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STAFF PAPER

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Project	Transition Resource Group for IFRS 17 *Insurance Contracts*		
Paper topic	Determining quantity of benefits for identifying coverage units		

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Introduction

1. We have received a submission about how to determine the coverage units of a group of insurance contracts. The coverage units establish the amount of the contractual service margin to be recognised in profit or loss for services provided in a period.

2. The objective of the paper is to provide background and an accounting analysis to support discussion at the Transition Resource Group for IFRS 17 *Insurance Contracts* (TRG).

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Structure of the paper

1. This paper includes the following:
   (a) background information;
   (b) implementation question; and
   (c) review of accounting requirements.
2. There is an Appendix to this paper that sets out some examples.

Background information

3. IFRS 17 requires an entity to recognise the contractual service margin of a group of insurance contracts over the coverage period of the group. The relevant paragraphs of IFRS 17 are:
   (a) Paragraphs 44(e) (and 45(e)) of IFRS 17

      [The CSM is adjusted for] the amount recognised as insurance revenue because of the transfer of services in the period, determined by the allocation of the contractual service margin remaining at the end of the reporting period (before any allocation) over the current and remaining coverage period applying paragraph B119.

   (b) Paragraph B119 of IFRS 17

      An amount of the contractual service margin 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 (see paragraphs 44(e), 45(e) and 66(e)). 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 service margin 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.

Implementation question

4. The submission asks what the definition of ‘quantity of benefits’ in paragraph B119(a) of IFRS 17 is. The submission identifies different factors that could be included in the determination of coverage units and uses seven examples to illustrate the effect of including or excluding those factors.

5. This paper considers questions relating to insurance contracts without investment components (four of the examples in the submission). We will consider questions relating to insurance contracts with investment components (the other three examples in the submission) at a later meeting. The staff think it will be easier to address those questions after the TRG has discussed the implementation of coverage units for insurance contracts without investment components.

6. The submission observes that the variety of insurance products means there are a number of issues to be addressed in determining the quantity of benefits provided by contracts in a group of insurance contracts. For example, some products provide a constant level of cover over the life of the contract (eg a death benefit of CU1m over a fixed term) whereas under other contracts the level of cover varies across periods (eg the benefit to be provided for a valid claim varies over time). In addition, some contracts lapse when an insured event occurs (for example a death benefit), whereas others continue for the contractual term unless cancelled (for example coverage for car accidents). Finally, under some contracts the likelihood of a claim varies across periods.

7. The submission therefore identifies different factors that might be included in determining the quantity of benefits arising from insurance coverage. To ease the

analysis of the application of the requirements of IFRS 17, the staff have grouped those factors as follows:

(a) variability across periods in the level of cover provided by the contracts in the group; and

(b) likelihood of an insured event occurring:

  (i) to the extent that likelihood affects the expected duration of a contract (eg expectations of lapses and cancellations); and

  (ii) to the extent that likelihood affects the amount expected to be claimed in a period.

8. Appendix A sets out the examples and different potential views given in the submission on how to determine the quantity of benefits, and hence the coverage units, in those examples. It also sets out the staff view based on the analysis below.

Review of accounting requirements

9. Paragraph B119 of IFRS 17 (reproduced above) requires the coverage units in a group to be based on the expected duration of the contracts in a group. Hence the staff think it is clear that expectations of lapses and cancellations of contracts (the factor described in paragraph 7(b)(i)) should be included in the determination of coverage units.

10. Paragraph BC279 of the Basis for Conclusions on IFRS 17 explains why IFRS 17 uses coverage units to determine the pattern of recognition of the contractual service margin in profit or loss. It states:

> As discussed in paragraph BC21, the Board views the contractual service margin as depicting the unearned profit for coverage and other services provided over the coverage period. Insurance coverage is the defining service provided by insurance contracts. 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 provided 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. The Board considered whether:

(a) the contractual service margin should be allocated based on the *pattern of expected cash flows* or on the change in the risk adjustment for non-financial risk caused by the release of risk. However, the Board decided the *pattern of expected cash flows* and the release of the risk adjustment for non-financial risk are not *relevant factors in determining the satisfaction of the performance obligation of the entity*. They are already included in the measurement of the fulfilment cash flows and do not need to be considered in the allocation of the contractual service margin. Hence, the Board concluded that coverage units better reflect the provision of insurance coverage. [Emphasis added.]

