especially if such algorithms vary by insurer.

Alternative approach: Increasing number of groups

16. One might also consider redefining groups to be more homogenous and to reduce the number of multiple services included in the groups. However, this will not solve the problem where multiple coverages are contained in a single contract through riders which cannot be separated. The problem is inherent in the way insurance contracts are designed. Furthermore, such an approach would potentially significantly increase the number of groups and/or portfolios and so be increasingly onerous operationally in addition to requiring excessive data and computational resources.

Implementation questions

17. Implementation question:

    (i) For groups of contracts with multiple services where the cash flows of those services are independently identifiable and measurable, do members agree that the Standard permits the CSM for a group of contracts to be determined at the individual service pattern level and aggregated to derive the CSM at the group level, provided the overarching requirements of Level of Aggregation as regards to loss recognition are followed?

    (ii) In any event, we believe preparers would find it helpful if the IASB could compile educational materials setting forth non-binding examples of the application of the IFRS17.B119(a).

Paragraph of IFRS 17 *Insurance Contracts*

18. 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.

19. IFRS 17 paragraph BC279

The Board noted that an entity provides this service over the whole of the coverage period, and not just when it incurs a claim. Consequently, IFRS 17 requires the contractual service margin to be recognised over the coverage period in a pattern that reflects the provision of coverage as required by the contract. To achieve this, the contractual service margin for a group of insurance contracts remaining (before any allocation) at the end of the reporting period is allocated over the coverage period in the current period and expected remaining future coverage, on the basis of coverage units, reflecting the expected duration and quantity of benefits provided by contracts in the group.

20. 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.

21. IASB Meeting January 2019 Agenda Paper 2E

Paragraph 42
Including an investment return service in addition to insurance coverage services in the determination of coverage units adds subjectivity and complexity to that determination. An entity would have to

assess the relative weighting of the benefits of the investment return service and the insurance coverage services, and the pattern of delivery of these services.

Paragraph 43
An entity is already required to make similar assessments for contracts under the variable fee approach, and for contracts applying the general model which provide more than one type of insurance coverage. As noted in Agenda Paper 2B for the June 2018 Board meeting in relation to the variable fee approach, practice will develop as IFRS 17 is implemented. The staff observe similar assessments are required in applying IFRS 15 *Revenue from Contracts with Customers* and guidance in that Standard considers potential or actual transaction prices services had they been offered on a standalone basis. The staff note that in practice, a similar type of analysis may be helpful in identifying whether an investment return service exists and the relative benefits for the policyholder. However, the staff do not recommend developing further guidance in IFRS 17 on how to make such assessments at this time, for the same reasons set out in paragraph 38-39 of this paper in relation to criteria or an objective for when an investment return service exists. Instead, the staff recommend requiring the assessments to be made on a systematic and rational basis, consistent with TRG members' observations on the determination of insurance coverage units.

22. IFRS 15 Revenue from Contracts with Customers

Paragraph 73
The objective when allocating the transaction price is for an entity to allocate the transaction price to each performance obligation (or distinct good or service) in an amount that depicts the amount of consideration to which the entity expects to be entitled in exchange for transferring the promised goods or services to the customer.

Paragraph 76
To allocate the transaction price to each performance obligation on a relative stand-alone selling price basis, an entity shall determine the stand-alone selling price at contract inception of the distinct good or service underlying each performance obligation in the contract and allocate the transaction price in proportion to those stand-alone selling prices.

Analysis of the question

23. Possible ways to apply IFRS 17:

Option A: CSM must be determined at the level of the group of contracts, which means an entity needs to determine coverage units which 'blend' the individual service components of contracts.

Option B: CSM may be determined at the standalone individual service component level, where the cash flows are independently identifiable and measurable, reflecting the individual services provided and aggregated to the group of contracts level.

The appendix sets out some working examples demonstrating the proposed approach under Option B.

24. Option A has limitations in that the determination of the blended coverage unit may be challenging or may vary by insurer as there is no universally accepted approach.

25. 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 2018 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. Option B is a reasonable proxy for reflecting the services provided to the policyholder, Option B also benefits from operational ease and a more accurate calculation, whilst being easy to explain to users. There is no loss of information under this approach compared with using Option A. The examples in the appendix demonstrate that, for cases where the components are individually identifiable and measurable, the proposed approach provides a suitable proxy.

Conclusion

26. For situations where the individual services provided have cash flows that are independently identifiable, Option B provides a method of calculation which accurately reflects the individual services being provided and so the underlying economics of the business, with no loss of information or accuracy compared to option A.

