IFRS 17 *Insurance Contracts*
Top technical issues in the Hong Kong insurance industry | October 2018

Introduction

This staff paper from the Hong Kong Institute of Certified Public Accountants (HKICPA) outlines the top three technical issues observed during implementation as a result of discussions from the HKICPA's Financial Reporting Standards Committee (FRSC)'s Hong Kong Insurance Implementation Support Group (HKIISG). FRSC is aware that there are different opinions in the industry on some of these issues, but nevertheless believes that there is reasonable technical justification for changes to be considered by the IASB. Accordingly, the FRSC decided to communicate these issues to the IASB in October 2018 for its consideration in responding to implementation challenges if required. Each issue mentions high level recommendations for the IASB to consider at this stage while at the same time the FRSC considers whether and how to test detailed proposed solutions that have been offered by members of HKIISG and the staff. HKICPA is open to further research and discussion with the IASB and our stakeholders for this purpose. As this paper sets out our current thinking on the technical issues, a further paper may be published to share developments to our thinking (if any) and/or findings of our proposed solutions.

The issues in this paper were also mentioned in the CFO Forum presentation to the EFRAG Board on 3rd July 2018, and in a letter from EFRAG to the IASB dated 3rd September 2018. Our stakeholders tell us that other issues identified in the CFO Forum presentation are also relevant to Hong Kong insurers, but not our priority.

Although this paper focuses on technical issues, we are aware that our stakeholders have other implementation concerns, such as the practical challenges arising from the granularity of the level of aggregation requirements. We raised these practical challenges (including the lack of system solutions, expertise and resources), jointly with the Canadian and Korean standard-setters, at the October 2018 meeting of the International Forum of Accounting Standard Setters. The audience comprised of other national standard-setters and IASB representatives.

Top three technical issues in the Hong Kong insurance industry

Issue 1: CSM allocation for indirect participating contracts (relates to topic 7 of October IASB Meeting Paper 2D)

IFRS 17 requires an insurer to recognise an amount on the balance sheet that depicts insurance services that have not been rendered on the balance sheet (referred as the contractual service margin, CSM), and to recognise an amount of the CSM in the profit or loss as and when the services are provided. The amount of CSM allocated to the profit or loss is determined based on the quantity of benefits provided under a contract and its expected coverage period. Issue 1 focuses on the determination of the expected coverage period when allocating CSM.

IFRS 17 acknowledges two broad types of insurance contracts—contracts without direct participation features (accounted under the general measurement model (GMM)) and contracts with direct participation features (accounted under the variable fee approach (VFA)).

IFRS 17 is clear that under GMM, the quantity of benefits includes only insurance coverage, and the CSM is recognised only over the period during which the entity provides coverage for insured events. In contrast to contracts under GMM, IFRS 17 acknowledges that contracts under VFA 'are substantially investment related service contracts'. This perspective is fundamental to the requirements of VFA and its scope. The IASB tentatively decided in June 2018 to clarify that coverage period for contracts with direct participation features includes periods in which the entity provides insurance or investment related services and, for contracts without direct participation features, coverage period relates to the period in which the entity provides insurance services. Some of our stakeholders tentatively consider the proposed amendment is sufficient. This is because they think that the allocation of CSM under the two different measurement models would appropriately reflect the requirements and principles of IFRS 17, and that IFRS 17's Basis for Conclusions sufficiently explain the IASB's rationale.

However, some stakeholders are concerned that the different accounting under GMM and VFA for insurance contracts with investment components could give rise to two, at times significantly, different CSM allocation patterns for economically similar contracts. In particular, these stakeholders emphasized that the inconsistent treatment of CSM for similar contracts could impact how the market and investors perceive their companies.

As an example, consider a simple universal life policy with an investment component where the maximum benefit payable is the higher of the sum assured on death or the investment-linked account balance. The GMM currently requires insurers to recognise all CSM up to the time the investment component amount exceeds the sum assured amount, even though the entity is still providing insurance services by standing ready to pay claims to the policyholder. In contrast, the VFA requires insurers to recognise CSM over the entire period where the insurer is providing services. CSM is therefore not appropriately recognised in the latter phases of the policy under GMM.