11. The staff think the rejection of the use of the pattern of expected cash flows in BC279(a) of the Basis for Conclusions on IFRS 17 indicates that expectations of the amount to be claimed in a period (the factor described in paragraph 7(b)(ii) above) are not relevant factors in the determination of the quantity of benefits.

12. That leaves the variability of the level of cover across periods (the factor in paragraph 7(a) above) to consider. The staff observe:

(a) coverage units were introduced to achieve an appropriate allocation of the contractual service margin of a group that contains contracts of different sizes. So if, for example, a group contains some contracts that offer a death benefit of CU10m and some that offer a death benefit of CU1m, the Board wanted to recognise an appropriate amount of the contractual service margin if the CU10m contracts have a different duration from the CU1m contracts. The staff think reflecting different

levels of cover across periods (for example a death benefit that fell from CU10m to CU1m over the duration of the contract) would be consistent with the principle of reflecting different levels of cover across contracts.

(b) paragraph B119 of IFRS 17 requires coverage units to be reassessed at the end of each reporting period based on the coverage provided in the period and to be provided in the future. The implied objective is to achieve an allocation of the contractual service margin over time that reflects the insurance service provided by the entity in each period.

13. The staff therefore conclude that the principle implicit in the words of IFRS 17 is that different levels of cover across periods should be included in the determination of the quantity of benefits. Practical issues are discussed in paragraph 19 below.

14. The staff also considered whether the different levels of cover across periods should reflect the contractual maximum level of cover or the level of cover reflecting expectations of events other than the likelihood of a claim. Consider the following examples:

(a) a contract provides cover for fire damage up to CU50m per year on a five year construction project. The value of the property covered is expected to increase over the 5 years. Should the coverage units expected to be provided in future periods reflect the constant CU50m limit, or the increasing value on which the entity is exposed to insurance risk?

(b) a contract provides cover for 5 years for default losses on a mortgage, after recovering the value of the property on which the mortgage is secured.[1] The balance of the mortgage will decline because of contractually scheduled payments, and cannot be increased. The staff conclusion in paragraph 13 above is that in principle the coverage units should reflect the contractually scheduled declining balance of the

[1] Assume the entity accounts for this contract under IFRS 17.

mortgage. Should they also reflect the effect of any expected increase in the value of the property on the amount of any possible claims?

(c) a contract provides health cover for 10 years for specified medical costs up to CU1m over the life of the contract, with the expected amount and expected number of claims increasing with age. The staff conclusions in paragraphs 9 and 11 above is that coverage units should reflect the likelihood of an insured event occurring to the extent it affects the expected duration of a contract but not to the extent it affects the amount expected to be claimed in a period.

15. The staff think the rejection by the Board of the use of the pattern of expected cash flows discussed in paragraphs 10 and 11 above indicates that the level of cover reflecting expected events should not be included in the determination of coverage units. Rather the benefit provided under the contract is the entity standing ready to meet the contractual maximum cover. This conclusion avoids making what seems a distinction without much substance between the expected number of claims and expected amount of claims in the example in paragraph 14(c) above.

16. Accordingly, in principle the coverage units in the examples in paragraph 14 above would reflect:

(a) example in 14(a)—the constant maximum limit of CU50 only.

(b) example in 14(b)—the declining balance of the mortgage, but not the expected value of the property.

(c) example in 14(c)—the limit of CU1m initially. The coverage units would be reassessed at each reporting date to reflect the reduction in the cover available because of claims already made.

17. Overall, the staff therefore concludes that the determination of coverage units of a group should:

(a) reflect the likelihood of an insured events occurring to the extent they affect the expected duration of contracts in the group (because of the

wording on expected duration of contracts in paragraph B119(a) of IFRS 17); and

(b) in principle reflect variability across periods in the level of cover provided by the contracts in the group (to be consistent with the treatment of contracts that provide different levels of cover), with the level of cover being the contractual maximum level of cover in each period, not the level of cover reflecting expected events (because of the rejection of the use of the pattern of expected cash flows in paragraph BC279(a) of the Basis for Conclusions on IFRS 17); but

(c) not reflect the likelihood of an insured events occurring to the extent they affect the amount expected to be claimed in a period (also because of the rejection of the use of the pattern of expected cash flows in paragraph BC279(a) of the Basis for Conclusions on IFRS 17).

