IFRS 17 Insurance contracts:
Ready, set ...
Implications for Hong Kong insurers
The International Accounting Standard Board (IASB or the Board) has concluded its deliberations on the new Insurance Accounting Standard, formerly referred to as IFRS 4 Phase II and now tentatively called IFRS 17 (the Standard). The Board is expected to issue the final Standard in the second quarter of 2017 and is required to be fully implemented by insurers by 2021.

This will represent the most significant change to accounting requirements ever undertaken by insurers in Hong Kong, requiring companies to entirely overhaul their financial statements and underlying actuarial models, financial reporting processes and systems. Given the scale of this change, investors and other stakeholders will want to understand the likely impact as early as possible (see Exhibit 1).

The Standard uses three different measurement approaches:

1. The Building Block Approach (BBA) for long-term contracts
2. The Premium Allocation Approach (PAA) for short-term contracts
3. The Variable Fee Approach (VFA) for direct participating contracts

The principles underlying these measurement approaches are radically different from Hong Kong’s current practices. Amongst other effects, the new requirement will:

• Change profit emergence patterns
• Increase loss recognition
• Add complexity to valuation processes, data requirements, assumption setting processes and the requirements for analyzing and communicating results

In the coming years, insurers will need to interpret and apply the new Standard to their insurance contracts and features – a process involving significant time and effort. The major change program required will extend beyond finance and actuarial teams and the expected effects will need to be communicated to a broad range of internal and external stakeholders.

In addition to the Standard, insurers will need to adapt to a wave of other accounting and regulatory changes over the next five years, including:

• IFRS 9 Financial Instruments – effective 1 January 2018
• IFRS 15 Revenue from Contracts with Customers – effective 1 January 2018
• IFRS 16 Leases – effective 1 January 2019
• Hong Kong Risk-based Capital (RBC) – expected before 2020

Given the increasing certainty of the new Standard, the anticipated scale of its changes, and the complexity of the implementation task, insurers should start formally assessing impacts and mobilizing their organizations now – starting with these seven actions.

### Exhibit 1: IFRS 17 Timing (Dec year-end)*

- **2016**: IFRS 17 Final Standard published
- **2017**: Disclosure of expected impacts of the issued, but not yet effective, Standard
- **2018**: Possible revised IFRS 9 classification from IFRS 17 transition
- **2019**: First IFRS 17 compliant financial statements
- **2020**: IFRS 17 start of comparative period
- **2021**: IFRS 17 effective date 1 Jan 2021
- **2022**: 

* Based on 2021 effective date
Hong Kong’s unique position

Hong Kong is home to the global and regional headquarters of many of the largest insurance groups in Asia-Pacific, as well as a large number of domestic life and non-life insurers. It is a mature and established market, but one with high growth rates, driven by both domestic and off-shore businesses. While the financial services sector infrastructure has long been world class, it is only recently that an independent regulator has been set up, and this body is expected to modernize the regulatory capital regime over the next few years.

This mix of characteristics means that the insurance industry in Hong Kong will face the following particular challenges when implementing the Standard:

- **Corporate complexity** – Implementation of the standard by large insurance groups will be driven from the regional or global headquarters in Hong Kong. This means that the managers of those firms will need to coordinate a large change project across various cultures, languages, time-zones, markets and regulatory frameworks. Some of the European-owned entities will already have experienced similar transitions during the Solvency II project, for others this will be the largest distributed financial transformation project they have ever undertaken.

- **Competing priorities** – The Independent Insurance Authority (IIA) will shortly take over responsibilities from the Office of the Commissioner of Insurance. It is expected that one of the first projects the IIA undertakes will be to bring Hong Kong’s regulatory capital regime in line with the International Association of Insurance Supervisors’ (IAIS) Insurance Core Principles. This change will be significant, and will occur over the same time frame as the implementation of the Standard. This will cause considerable strain on actuarial, finance and related resources, and will compete for management attention.

- **Capability and systems** – Until now, many Hong Kong based insurers have not had the need to use market consistent valuation and stochastic modeling techniques. Actuaries, accountants, system engineers and management will need to work to develop understanding and capability, and upgrade their systems to meet the requirements of the Standard.

- **Managing volatility** – Along with many other markets in Asia, Hong Kong has a limited long-term bond market. This will create challenges both in determining the yield curve used to value liabilities, and in managing economic and accounting volatility after implementing the Standard.

- **Multiple types of participating products** – Hong Kong has a mix of styles of participating products, which may qualify for different measurement models. This will make comparisons between companies and product lines difficult.
Proactive responses to IFRS 17

- Communicate early to key stakeholders, including the Board, market analysts and shareholders, providing clarity around the expected impacts to the financial statements and profit profiles
- Analyze current management reporting, key performance indicators (KPI) and incentive frameworks for continuing applicability and incorporate necessary changes for analyzing margins and volatility
- Update volatility and Asset-Liability Management (ALM) frameworks for measurement changes under IFRS 17 and assets under IFRS 9
- Monitor development of Hong Kong RBC and incorporate changes as needed
- Discuss implementation options and potential consequences with industry peer group through share forum sessions and insurance seminars
- Liaise with local regulator and professional association on interpretation and implications of the new Standard and potential impacts on local regulatory reporting requirements

CFO

- Update the Chart of Accounts (COA) and account mappings
- Update the current Balance Sheet and Profit and Loss (P&L) formats to meet new presentation requirements
- Update accounting policies and practice manuals
- Analyze closing and reporting processes, including updated closing & reporting timelines and responsibilities
- Engage with taxation authorities to discuss implications and transition approaches if taxable income calculations are based on current accounting treatments
- Design specific controls to drive new process quality, robustness and integration into existing control frameworks
- Update process and controls documentation and operating procedures
- Create new or revise existing internal (e.g., forecasts and other management reports) and external (e.g., investor and analyst packs) reporting templates
- Build in additional time to design and complete increased disclosures for each reporting period
- Focus on the auditability of reported figures – this will require a high level of interaction and consultation with the internal and external auditor during the implementation process

