Hong Kong Institute of
Certified Public Accountants
香港會計師公會

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Sent electronically through the IASB Website (www.ifrs.org)

12 February 2016

Mr Hans Hoogervorst
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Hans,

IASB Exposure Draft ED/2015/11
Applying IFRS 9 Financial Instruments with IFRS 4 Insurance Contracts

The Hong Kong Institute of Certified Public Accountants ("HKICPA") is the only body authorised by law to set and promulgate standards relating to financial reporting, auditing, and ethics for professional accountants, in Hong Kong. The HKICPA welcomes the opportunity to provide you with our responses to the questions raised in ED/2015/11.

The HKICPA appreciates the IASB's efforts in considering two optional approaches that seek to address any issues that would arise from the misalignment of effective dates of IFRS 9 *Financial Instruments* and the forthcoming insurance contracts standard.

Overall, the HKICPA considers both the deferral approach and the overlay approach are necessary to address the different circumstances and operational complexities that may be encountered by individual entities, as there is a diverse range of entities with insurance activities within the scope of IFRS 4.

While insurers could adopt IFRS 9 based on the existing IFRS 4, in reality, the linkage between the assets and liabilities for an insurance business is so intertwined that implementation of IFRS 9 before understanding the full requirements of the forthcoming insurance contracts standard would be challenging from an operational, accounting and reporting perspective. Hence, the HKICPA believes that there is a stronger argument in providing the deferral approach for insurance entities to facilitate a well-thought out, effective and efficient implementation of both IFRS 9 and the forthcoming standard.

However, the HKICPA has serious concerns that the proposed criterion outlined in the deferral approach for the eligibility, assessment and application of the predominance test at the reporting entity level is overly quantitative. We strongly encourage the IASB to consider more principle-based eligibility criteria for the deferral approach that includes qualitative as well as quantitative conditions.

The HKICPA broadly supports providing both the deferral approach and the overlay approach as options for entities in applying IFRS 9 with IFRS 4.

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Our responses to the questions in ED/2015/11 are outlined in detail in the Appendix.

If you have any questions regarding the matters raised in this letter, please contact me or Kam Leung (kamleung@hkicpa.org.hk), Associate Director of our Standard Setting Department.

Yours sincerely,

Christina Ng
Head of Financial Reporting, Standard Setting Department

Encl.

Overview of insurance outreach conducted in Hong Kong

In forming the views of the Hong Kong Institute of Certified Public Accountants ("HKICPA") on ED/2015/11, the HKICPA:

(i) issued an Invitation to Comment on ED/2015/11 on 11 December 2015. We received eight comment letters from various Hong Kong associations representing banks, lawyers and insurers, government bodies for treasury and insolvency, the tax authority, and the Hong Kong insurance regulator. The insurance regulator, the association of banks and the federation of insurers provided substantive comments on ED/2015/11.

(ii) held a roundtable discussion on 27 January 2016. The roundtable participants comprise five major insurers, five banks or asset management companies with insurance operations, and four large accounting firms. IASB representatives Darrell Scott and Andrea Pryde were present at the roundtable.

(iii) hosted a meeting with two buy-side analysts, one from a global asset management fund and the other from a large investment bank. Darrell and Andrea were present at the meeting.

(iv) sought the input of its Insurance Advisory Panel, which comprises representatives from the Hong Kong insurance sector and technical and industry experts from the large accounting firms.

Most of the feedback received on ED/2015/11 from our outreach outlined above have been incorporated in the responses to the questions below.

Overall HKICPA views

The HKICPA considers that the forthcoming insurance contracts standard will bring about significant improvements to the quality of financial reporting for the insurance sector as long as the standard is principle-based, understandable and implementable. We would therefore support the IASB in utilising the extensive inputs received from comment letters and over two years of outreach activities since the last exposure draft was published, and to work towards the publication of the standard as soon as possible.

The HKICPA also considers IFRS 9 *Financial Instruments* to be a major improvement to IAS 39 *Financial Instruments: Recognition and Measurement* and, ideally, would like all entities to apply IFRS 9 at the same time. The HKICPA has already issued HKFRS 9 (the equivalent of IFRS 9) which will be applicable (when it becomes effective) to all entities in Hong Kong that apply HKFRS (the equivalent of IFRS). In doing so, we were made aware that our insurance stakeholders in Hong Kong have significant concerns about the possible negative implications that would arise from the different effective dates of IFRS 9 and the forthcoming insurance contracts standard.

We have considered the feedback received from our stakeholders in relation to ED/2015/11 and it is evident that the impact of the accounting mismatches described in ED/2015/11 affects those stakeholders that issue contracts under IFRS 4 in varying degrees.