18. The staff think these conclusions are supported by the words in IFRS 17 and are consistent with the explanations in the Basis for Conclusions.

19. On the variability across periods in the level of cover provided (paragraph 17(b)), from a practical perspective the staff observe:

(a) if the determination of coverage units reflects different levels of cover across periods, the only information required for the determination is the level of cover provided in the current period and expected to be provided in the future. The level of cover provided in the past is not relevant. In contrast, if the determination of coverage units does not reflect different levels of cover across periods, an entity would determine the coverage units based on the average benefits over the duration of the contract. Hence, at any point mid-contract, the entity would need to know what that average was, ie what service had already been provided in past periods, not just the service for the current period and expected to be provided in the future.

(b) if a group includes contracts with different levels of cover that vary in different ways over time, reflecting the change in levels of cover

provided by the group across periods may be more complex than using a constant level of cover for each contract determined on initial recognition (for example an average level of cover);

(c) the interaction with investment components is likely to be more complex if the quantity of benefits reflects changing levels of cover than if it reflects a constant level of cover.

20. The staff will analyse issues relating to contracts with investment components for the next TRG meeting. The staff is interested in TRG members views on the other practical aspects of reflecting different levels of cover across periods (paragraphs 19(a) and 19(b) above).

TRG Discussion

Question to TRG members

What are your views on the implementation question presented above?

Appendix A – examples

A1. This appendix sets out the examples and potential views of the requirements of IFRS 17 included in the submission. The staff have added their view of the application of their conclusions in the paper.

Example 1 Credit life insurance

A2. Credit life insurance is a life insurance policy that pays a death benefit equal to the principal and interest outstanding on a loan at the time of death. In an amortising loan, the principal will reduce contractually each period when periodic payments are made.

A3. What is the "quantity of benefits provided under a contract" in each period in a credit life insurance contract over an amortising loan?

A4. View A: The insurer is standing ready to pay a claim in the event of a death of the borrower. This is consistent over the life of the contract and therefore the quantity of benefits provided under the contract is constant over the life of the contract. As a result, the contractual service margin will be recognised in a straight line pattern over the expected duration of the contract.

A5. View B: The quantity of benefits provided under the contract is the amount of principal outstanding during each period. In effect this is a life insurance policy with a decreasing face amount. As that face amount is reduced each period and is not dependent on the probability of death, this reduction should be considered in the quantity of benefits provided in each period.

A6. View C: Either approach is acceptable under IFRS 17.

A7. Staff view: the entity is standing ready to pay an amount equal to the principal and interest outstanding on the loan because that is the contractual maximum amount. Hence the quantity of benefits should reflect the decreasing balance of

the loan. This conclusion assumes that the loan has contractual repayments and that the amount of the loan cannot be increased. (Same result as View B.)

Example 2 Reinsurance adverse development cover contract

A8. A reinsurance adverse development cover contract will pay claims in excess of a stated aggregate amount on a group of underlying property and casualty contracts where the claim event has already incurred. There may be a total aggregate limit to the amount payable under the contract. Because there is uncertainty in the ultimate amount and timing of the final settlements of the underlying claims, the insured event is the determination of the ultimate cost of settling those claims. This will also be the case in a transfer of a portfolio of insurance contracts or a business combination.

A9. What is the "quantity of benefits provided under a contract" in each period in the reinsurance adverse development cover contract?

A10. View A: The assuming reinsurer is standing ready to pay claims over the life of the contract. The unit of account is the reinsurance contract and not the underlying contracts. The total aggregate limit to the amount that could be paid is constant, either because it is stated or unlimited. Therefore the pattern of quantity of benefits is straight line over the life of the contract which would end at the date of the last expected settlement payment. If the contract has an upper limit that is expected to be reached, the expected duration would be the expected time the last cash payment would be made to reach the limit. If there is no upper limit, the expected duration would be the period to when it is expected there will be no other cash payments.