Controllers

- Allocate time and resources to projects to design, build and test new data, modeling, and actuarial systems capability
- Update methodology guidance for discount curve and assumption setting
- Create a new or revise the existing calculation engine for amortizing and adjusting the Contractual Service Margin (CSM)
- Work with the finance team to estimate impacts on transition
- Assist in making sure the reported figures and actuarial systems are auditable

Appointed actuary

- Assess current data availability against new data requirements for both model inputs and outputs
- Change the content and structure of data captured from business units to support group reporting
- Change the process for reporting additional data to the group reporting team
- Enhance scrutiny of data quality, storage and archiving – given the retrospective transition requirements, this should happen ahead of the date of implementation
- Enhance data reconciliation based on new data needs
- Enhance scrutiny of data governance and management (including master data management)

Operations

- Perform detailed reviews of product offerings and pricing strategy to adapt to changes in profit profiles

Underwriting

- Review investment policies and ALM strategy based on the impacts of the new measurement models for both insurance contracts and financial instruments

Investment
Transition and implementation program

In the next three years, insurers based in Hong Kong will need to implement significant technical and practical changes.

EY is already working with major insurers in Europe and Asia as they assess the technical, commercial and operational impacts of these changes, mobilize their implementation programs and, importantly, educate their stakeholders.

In our experience, proactively maintaining market confidence in an insurer's ability to smoothly execute these programs is essential.

As the Standard is finalized and the effective date approaches, external stakeholder's interest will increase. Local insurers must be prepared to educate stakeholders on the expected impacts and communicate their execution plans. This will require a well-planned program and a clear organizational view of the effects of the new Standard.

EY has the experience to help insurers assess these effects, and design and implement a cohesive and tailored conversion program – as illustrated in Exhibit 2.

Exhibit 2. IFRS 17 implementation program (illustrative)
The three measurement models

**Building Block Approach (BBA)**
- Default valuation approach
- Insurance contract valued using fulfilment cash flows – the present value of expected weighted average future cash flows, plus a risk adjustment
- Offset by the CSM, which represents unearned profit the insurer recognises as it provides services under the contract

**Premium Allocation Approach (PAA)**
- Optional simplified approach for contracts with a duration of one year or less, or where it is a reasonable approximation to BBA
- Many non-life, and some life, insurance contracts will meet these criteria
- Insurance contract valued as a pre-claims coverage liability and an incurred claims liability
- Similar approach to existing non-life insurance contract measurement

**Variable Fee Approach (VFA)**
- Applies to participating contracts, as defined by three criteria, but based on policyholders sharing in the profit from a clearly identified pool of underlying items
- Insurance contract liability based on the obligation for the entity to pay the policyholder an amount equal to the value of the underlying items, net of a consideration charged for the contract – a ‘variable fee’

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Initial questions when analyzing your contracts

1. Is this an insurance contract? If so, what is its duration?
2. Do we have non-insurance components that must be separated?
3. What additional data do we need for disclosures and presentation?
4. What are the implications for our ALM, product strategy, pricing and profit release patterns?
5. Which measurement model should we apply? What changes do we need to make to our valuation systems and processes?
6. Which transition approach should we use?
7. Do we have non-insurance components that must be separated? Are any of the contracts onerous?
8. To what extent can we group individual contracts?
Key features and challenges of the expected Standard

A marathon accounting project...

The IASB’s Insurance Contracts project has been a marathon not a sprint. However, we are now approaching the finishing line.

In 2013, the Board issued a revised exposure draft on the accounting for insurance contracts (the ED).

The IASB received extensive feedback on the ED, including concerns that it would result in:

- Volatility in results that did not appropriately reflect the underlying performance
- A profit release pattern for participating contracts that did not reflect underlying performance
- Increased complexity that outweighed benefits

In response to the industry’s concerns, the IASB recognized the need to revisit many aspects of the proposed Standard.

Its deliberations, throughout 2014, 2015 and 2016, have led to extensive changes to the proposed measurement model. On a number of topics the IASB appears to have accepted pragmatic solutions with the aim of developing a Standard acceptable to most in the international industry.

At the February 2016 IASB meeting:

- All Board members agreed that the mandatory due process in the insurance contracts project had been met.
- The Board unanimously granted the staff permission to begin the drafting process for the new Standard, without the need for re-exposure.
- None of the Board members expressed an intention to dissent from the new Standard.

At a further meeting in June 2016 the IASB decided on certain issues that arose during the drafting process:

- CSM is measured for a group of contracts after initial recognition. An entity should group together contracts which, at inception, have: (a) expected cash flows that are expected to respond similarly to changes in key assumptions; and (b) similar expected profitability.
- For contracts without direct participation features, experience adjustments and changes in estimates of present value (PV) of future cash flows (‘adjustments’) that relate to future coverage or other services adjusting the CSM. Adjustments caused by changes in financial assumptions do not affect the CSM.
- An entity has an accounting policy choice on whether to disaggregate changes in measurement of the risk adjustment between finance and underwriting components.
- If an entity disaggregates insurance finance income or expenses between P&L and Other Comprehensive Income (OCI), this should be based on a systematic allocation in P&L over the life of the contract, and requires specified disclosures.
- Reinsurance contracts issued and reinsurance contracts held by an entity are outside the scope of the VFA.
The IASB did targeted field testing of the proposed standard in a draft form with 12 participants between July and September 2016. At a meeting in November 2016 the Board took several decisions relating to issues which were raised during the field testing:

- The standard will give guidance on the level of aggregation required, moving away from the principles-based approach in the previous drafts (see section Definition and scope).
- The Board made several changes to address concerns about transition measures, including allowing entities to choose between a fair value (FV) approach and a modified (previously “simplified”) retrospective approach when a full retrospective approach is impractical.
- Some field testing respondents had difficulty in determining if a change in the estimate of the PV of future cash flows related to an experience adjustment arising in the current period or not. If it did, the combined effect of the adjustment and the directly caused change in the estimate of future cash flows should be recognized in P&L. This approach was previously viewed by the Board as an appropriate compromise that would avoid the recognition of a loss or gain in the current period and a consequential gain or loss in future periods when a claim is incurred earlier or later than expected.