27. Option B is a valid application of IFRS 17 in such circumstances.

Is the question pervasive?

28. Many preparers will be faced with challenges on how to determine the coverage units for groups of contracts with multiple services. A number of different stakeholder groups are already investigating various approaches although, to date, they have not been able to determine an approach that can be implemented. The interpretation of the Standard, particular for IFRS17.B119 is critical and has a material impact on the system solutions being developed.

Appendix: Examples on proposed approach

Example A

29. In a given year, Entity A sells two thousand, unrelated, insurance contracts being (i) a thousand base whole of life insurance policies, and (ii) a thousand base medical reimbursement policies.

30. The base life insurance policy provides a death benefit equivalent to the sum of the sum assured and an accumulated fund value. The base medical reimbursement is a common medical product offered in the Hong Kong market, providing reimbursement per inpatient hospitalisation on surgery, room and board etc.

31. Under this example the policies are separate contracts, i.e. the lapse of one has no impact on the other. The policies are priced separately and charged with different premium, cash flows are independently identifiable. The CSM on initial recognition of the life insurance policies is CU2,000 and for the medical reimbursement policies is CU1,800.

32. For the life insurance policy, the coverage unit is assessed as the death benefit provided which accumulates over time. For the medical reimbursement policy, the policy provides medical reimbursement cover which is viewed as providing a level service of cover as the benefits provided are constant throughout the policy i.e. do not vary by age or duration, and so the number of policies in force ("NOP") is used as a coverage unit. For simplicity, the coverage units are not discounted, although in practice this would likely occur.

Product Summary

Item	Policy 1	Policy 2
Type	Life insurance	Medical reimbursement
Coverage Unit	Death Benefit = sum assured ("SA") + Account Value ("AV")	Number of policies in force ("NOP")
Coverage period and contract boundary	Whole life (up to age 100)	Guaranteed renewable annually (up to age 80)
Initial CSM	CU2,000	CU1,800

Assumptions:

- The policyholders are all assumed to be a male aged 60, with projections to age 100.
- The types of contracts fall into two different groups of contracts, one for the life insurance and one for the medical reimbursement.

CSM release:

The table below shows the coverage units for the individual contracts and the proposed CSM release pattern for 5 year intervals.

Time (Years)	Coverage units		Proposed CSM Release pattern		
	Life policy (Death benefit)	Medical policy (NOP)	Life policy	Medical rider	Aggregated CSM pattern
0	4,774	1,000	6	95	101
5	19,611	951	23	90	113
10	21,372	904	25	86	111
15	27,921	860	33	81	114
20	35,869	818	42	77	119
25	45,477	-	54	-	54
30	56,843	-	67	-	67
35	73,096	-	86	-	86
40	94,645	-	111	-	111

Notes:

- The CSM pattern for the separate groups of contracts is determined on the respective coverage units. The aggregated CSM pattern for the two groups of contracts is shown.
- The NOP assume mortality, morbidity and lapse decrements, with no discounting for simplicity.
- The life insurance policies exist until age 100 while the medical policies ceases after age 80.
- The total CSM of 3,800 is released over the 40 year lifetime of the groups of contracts, with the life policies amount of CU2,000 being released over 40 years and the medical policies amount of CU1,800 being released over 20 years.

Example B

33. Entity B sells the same types of policies as Entity A above but as a base life insurance policy and a non-cancellable medical reimbursement rider, the base and rider are combined into one contract where the lapse of the base would cause the lapse of the rider. Entity B sells one thousand such contracts. The services provided by Entity B are otherwise identical to Entity A. The rider is non-compulsory, i.e. the policyholder chooses to purchase the rider together with the base policy.

34. The total CSM under the contracts is assessed on initial recognition to be CU3,800, applying IFRS 17 measurement requirements. The basic and rider are priced separately and charged with different premium, with the cash flows being independently identifiable.

Product Summary

Item	Basic policy	Rider
Type	Life insurance	Medical reimbursement
Coverage Unit	Death Benefit = sum assured ("SA") + Account Value ("AV")	Number of policies in force ("NOP")
Coverage period and contract boundary	Whole life (up to age 100)	Guaranteed renewable annually (up to age 80)
Initial CSM	CU2,000	CU1,800

Assumptions:

- The policyholders are assumed to be a male aged 60, with projections to age 100.
- The base plan and medical rider are priced separately and charged with different premium, the cash flows are independently identifiable. The total premium charged for the contract is the sum of premium of the base plan and medical rider.
- The services provided by Entity B are identical to Entity A above.

CSM release:

There is no common denominator between the coverage units of the basic and rider policy and so no clear way to determine a blended coverage unit for the total CSM. The cash flows are however separately identifiable and as such, the proposed method above is applied.