We note that in the IFRS 17 Basis for Conclusions, the IASB concluded that the measurement of the liability for remaining coverage and the resulting profit and revenue recognition should be broadly consistent with IFRS 15 *Revenue from Contracts with Customers*.

However, this is not the case for some insurance contracts with investment components accounted for under GMM, as the recognition of profit can be heavily front-loaded or back-loaded even though the insurer is still providing services. In order to appropriately reflect the provision of services, which includes the stand ready obligation to pay claims[1], we think that CSM allocation for insurance contracts with investment components under the GMM should be consistent with the general revenue recognition principles and the concept of an obligation under the *Conceptual Framework for Financial Reporting* (March 2018). Under IFRS 15, an entity shall recognise revenue when (or as) the entity satisfies a performance obligation by transferring a promised good or service to a customer. The promised good or service is transferred when (or as) the customer obtains control of the asset. The Conceptual Framework states that an obligation is a duty or responsibility that an entity has no practical ability to avoid.

We also observe that the different profit recognition patterns for economically similar contracts under GMM and VFA may create opportunities for some companies, depending on the prudential regulations in their jurisdiction, to structure transactions by directly linking the investment component with the insurance contract according to when they want their profit recognized, reflecting the form but not substance of the transactions.

Next steps

In our recommendation to the IASB staff, we recommended that the IASB reconsiders whether the pattern of CSM allocation under the GMM for insurance contracts with investment components should be consistent with the general revenue recognition principles to ensure comparability of economically similar contracts. We also provided some high level suggestions for the IASB to consider when exploring the

1 The May IASB TRG meeting paper 5 example 16 acknowledged that a policyholder benefits from the insurer standing ready to meet valid claims—that is, the policyholder continues to benefit from the service provided by the entity even when there is no insurance risk to the insurer.

issue. We will continue to work with our stakeholders and the IASB and share our test findings and analysis (if any).

Issue 2: Transition (relates to topic 24 of October IASB Meeting Paper 2D)

HKICPA understands the transition approach is particularly relevant to the life insurance industry as insurance contracts can have a duration of several decades. Applying the full retrospective approach is expected to be impracticable in many cases due to the need for detailed historical data for live contracts with a long historic period at the transition date. Therefore, we understand that most entities want to be able to apply the modified retrospective approach to achieve the highest degree of comparability with the full retrospective approach.

Our stakeholders have reported that in practice, the modified retrospective approach does not appear to provide the simplifications that are expected. This is because entities are working with old data that could have been impacted by changes in IT systems and company ownership over the years. These entities may struggle to prove that the data is accurate and complete to meet the requirements of the modified retrospective approach, which makes its application more limited than the IASB may have intended.

In particular, many entities reported that the permission to use hindsight in the modified retrospective approach requires a full history of cash flows and data, making the entity's effort in terms of data retrieval as demanding as the full retrospective approach. For example, in restating the CSM opening balance, the only difference would be the absence of the effort to retrieve the contemporary assumptions for the initial measurement of the CSM which are instead assumed to be identical to the cash flows produced by actual events from initial recognition to transition date. In addition, entities reported difficulties in interpreting the varying degrees of 'reasonable and supportable' referred in IFRS 17:

- having or not the reasonable and supportable information required to apply the modified retrospective approach (IFRS 17.C6(a))
- not having reasonable and supportable information required to apply the fully retrospective approach (IFRS 17.C8)

Next steps

We recommended that the IASB improve the understandability of the modified retrospective approach, and simplify its requirements for historical data. This would enable entities to achieve the closest outcome to the full retrospective approach using reasonable and supportable information available without undue cost or effort, which is the objective of the modified retrospective approach.