However, due to the concerns raised during the subsequent editorial review, the Board has revised the tentative decision at the meeting in February 2017. For contracts measured under the general model and VFA, all changes in estimates of the PV of future cash flows arising from non-financial risks, including those that are directly caused by experience adjustments, will be adjusted against the CSM. Exceptions to this are where those changes to estimates: (i) relate to incurred claims, (ii) result in increases in the insurance liability that exceed the carry amount of the CSM or result in decreases in the insurance liability that need to be allocated to loss components (recognized in P&L in the past) in which case, the changes are recognized in P&L.

- The draft IFRS 17 permits entities to recognize the effects of changes in financial options and guarantees in P&L instead of the CSM when an entity applies the VFA and mitigates that risk with a derivative to avoid potential accounting mismatches.
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Finally the IASB agreed with the staff recommendation for the mandatory effective date of IFRS 17, i.e., an entity should apply IFRS 17 for annual periods beginning on or after 1 January 2021.

Given this timeline, insurers have expressed concern that the introduction of the new Standard will interact with the earlier introduction of IFRS 9 Financial Instruments, which becomes effective from 1 January 2018. In response, in September 2016 the Board issued amendments to the current IFRS 4, providing conditional deferral options.

The scene is now set and it is expected that IFRS 17 will be issued in the first half of 2017.

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1 EY Insurance Accounting Alert September 2016 — IASB issues amendments to IFRS 4 to address the different effective dates of IFRS 9 and IFRS 17
... leading to a new accounting landscape

The following sections take a deeper dive into the key features of the new accounting Standard (see Exhibit 3), their expected implications and implementation challenges they will present.

Exhibit 3. Key focus areas of IFRS 17

Financial instruments and other accounting changes (see page 19)
Definition and scope

Definition of an insurance contract
Since the definition of an insurance contract under the proposed Standard is unchanged from the current IFRS 4, most contracts will not be affected.

However, additional guidance on the “significant insurance risk” test states that it should be based on the present, rather than absolute value of future potential cash flows of a particular contract.

Contracts containing deferred payment features may not meet the insurance contract definition.

Implications
• More granularity in contract groupings for valuation purposes will create additional complexity to the valuation models, processes and data requirements.
• The Liability Adequacy Test (LAT) will be replaced by an “onerous contracts” recognition test. This will be measured at a more granular level than the current LAT.
• Some life insurance contracts may be considered short-term, accelerating profit recognition and amortization of acquisition costs.
• Some general insurance contracts will be considered long-term, becoming subject to a more complex valuation methodology.
• Additional guidance on the “significant insurance risk” test means contracts that are currently borderline or with deferred payment features may not meet the insurance contract definition.

Exhibit 4. Illustrative schematic of proposed level of aggregation

<table>
<thead>
<tr>
<th>Year</th>
<th>Whole of Life</th>
<th>Annuities</th>
<th>Other profitable</th>
<th>Onerous</th>
</tr>
</thead>
<tbody>
<tr>
<td>2021</td>
<td>No significant risk of becoming onerous</td>
<td>No significant risk of becoming onerous</td>
<td>No significant risk of becoming onerous</td>
<td>No significant risk of becoming onerous</td>
</tr>
<tr>
<td>2022</td>
<td>No significant risk of becoming onerous</td>
<td>No significant risk of becoming onerous</td>
<td>No significant risk of becoming onerous</td>
<td>No significant risk of becoming onerous</td>
</tr>
<tr>
<td>2023</td>
<td>Other profitable</td>
<td>Other profitable</td>
<td>Other profitable</td>
<td>Other profitable</td>
</tr>
</tbody>
</table>

Derecognition and the contract boundary
Derecognition timing and the contract boundary is critical as it determines which valuation approaches are available, the periods over which profits are released, and which future cash flows should be included for valuation purposes.

Cash flows are within the boundary of an insurance contract when the entity “can compel the policyholder to pay the premiums or has a substantive obligation to provide the policyholder with coverage or other services.”

The insurer’s substantive obligation ends when:
• “the insurer has the right or practical ability to reassess the risks of the particular policyholder and, as a result, can set a price or level of benefits that fully reflects these risks, or
• both of the following criteria are satisfied:
  • the insurer has the right or the practical ability to reassess the risk of the portfolio of insurance contracts that contains the contract and, as a result, can set a price or level of benefits that fully reflects the risk of that portfolio, and
  • the pricing of the premiums for coverage up to the date when the risks are reassessed does not take into account the risks that relate to future periods.”

This means insurers will need to assess contract boundaries for all their contracts. In Hong Kong many products have renewable features, either annually, or after a set premium payment term. Where the firm can vary the premiums at renewal as outlined above, the contract boundary may be drawn at the renewal date. If this is the case, the results will be rather different from current valuations which include cash flows beyond that point.

For contracts deemed to have a one-year boundary, acquisition costs may cause them to fail the onerous contracts test in their first year, and will accelerate amortization of their acquisition cash flows.

Some general insurance contracts, such as engineering, construction or lenders’ mortgage insurance, will have a contract boundary greater than one year and therefore may need to apply a more complex valuation approach.