The table below shows the coverage units "in the group" for the individual components and the CSM release pattern for 5 year intervals.

Time (Years)	Coverage units		Proposed CSM Release pattern		
	Basic (Death benefit)	Rider (NOP)	Basic	Rider	Group of Contracts
0	4,774	1,000	6	95	101
5	19,611	951	23	90	113
10	21,372	904	25	86	111
15	27,921	860	33	81	114
20	35,869	818	42	77	119
25	45,477	-	54	-	54
30	56,843	-	67	-	67
35	73,096	-	86	-	86
40	94,645	-	111	-	111

Notes:

- The CSM pattern for the Group of contracts is shown above and is the sum of the individual component CSMs, where the CSM release pattern of the individual components is based on the coverage units of those respective components.
- The Basic policy exists until age 100 while the medical rider ceases after age 80.
- The NOP assume mortality, morbidity and lapse decrements, with no discounting for simplicity.
- The total CSM of 3,800 is released over the 40-year lifetime of the contract. The release is done by applying the proposed method. That is, for the individual basic and rider policies the total CSM released over the respective periods they are in force is CU2,000 and CU1,800, respectively.
- As the services provided by Entity B are identical to those by Entity A, the CSM pattern for the Group of Contracts should be identical under both examples, which is demonstrated in the results above. The proposed approach therefore provides a suitable proxy for blending the coverage units of the contract.

Example C

35. All the policyholders in Example B above, decide to lapse their rider after 5 years, whilst continuing to pay the base contract. Otherwise the experience is in line with expectations.

36. The services provided by the rider are therefore no longer provided and the unrecognized CSM must be released.

37. The table below shows the coverage units for the individual components and the proposed CSM release pattern for 5 year intervals.

Time (Years)	Coverage units		Proposed CSM Release pattern		
	Basic (Death benefit)	Rider (NOP)	Basic	Rider	Group of Contracts
0	4,774	1,000	6	95	101
5	19,611	951	23	1,336	1,359
10	21,372	-	25	-	25
15	27,921	-	33	-	33
20	35,869	-	42	-	42
25	45,477	-	54	-	54
30	56,843	-	67	-	67
35	73,096	-	86	-	86
40	94,645	-	111	-	111

Notes:

- The CSM pattern for the Group of contracts is shown above and is the sum of the individual component CSMs, where the CSM release pattern of the individual components is based on the coverage units of those respective components.
- The Basic policies exists until age 100 while the medical riders cease after 5 years due to lapse, the outstanding CSM of the riders is released.
- The NOP assume mortality, morbidity and lapse decrements, with no discounting for simplicity.
- The total CSM of 3,800 is accounted for following the proposed approach being (i) the CU2,000 from the base contracts, released over the 40 year period, (ii) CU464 released over the first 5 years of the riders, and (iii) CU1,336 released on lapse.

Coverage units and CSM release pattern

Time (Years)	Coverage units		Proposed CSM Release pattern		
	Life policy (Death benefit)	Medical (NOP)	Life policy	Medical	Aggregate (Basic + Rider)
0	4,774	1,000	6	95	101
1	8,166	990	10	94	104
2	12,127	980	14	93	107
3	16,008	970	19	92	111
4	19,809	961	23	91	114
5	19,611	951	23	90	113
6	19,415	942	23	89	112
7	19,221	932	23	88	111
8	19,352	923	23	87	110
9	21,140	914	25	86	111
10	21,372	904	25	86	111
11	22,601	895	27	85	112
12	23,859	886	28	84	112
13	25,155	878	30	83	113
14	26,562	869	31	82	113
15	27,921	860	33	81	114
16	29,468	852	35	81	116
17	30,810	843	36	80	116
18	32,254	835	38	79	117
19	34,229	826	40	78	118
20	35,869	818	42	77	119
21	37,496	-	44	-	44
22	39,510	-	47	-	47
23	41,467	-	49	-	49
24	43,655	-	51	-	51
25	45,477	-	54	-	54
26	47,760	-	56	-	56
27	50,151	-	59	-	59
28	52,559	-	62	-	62
29	55,204	-	65	-	65
30	56,843	-	67	-	67
31	59,779	-	70	-	70
32	62,957	-	74	-	74
33	66,134	-	78	-	78
34	69,531	-	82	-	82
35	73,096	-	86	-	86
36	76,944	-	91	-	91
37	81,065	-	95	-	95
38	85,270	-	100	-	100
39	89,872	-	106	-	106
40	94,645	-	111	-	111