Issue 3: Reinsurance (Relates to topics 12 and 14 of October IASB Meeting Paper 2D)

The approach to reinsurance gives rise to several accounting mismatches. Examples include:

a) For reinsurance contracts held, a cedant has to recognize losses on onerous contracts immediately through the profit or loss, whereas the relief from a corresponding reinsurance contract held has to be deferred and recognised over the coverage period.

   This mis-match on initial recognition between the reinsurer and cedant has been raised separately by a number of national standard setters, including Hong Kong, in an earlier occasion with IASB representatives. Therefore, this paper does not cover this issue in detail.

b) For reinsurance contracts held, a cedant must recognize cash flows of new business not yet written.

The February IASB TRG meeting observed that the boundary[2] of a reinsurance contract held should include cash flows from underlying contracts covered by a reinsurance contract, even if they are expected to be issued in the future. This means that accounting for reinsurance contracts held requires the cash flows to include estimates of underlying insurance business that is not yet written/recognized. Some stakeholders have expressed concerns that the requirement to estimate and recognise such cash flows is, in practice, judgemental to apply and at times subjective. As such, these stakeholders question whether users of financial statements would find the information from this requirement useful.

From the cedant's perspective, the cash flows recognised for reinsurance contracts held (including those expected to be issued in the future) as a result of this requirement may be larger than the corresponding insurance fulfilment cash flows of the contracts currently issued. There is a view that this requirement appears to be inconsistent with other IFRS principles. For example, when an entity expects to receive reimbursements to settle some or all of its provisions under IAS 37, the amount recognized as a reimbursement asset cannot exceed the amount of the related liability. Another example is, under IAS 36, the carrying value of assets should not be larger than the asset's recoverable amount. Applying these IFRS principles to the carrying value of reinsurance contracts held, it would appear that the cedant could potentially expect to claim more (under its reinsurance held including estimates of business not yet written) than it knows it is obligated to pay (under its insurance business already written).

We therefore question whether this requirement produces information that faithfully represents the insurer's right to claim reinsurance cash flows from insurance business not yet written, and whether that information is useful to users of financial statements given its judgemental nature.

Next steps

We recommended the IASB to reconsider whether this particular aspect of accounting for reinsurance contracts held is appropriate in the context of the well-established principles of other IFRS.

Conclusion

HKICPA is committed to continuing our assessment of implementation developments in Hong Kong, facilitating discussions with the industry, and working together with the industry and the IASB in resolving those challenges. HKICPA also continues to engage with Hong Kong investors in obtaining feedback on IFRS 17 and possible developments (if any). Finally, HKICPA is supportive of the IASB using the outcomes of the Board's feedback received and own activities to efficiently decide, where appropriate, whether amendments or simplifications to IFRS 17 are necessary.

2 The May IASB TRG meeting outcome on the boundary of reinsurance contracts reaffirmed the principle that both rights and obligations need to be considered when applying IFRS 17.34 for assessing the boundary of a contract:

- For reinsurance contracts held, cash flows are within the contract boundary if they arise from substantive rights and obligations that exist during the reporting period in which the entity is compelled to pay amounts to the reinsurer or in which the entity has a substantive right to receive services from the reinsurer.
- A right to terminate coverage that is triggered by the reinsurer's decision to reprice the reinsurance contract is not relevant when considering whether a substantive obligation to pay premiums exists. Such a right is not within the entity's control and therefore the entity would continue to be compelled to pay premiums for the entire contractual term.
- The entity's expectations about the amount and timing of future cash flows, including with respect to the probability of the reinsurer repricing the contract, would be reflected in the fulfilment cash flows.

An outcome of the September TRG meeting paper AP11 on submission 75 regarding the boundary of a reinsurance contract issued suggests that the contract boundary is the same from each perspective [of the cedant and reinsurer] because: (a) when the cedant has a right to receive services, the reinsurer has an obligation to provide services; and (b) when the cedant has an obligation to pay premiums, the reinsurer has a right to compel the payment of premiums.