2 In February 2017, the Board decided to introduce a narrow exemption: if specific constraints in law or regulations would result in contracts being recognized in different groups, they can be grouped together.
Implications

- The embedded derivative separation requirements are unchanged from current requirements.
- The investment component separation requirements are different, with no option to unbundle voluntarily, and separation and accounting under IFRS 9 required if the investment component is “distinct” from the insurance component.
- If a product provides goods and services not related to insurance risk (e.g., preventative or lifestyle benefits), separation may be required and some allocated revenue recognized under IFRS 15.
- Contract benefits will require analysis. If separation is required this will add to the data requirements and accounting complexity.

Current unbundling requirements

Under the current Standard, in certain circumstances embedded derivatives and deposit (investment) components must be unbundled from the host insurance contract and accounted for separately. In other circumstances, insurers have the option to voluntarily unbundle deposit components.

As shown in Exhibit 5, the new Standard retains the concept of unbundling, described now as “separation and disaggregation”. However, the option to voluntarily separate components has been removed, and new components have been added.

Embedded derivatives

The new Standard has retained the current requirements to unbundle (or separate) embedded derivatives, so no changes are expected in this area.

Investment components

“Distinct” investment components should be separated and accounted for in accordance with IFRS 9. An investment component is “distinct” if a contract with equivalent terms is sold, or could be sold separately in the same market or same jurisdiction, either by entities that issue insurance contracts or by other parties.

However, it is not considered distinct if the investment and insurance components are highly interrelated, i.e., if one cannot be measured without considering the other.

Performance obligations to provide goods or services

Distinct performance obligations to provide goods or services — defined with reference to IFRS 15 as “a promise in a contract with a custom to transfer a good or service to the customer” — must be separated from the host insurance contract.

However, similar to the investment component, separation is not required if the cash flows and risks associated with the goods or service are highly interrelated with the cash flows and risks associated with the insurance components in the contract.

Where goods and services are being provided outside of delivering a benefit related to insurance risk, for example preventative or lifestyle benefits, insurers may need to separate these components and account for an allocated revenue component in accordance with IFRS 15. Several companies in Hong Kong have products which include such features, and will need to treat them accordingly.

Exhibit 5. Separation and disaggregation
Building block approach (BBA)

The BBA will be the core measurement model, with the insurance contract liability comprising fulfilment cash flows and the CSM. The fulfilment cash flows include:

- The expected, probability-weighted, discounted cash flows within the contract boundary. The objective is to determine the expected value, or statistical mean, of the full range of possible scenarios, which will be discounted to PV at a discount rate that reflects the characteristics of those cash flows. This scenario-based approach is more complex than the current conservative or net premium valuation used in Hong Kong.

If the scenarios represent a symmetric distribution, then a deterministic approach may still be possible. However, the proposed discount rate will not be observable in the market. As such, it will need to be inferred from other financial instruments, applying judgement.

- A risk adjustment reflecting the level of compensation the insurer would demand for bearing the uncertainty about the amount and timing of cash flows. The technique used to determine the risk adjustment is not specified, but the result will need to be translated into a disclosed confidence level.

The CSM is the expected unearned contract profit in an insurance contract. At inception, it will be equal and opposite of the fulfilment cash flows plus pre-coverage cash flows (i.e., acquisition costs).

Interest will accrue on the CSM based on the discount rate locked in at inception. The rate will be a weighted average for each unit of account, with an allowed averaging period of up to one year. Actuaries and accountants will have to think through the mechanics of averaging and the implications for accrual, e.g., the effect of averaging on forward accrual rates.

At the November 2016 meeting the Board confirmed that the CSM for a group of contracts must be allocated over the current and expected remaining coverage period on the basis of the passage of time. The allocation must be based on coverage units, reflecting the expected duration and size of the contracts in the group. Releasing CSM on this basis is likely to lead to some unexpected profit emergence patterns.

All fulfilment cash flow assumptions will be updated each reporting period. The CSM will buffer some of this impact. Changes to estimated cash flows and the risk adjustment from non-economic assumptions about future coverage and services will be added to or deducted from the CSM with other changes released to the P&L.

The CSM mechanism means contracts will be aggregated in cohorts for individual reporting periods, as described in the section above. This is much more granular than the current practice in Hong Kong. It will complicate data and modeling, assumption setting and valuation processes, and the manner in which results are analyzed and explained.

Insurers will be able to choose whether other discount rate changes are either recognized fully in P&L or in OCI, with interest accrued to the P&L at the locked-in discount rate at inception.

Implications

- The BBA is considerably different from the current net premium valuation used in Hong Kong. The methodology will result in different profit outcomes and require new modeling, data and processes.

- Contract aggregation at a cohort level will be much more granular than the current practice. Combined with the need for probability-weighted expected cash flows, this will add significant effort and complexity to the valuation.

- Calculating the discount rate and risk adjustment will require new techniques and application of considerable judgement.

- The release of the CSM, based on the passage of time and coverage units, will give some products unexpected profit emergence patterns.
The PAA, or simplified approach, may be used where:

- The contract coverage period, including premiums within the contract boundary, is one year or less, or
- The use of the PAA produces a reasonable approximation of the BBA.

To assess whether or not the PAA can be used, insurers must first define the contract boundary, and hence the coverage period. Many non-life insurance contracts meet the first criterion by having a coverage period of one year or less. However, companies will need to demonstrate that contracts with longer coverage periods meet the second criterion. If not, they will have to use the BBA instead. Such contracts could include engineering, construction or lenders' mortgage insurance.

Non-life insurers in this scenario will need to develop more complex modeling than currently applied, requiring more data and the development of long-term assumptions. This also means insurers will present financial statements with a mix of valuation techniques, complicating the way results are analyzed and communicated.

The PAA is similar to Hong Kong’s current non-life insurance accounting and incorporates two elements to measure the insurance contract liability:

- A liability for the remaining coverage, which measures the insurer’s obligation to provide coverage to the policyholder during the coverage period.