A11. View B: The quantity of benefits is coverage of underlying previously incurred claims. These claims will each be settled at points in time in the future. As the number of claims being covered will decrease over time, the quantity of benefits provided under the contract each period will also decrease. The reinsurer could establish an estimate of the total underlying direct claims settlement payments as the quantity of benefits provided by the contract. The quantity of benefits will decrease over time as underlying claims are settled, thereby resulting in a

decreasing amount of contractual service margin recognition over time. This would be similar to how the contractual service margin pattern for a group of life insurance contracts would occur which, while straight line if considered on a per contract basis, would be decreasing for the group as a whole as expected lapses and deaths decrease the coverage units in future years.

A12. View C: Either approach is acceptable under IFRS 17

A13. Staff view: the entity is standing ready to pay claims over the life of the contract. At initial recognition of the group, the contractual maximum amount that could be claimed in any period is constant. Hence the coverage units reflect a level amount of cover in each period. Nonetheless, the expected duration of the contract reflects the period over which the entity expects to make claims up to the limit. (Same as view A.) The staff observes that at each reporting date the entity will reassess the expected duration of the contract. The staff also observes that if a group includes contracts with limits of different amounts or durations, the coverage units for each contract will need to be set to in a way that captures those differences.

Example 3 Five year warranty coverage contract

A14. A five year warranty coverage contract provides for replacement of a purchased item if it fails to work properly within five years of the date of purchase. Claims are typically skewed toward the end of the coverage period as the purchased item ages. These products are typically very profitable and one would expect them to have a large contractual service margin compared to the risk adjustment when compared to other insurance contracts.

A15. Under the general model, the contractual service margin would be recognised on a straight line basis over the coverage period because the coverage units are constant (assuming the covered item purchase price is expected to be constant during the period). The risk adjustment would be recognised as risk expires.

A16. If the Premium Allocation Approach were applicable, the PAA profit pattern would differ from the general model because premium revenue would be recognised in a pattern reflecting the expected occurrence of claims if it were

determined that the release of risk was expected to differ materially from the passage of time (Similar to the current revenue recognition pattern).

A17. Staff view: the staff agree that the coverage units are constant over the periods. The staff agree that if the PAA were applied, it could give a different pattern of total profit recognition, including the release of risk, for some contracts. If that were the case, the group might not be eligible for the PAA.[2]

Example 4 Life contingent pay out annuity

A18. A life contingent pay out annuity pays a fixed monthly amount of CU10 each period until the annuitant dies.

A19. What is the quantity of benefits provided under the contract in each period?

A20. View A: There is a constant level of benefits provided over the life of the annuitant. The contractual service margin would be amortized straight line over the remaining expected life of the annuitant. That is the quantity of benefit is 10 per year, and the coverage duration is the length of time until there is zero probability of making a payment to the policyholder = 40 years. This results in 400 coverage units being provided over the entire contract. The amount of amortisation of the contractual service margin in each year is then calculated as: (opening contractual service margin + interest accretion) * (coverage units in current year / total coverage units in current and all future years).

A21. View B: The contract is a series of individual promises to pay a fixed amount at a future point in in time if the annuitant is alive at that point in time. The cumulative coverage units in the first period are the total expected dates a payment will be made. The second period cumulative coverage units would be one less coverage unit as a coverage unit expired with the reaching of the first promise to pay at a point in time. That is the quantity of benefit and coverage duration are determined together by multiplying the face amount by the

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[2] An entity would need to consider all facts and circumstances in assessing whether a group of insurance contracts qualifies for the PAA.

probability of making payment in each year (not the probability weighted cash flow).

A22. View C: Either approach is acceptable under IFRS 17

A23. Staff View: The coverage units are determined by the quantity of benefits and the expected duration. The quantity of benefits is a constant benefit of 10 per year. The expected duration is the probability-weighted average duration of the contract. (The staff does not think any of views A-C give the same result as this). The staff also observes that the expected duration, and hence coverage units, should be reassessed at each reporting date.