A liability for incurred claims, which measures the insurer’s PV obligation to investigate and pay claims that have already occurred—whether reported or not. The liability for incurred claims will be calculated using the BBA methodology.

If the coverage period is less than one year, the insurer may choose to immediately expense directly attributable acquisition costs.

The liability for remaining coverage is measured by allocating contract premiums over the coverage period, with revenue recognised either:

- On the basis of the passage of time, or
- If the expected pattern of release of risk differs significantly from the passage of time, then on the basis of expected timing of incurred claims and benefits.

This revenue recognition allocation approach differs from the BBA, as it is based on the passage of time and expected number of contracts, and may generate a more appropriate profit release pattern.

For this reason, as well as the simplified measurement approach and reduced effort compared to the BBA, we expect many insurers will elect to apply the PAA where possible.
Implications

- VFA is to be used for contracts with direct participation features, representing a variation on the BBA.
- Companies will need to analyze all their participating contracts to assess whether they meet the three criteria, and hence determine which approach applies.
- This approach has generally been welcomed by the industry as it appears to lead to a more appropriate profit emergence pattern than other alternatives.
- The VFA limits the impact of market volatility in SCI as movements in shareholders' share are absorbed by the CSM and therefore spread over the remaining coverage period.

The VFA is the measurement approach for participating contracts that meet three criteria:

- The contractual terms specify that the policyholder participates in a share of a clearly identified pool of underlying items
- The entity expects to pay to the policyholder a substantial share of the returns from the underlying items
- A substantial proportion of the cash flows that the entity expects to pay to the policyholder are expected to vary with the cash flows from the underlying items

The VFA assumes that a participating contract creates an obligation for the entity to pay the policyholder an amount equal to the value of the underlying items, net of a consideration charged for the contract – a “variable fee”.

Accordingly, the entity’s interest in the contract would represent a variable fee for the service of managing the items on behalf of a policyholder.

This approach requires changes to the estimate of future fees an entity expects to earn from participating contract policyholders to be adjusted against the CSM. The CSM on direct participating contracts would be recognized in P&L as part of the entity’s underwriting results on the basis of the passage of time.

Two main differences will arise between contracts measured under the VFA versus the BBA:

<table>
<thead>
<tr>
<th>Points of difference</th>
<th>BBA</th>
<th>VFA</th>
</tr>
</thead>
<tbody>
<tr>
<td>Changes in the value of options and guarantees</td>
<td>Recognized in the statement of comprehensive income (SCI)</td>
<td>Recognized in the CSM</td>
</tr>
<tr>
<td>Interest accretion in the CSM</td>
<td>Based on a curve locked in at inception</td>
<td>Based on current market interest rates</td>
</tr>
</tbody>
</table>

Participating contracts which do not satisfy the criteria above will lead to a “cliff effect”, whereby two economically almost identical contracts may report quite different results if one qualifies for the VFA and the other does not. Given the wide range of participating products in Hong Kong, and particularly the number of products such as universal life which are likely to fall into the indirect participating bucket, we expect this to be a significant issue. It is entirely possible that two firms with different histories, selling participating products with similar benefits but different mechanics, will account for those products in very different ways.

Exhibit 8. The Variable Fee Approach (VFA)

<table>
<thead>
<tr>
<th>Continuum of insurance contracts</th>
</tr>
</thead>
<tbody>
<tr>
<td>Type of contract</td>
</tr>
<tr>
<td>Measurement</td>
</tr>
<tr>
<td>Interest expense</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Topic</th>
<th>General model</th>
<th>Variable fee model</th>
</tr>
</thead>
<tbody>
<tr>
<td>Changes in market variables</td>
<td>All changes in SCI (P&amp;L or OCI)</td>
<td>Changes in shareholder’s share (including guarantees) in CSM</td>
</tr>
<tr>
<td>Changes in market variables – when risk mitigated</td>
<td>All changes in SCI (either P&amp;L or OCI)</td>
<td>Changes in shareholder's share (excluding guarantees) in CSM, guarantees in P&amp;L</td>
</tr>
<tr>
<td>Accretion of CSM</td>
<td>Locked in rate</td>
<td>Current yield</td>
</tr>
<tr>
<td>Insurance investment expense</td>
<td>A variation of effective yield</td>
<td>Current period book yield</td>
</tr>
</tbody>
</table>
Implications

- Premium revenue will no longer appear on the face of the P&L, but will be replaced by “insurance contracts revenue”. This is calculated based on movements in a number of different elements, requiring stakeholder education about its meaning and importance.

- There is a risk that, if the new format does not provide useful information to investors, further supplementary information outside the financial statements will proliferate.

The proposed Standard includes specific requirements for presenting insurance-related balances in the financial statements. The biggest change for some insurers will be seen in the P&L, which will now separate investment performance explicitly from operating results.

Exhibit 9 provides an example showing how certain income and expense items will be presented.

An entity will be prohibited from presenting premium information in the SCI if that information is not consistent with commonly understood notions of revenue.

However, premium related information can still be disclosed in the notes to the financial statements.

Rather than premium revenue, an item called insurance contracts revenue will be shown, calculated as described in Exhibit 9. Claims and other expenses related to the insurance contracts will then be disclosed, leading to an Operating Result for the entity.

Exhibit 9. Illustrative statement of comprehensive income

<table>
<thead>
<tr>
<th>Statement of comprehensive income</th>
</tr>
</thead>
<tbody>
<tr>
<td>Insurance contracts revenue       X</td>
</tr>
<tr>
<td>Claims and expenses incurred      (X)</td>
</tr>
<tr>
<td><strong>Operating result</strong>              X</td>
</tr>
<tr>
<td>Investment income                 X</td>
</tr>
<tr>
<td>Interest expenses                 (X)</td>
</tr>
<tr>
<td><strong>Investment result</strong>             X</td>
</tr>
<tr>
<td>Other profit and loss             X</td>
</tr>
<tr>
<td>Corporate tax                     (X)</td>
</tr>
<tr>
<td>Profit after tax                  X</td>
</tr>
<tr>
<td>Other comprehensive income        (X)</td>
</tr>
<tr>
<td><strong>Total comprehensive income</strong>    X</td>
</tr>
</tbody>
</table>

- Release in CSM
- Change in risk adjustment
- Expected claims (in fulfilment cash flows)
- Expected expenses (in fulfilment cash flows)
- Allocating premium relating to the recovery of directly attributable acquisition costs
- Excluding investment components
- Actual claims incurred
- Actual expenses incurred
- Allocating premium relating to the recovery of directly attributable acquisition costs
- Onerous contracts
- Excluding investment components
- Calculated using locked-in rates (if the OCI option is selected)
- Effect of discount rate changes on fulfilment cash flows (if the OCI option is selected)
Reinsurance

Implications

- Reinsurers will measure insurance contracts issued under the standard insurance contract models (the BBA or PAA).
- Reinsurance assets and underlying direct contracts should match as cedants will use the same inputs and assumptions to value the underlying contracts and the reinsurance asset. However, some mismatches will still occur, as outlined below.

Reinsurers will measure reinsurance contracts by applying the same principles as those for all insurance contracts. As such, the requirements and observations made throughout this document apply to them as well. The exception is the VFA, which the Board has decided should not be applied by the reinsurer to business which it accepts. This may have unintended consequences, or create opportunities for innovative reinsurance structures.

On the other hand, cedants holding reinsurance contracts have particular requirements to consider:

- When measuring the reinsurance assets, cedants should use assumptions that are consistent with those used to measure the corresponding part of the underlying contracts.
- The reinsurance asset will include an allowance for reinsurance default; whereas the direct contract will not.
- The recognition requirements for insurance contracts are modified such that for retroactive contracts a negative “day one difference” (cost of reinsurance) must only be recognized immediately in P&L if it relates to past events.

- The reinsurance CSM will be released into profit only based on the passage of time; while direct contracts will be released based on both the passage of time and expected number of contracts.

These requirements will lead to a number of accounting mismatches between measurement of the reinsurance contract and that of the related direct insurance contracts.

To take an extreme example, an entity with 100% quota share reinsurance and no retained risk or profit share will still report an underwriting P&L due to accounting mismatches from one period to the next. Over the life of the contracts this will even out, but it will introduce unexpected volatility in the interim.

Exhibit 10. Reinsurance measurement for cedants

Calibrated to the reinsured portion of the premium of the (direct) insurance contract

Calibrated to the reinsured portion of the premium of the (direct) insurance contract
Transition

Implications

- If 1 January 2021 is the effective date, the opening Balance Sheet for companies with a December year end will be 1 January 2020 – less than three years away.
- Recognizing the challenges that insurers, particularly life insurers, will face in obtaining reliable data to apply the full retrospective approach, a number of transition options have been provided to simplify the approach.
- Nonetheless, preparing to apply the transition to the new Standard will be an enormous undertaking, affecting many parts of the organization, particularly the finance and actuarial departments.
- Tax implications, both on transition and for ongoing calculations will need to be addressed.

In principle, the new Standard will need to be applied retrospectively, with entities required to restate comparative information about insurance contracts. For each portfolio, the cumulative effect of transition will be recognized in:

- Opening retained earnings
- Accumulated OCI for changes in interest rates since the beginning of the contract

In addition, insurers will be able to make some limited redesignations of financial asset classifications previously made under IFRS 9 (see further discussion on the interaction with IFRS 9 on page 18).

To fully retrospectively apply the BBA, an insurer would need to determine the original fulfilment cash flows for each portfolio of insurance contracts – including the inception discount rate and the original CSM – and then roll this forward for each portfolio to the transition date. Apart from the difficulty of sourcing data for this exercise, it will be difficult to retrospectively determine the fulfilment cash flows as they would have been calculated at inception date without applying hindsight.

For many insurers, making full retrospective application will not be practicable. In this case, three simplifications are allowed:

- Modified retrospective approach (previously referred to as a simplified retrospective approach)
- FV approach
- Specific simplifications for participating contracts

Insurers will be allowed to choose between the modified retrospective and FV approaches. The objective of a modified retrospective approach is to achieve the closest outcome to retrospective application that is possible using reasonable and supportable information.

An entity is allowed to use a number of specified modifications, but must use the minimum modifications necessary to achieve the above objective without undue cost or effort. For example, an entity will be allowed to group together contracts issued more than one year apart into a single group.

When applying a modified retrospective approach, an entity maximizes the use of information that would have been used to apply a fully retrospective approach, but need only use information available without undue cost or effort.

Potential tax issues

To the extent that taxable income is calculated by reference to accounting revenues or expenses, there will be:

- A transitional impact from the adjustment to opening retained earnings or OCI
- An ongoing impact on tax calculations

It is not yet clear how the Standard will affect the tax regime in Hong Kong, if at all, and whether the Inland Revenue Department (IRD) will respond. It will be important for the industry to engage with the IRD to gain certainty prior to transition.

<table>
<thead>
<tr>
<th>Simplifications for participating contracts</th>
<th>FV approach</th>
<th>Modified retrospective approach</th>
</tr>
</thead>
<tbody>
<tr>
<td>CSM at initial application should be measured as:</td>
<td>CSM at the beginning of the earliest period presented equals the difference between the FV of the insurance contract and the fulfilment cash flows</td>
<td>► The accumulated fee for service provided in past periods</td>
</tr>
<tr>
<td>► The FV of the shareholder’s share of the returns from underlying items, LESS</td>
<td>► Interest expense in P&amp;L and OCI based on simplified discount rate</td>
<td>► The remaining net cost of providing the contract plus costs already incurred, LESS</td>
</tr>
<tr>
<td>► The IRD to gain certainty prior to transition.</td>
<td>► Estimated cash flows</td>
<td>► Modified retrospective approach</td>
</tr>
<tr>
<td>► Risk adjustment</td>
<td>► Discount rate at initial recognition</td>
<td>(previously referred to as a simplified retrospective approach)</td>
</tr>
<tr>
<td>► Discount rate at initial recognition</td>
<td>► The FV of the shareholder’s share</td>
<td>► FV approach</td>
</tr>
<tr>
<td>► The CSM for these contracts must be determined at the beginning of the earliest period presented (rather than at the date of initial application)</td>
<td>► The IRD to gain certainty prior to transition.</td>
<td>► Specific simplifications for participating contracts</td>
</tr>
</tbody>
</table>
Disclosure

Implications

- The proposed disclosures cover similar topics to the disclosures insurers currently provide.
- However, the nature of the measurement methodologies in the new Standard means these disclosures are likely to be more detailed and complex to prepare than the current disclosures.
- Judgement will be needed to determine the appropriate level of disclosures and disaggregation.

One of the primary objectives of the IASB's project on insurance contracts is to increase transparency in insurers' financial statements.

This includes providing information about:
- how much risk the insurer has taken on;
- how much uncertainty is contained in the amounts reported; what drives performance;
- how much an insurer expects to pay to fulfil its insurance contracts; and the hidden value of embedded options and guarantees.

Although some of this information can be provided on the face of the financial statements, much will come in the form of more detailed disclosures in the footnotes. Exhibit 11 provides a summary of these new disclosure requirements.

At first glance this looks similar to the current IFRS4 and Hong Kong Financial Reporting Standards (HKFRS) disclosure requirements. However, the guidance and discussion provided to date by the IASB suggests more granularity is expected than is currently practiced. The risk disclosures in particular will be expanded to cover all market risks and liquidity risk, and more detail will be required.

The entity will need to determine the appropriate level of disaggregation of these disclosures, which might include:
- Type of contract (e.g., major product lines)
- Geographical area
- Reportable segment

For example, for material measurements an insurer must disclose the methods used and the processes for estimating inputs. If practicable, the insurer would also provide quantitative information about the significant inputs used. These will include disclosures regarding the risk adjustment, discount rates and pattern of CSM recognition. The IASB provided an illustration of how these disclosures might look – see Exhibit 12.

Insurers will need to develop systems, source data and valuation models with these disclosure requirements in mind.

Exhibit 11. Summary of disclosures

<table>
<thead>
<tr>
<th>Balance Sheet and Profit and Loss items</th>
<th>Development of Balance Sheet Items</th>
<th>Valuation methods and inputs used</th>
<th>Reconciliation of booked premiums to insurance revenues</th>
<th>Interest rate curve used for discounting</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Type and extent of risks</strong></td>
<td>Framework</td>
<td>Insurance risks</td>
<td>Other risks</td>
<td>Framework</td>
</tr>
<tr>
<td></td>
<td>Risk appetite</td>
<td>Exposure</td>
<td>Exposure</td>
<td>Risk appetite</td>
</tr>
<tr>
<td></td>
<td>Risk management</td>
<td>Concentrations</td>
<td>Concentrations</td>
<td>Risk management</td>
</tr>
<tr>
<td></td>
<td>Regulatory law</td>
<td>Claims settlement</td>
<td>Maturity analysis</td>
<td>Regulatory law</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Sensitivity analysis</td>
<td>Sensitivity analysis</td>
<td></td>
</tr>
</tbody>
</table>

Exhibit 12. Illustrative input disclosure

<table>
<thead>
<tr>
<th>Amount recognised on the Balance Sheet</th>
<th>Method used</th>
<th>Key inputs</th>
<th>Range (weighted avg.)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Product line 1</td>
<td>Method 1</td>
<td>Input X</td>
<td>X % – Y % (Z%) A.X – B.X (C.X)</td>
</tr>
<tr>
<td></td>
<td>Method 2</td>
<td>Input Y</td>
<td>X % – Y % (Z%) A.X – B.X (C.X)</td>
</tr>
<tr>
<td></td>
<td>Method 3</td>
<td>Input A</td>
<td>X % – Y % (Z%) A.X – B.X (C.X)</td>
</tr>
<tr>
<td></td>
<td>Method 3</td>
<td>Input B</td>
<td>X % – Y % (Z%) A.X – B.X (C.X)</td>
</tr>
<tr>
<td></td>
<td>Method 3</td>
<td>Input L</td>
<td>X % – Y % (Z%) A.X – B.X (C.X)</td>
</tr>
<tr>
<td>Product line 2</td>
<td>Method 1</td>
<td>Input X</td>
<td>X % – Y % (Z%) A.X – B.X (C.X)</td>
</tr>
<tr>
<td></td>
<td>Method 2</td>
<td>Input Y</td>
<td>X % – Y % (Z%) A.X – B.X (C.X)</td>
</tr>
<tr>
<td></td>
<td>Method 3</td>
<td>Input A</td>
<td>X % – Y % (Z%) A.X – B.X (C.X)</td>
</tr>
<tr>
<td></td>
<td>Method 3</td>
<td>Input B</td>
<td>X % – Y % (Z%) A.X – B.X (C.X)</td>
</tr>
<tr>
<td></td>
<td>Method 3</td>
<td>Input L</td>
<td>X % – Y % (Z%) A.X – B.X (C.X)</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

IFRS 9 implementation
Our point of view

- Insurers based in Hong Kong will need to reconsider financial asset classification and how the resulting measurement interacts with liability measurement under IFRS 17.
- Those firms holding equity instruments and certain types of complex debt instruments will experience volatile results once the new standards are in place.
- Companies with large Universal Life blocks which fall outside the scope of the VFA can expect more volatility in their P&L after the standards are implemented due to the mismatch between asset returns and movements in insurance liabilities including the CSM.
- We expect most insurers in Hong Kong will qualify for the deferral option, although a few significant bank-owned entities may choose not to do so as they will need to prepare for IFRS 9 as from 2018 for their group reporting.

As shown in Exhibit 13, IFRS 9 — Financial Instruments will become effective from 1 January 2018, with a comparative period starting from 1 January 2017.

IFRS 9 comprises of three topics:

- Classification & measurement
- Hedge accounting (micro)
- Impairment

Based on a business model test and cash flow characteristics test, financial instruments will be classified as one of the following:

- Debt instruments at amortized cost
- Debt instruments at FV through other comprehensive income (FVOCI) — with gains and losses reclassified to P&L
- Debt instruments, derivatives and equity instruments at FV through P&L
- Equity instruments designated at FVOCI (without gains and losses reclassified to P&L)

The option of a conditional FV through P&L will still be available. Given the variety of treatments currently used in Hong Kong, it is not clear which combination of options will be chosen. Decisions will be driven by the interaction with IFRS 17 and the application of the VFA, amongst other issues.

For debt instruments not measured at FV through P&L, a new impairment testing model will apply. This will be an expected loss model, re-assessed at each reporting period, in contrast to the current incurred loss model.

Relief for insurers

In September 2016 the IASB amended the current IFRS 4 to give insurers two options for managing the transition to IFRS 9 and IFRS 17:

- A temporary exemption will let some eligible entities delay the implementation date of IFRS 9 if they are “predominantly” insurers. Predominance is assessed by calculating the ratio of insurance related liabilities to total liabilities.

<table>
<thead>
<tr>
<th>Entity Predominance ratio (X)</th>
<th>Eligibility for deferral</th>
</tr>
</thead>
<tbody>
<tr>
<td>X &gt; 90%</td>
<td>Eligible</td>
</tr>
<tr>
<td>90% ≥ X &gt; 80%</td>
<td>Able to defer if the entity does not have significant activity unrelated to insurance</td>
</tr>
<tr>
<td>X &lt;= 80%</td>
<td>Not eligible to defer</td>
</tr>
</tbody>
</table>

- An overlay approach will allow an entity applying IFRS 9 to remove the effects of some accounting mismatches by introducing a line item in the P&L which transfers elements to OCI. Financial assets qualifying for the overlay approach could include surplus financial assets that an entity holds for the purposes of regulatory requirements or internal capital objectives. Even if using the overlay approach, if an insurer initially applies IFRS 9 before IFRS 17, they will be allowed (but not required) to reassess the business model for classifying and measuring financial assets under IFRS 9 upon applying the new insurance contracts Standard.

Both options also include significant disclosure requirements which will require investment in new systems and processes to prepare.

Exhibit 13. IFRS 9 effective date compared to IFRS 17
How EY can help

<table>
<thead>
<tr>
<th>EY service offerings</th>
<th>EY tools and accelerators</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mobilize, analyze and evaluate</td>
<td>▶ Training, webcasts and workshops</td>
</tr>
<tr>
<td>▶ Assistance on key technical questions</td>
<td></td>
</tr>
<tr>
<td>▶ Develop operational impact assessment</td>
<td></td>
</tr>
<tr>
<td>▶ Conduct financial impact analysis</td>
<td></td>
</tr>
<tr>
<td>▶ Estimate of resource needs and costs</td>
<td></td>
</tr>
<tr>
<td>▶ Roadmap of activities for implementation</td>
<td></td>
</tr>
<tr>
<td>▶ IFRS 17 Operational Impact Analyzer</td>
<td></td>
</tr>
<tr>
<td>▶ IFRS 17/IFRS 9 training materials</td>
<td></td>
</tr>
<tr>
<td>▶ Gap analysis approach</td>
<td></td>
</tr>
<tr>
<td>▶ Roadmap and Costing templates</td>
<td></td>
</tr>
</tbody>
</table>

Design smart tailored implementation program

▶ Pilot testing
▶ Design new Target Operating Model (TOM) and KPIs
▶ Run system impact assessment
▶ Prepare data analysis for transition
▶ IFRS 17 Prophet Prototype Tool (BBA)
▶ Financial impact analysis tool
▶ Data & System impact analysis tool
▶ System architecture examples

Program implementation

▶ Investor and stakeholder education
▶ Run system tests
▶ Model accounts, data model and COA
▶ IFRS 17/IFRS 9 training materials

Dry run

▶ Prepare transition data
▶ Implement new TOM
▶ Re-design of control frameworks and processes
▶ Populate proforma financial statements
▶ Conduct Board awareness sessions
▶ Model accounts, data model and COA

Live reporting

▶ Investor and stakeholder education
▶ Project management on implementation
▶ Technical support
▶ IFRS 17 COA
▶ IFRS 17/IFRS 9 training materials

EY tools and accelerators

IFRS 17 Operational Impact Analyzer

A web based tool to identify operational gaps from a micro and macro perspective on the insurer’s existing processes, systems, data, models and policies, compared to the new requirements of IFRS 17.

Gaps by topic

Presentation and disclosure 13
Variable fee approach 8
Level of aggregation 21
Discounting 9
CSM 22

IFRS 17 Prophet Prototype Tool

An actuarial model in Prophet to identify the inputs needed from actuarial models to support IFRS 17 reporting.

The tool demonstrates the impacts of changing assumptions and cash flows on reported results. It can also perform multiple model runs to produce Analysis of insurance liability and separate the impact of different assumption and experience changes.

The tool is capable of calculating IFRS 17 insurance liabilities for a contract or a portfolio at inception and subsequent measurement dates.
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