While insurers could adopt IFRS 9 based on the existing IFRS 4, the linkage between the assets and liabilities for an insurance business is so intertwined that implementation of IFRS 9 before understanding the full requirements of the forthcoming insurance standard would be challenging from an operational, accounting and reporting perspective.

Based on this feedback, the HKICPA concluded that the proposed temporary exemption to defer IFRS 9 ("deferral approach") would be necessary for insurance entities to facilitate a well-thought out, effective and efficient implementation of both IFRS 9 and the forthcoming new insurance contracts standard. We also consider that it would be appropriate to permit the deferral approach to be applied by entities below the reporting entity level. In addition, the eligibility criteria should be principle-based and should consider a wide-range of factors.

The HKICPA also considers the overlay approach may be helpful for standalone entities within a banking or asset management group, that do not qualify for the deferral approach, but nonetheless issue insurance contracts.

In light of the above considerations, on balance, we are more inclined to support providing, as options in applying IFRS 9 with IFRS 4, both the deferral approach and overlay approach.

The HKICPA also considers that the proposed presentation and disclosure requirements would be able to assist the users of financial statements in the interim. While we do encourage the IASB to take into consideration the suggestions in Questions 2, 3 and 4, we believe that this should be balanced with the general principle outlined in IAS 1 *Presentation of Financial Statements* that permits entities to determine the presentation that is most relevant to an understanding of the entity's financial performance.

Summary of responses to questions in ED/2015/11

Question 1—Addressing the concerns raised
Paragraphs BC9–BC21 describe the following concerns raised by some interested parties about the different effective dates of IFRS 9 and the new insurance contracts Standard: (a) Users of financial statements may find it difficult to understand the additional accounting mismatches and temporary volatility that could arise in profit or loss if IFRS 9 is applied before the new insurance contracts Standard (paragraphs BC10–BC16). (b) Some entities that issue contracts within the scope of IFRS 4 have expressed concerns about having to apply the classification and measurement requirements in IFRS 9 before the effects of the new insurance contracts Standard can be fully evaluated (paragraph BC17–BC18). (c) Two sets of major accounting changes in a short period of time could result in significant cost and effort for both preparers and users of financial statements (paragraphs BC19–BC21). The proposals in this Exposure Draft are designed to address these concerns. Do you agree that the IASB should seek to address these concerns? Why or why not?

Summary of outreach feedback on Question 1

All of our respondents agree that the IASB should address the concerns outlined in paragraphs BC9 – BC21 of ED/2015/11 as it will help avoid any negative implications that would be caused by the misalignment of the effective dates of IFRS 9 and of the forthcoming new insurance contracts standard. This is consistent with the view of the HKICPA.

Question 2—Proposing both an overlay approach and a temporary exemption from applying IFRS 9
The IASB proposes to address the concerns described in paragraphs BC9–BC21 by amending IFRS 4: (a) to permit entities that issue contracts within the scope of IFRS 4 to reclassify from profit or loss to other comprehensive income some of the income or expenses arising from designated financial assets that: (i) are measured at fair value through profit or loss in their entirety applying IFRS 9 but (ii) would not have been so measured applying IAS 39 (the 'overlay approach') (see paragraphs BC24–BC25); (b) to provide an optional temporary exemption from applying IFRS 9 for entities whose predominant activity is issuing contracts within the scope of IFRS 4 (the 'temporary exemption from applying IFRS 9') (see paragraphs BC26–BC31). Do you agree that there should be both an overlay approach and a temporary exemption from applying IFRS 9? Why or why not? If you consider that only one of the proposed amendments is needed, please explain which and why.

Summary of outreach feedback on Question 2

Most, if not all, of our respondents agree that both an overlay approach and a deferral approach should be permitted to address the concerns in paragraphs BC9 – BC21 of ED/2015/11. Both approaches are necessary to address the different circumstances and operational complexities that may be encountered as there is a diverse range of entities with insurance activities within the scope of IFRS 4. This is consistent with the view of the HKICPA.

Respondents from the insurance sector and practitioners were particularly in favor of the deferral approach over the overlay approach. The banking and asset management sectors with insurance operations noted that both options would be useful particularly in situations where the parent and subsidiaries have different activities (e.g. where the parent is within the banking sector and regulated as a bank, and the subsidiary is within the insurance sector and regulated as an insurer). In this case, the subsidiary, while having to apply IFRS 9 for the purpose of consolidated financial statements, will still have the option when preparing its separate IFRS financial statements of applying the overlay approach to be more consistent with its parent, or applying the deferral approach for simplicity in its standalone accounts.

These respondents consider that both the overlay approach and deferral approach would lead to additional costs. However, they think that these additional costs would be justified if using either approaches would help them better explain their financial information as a result of the misalignment of the effective dates.

The analysts commented that the ideal situation is for both standards to be applied at the same time to minimize any accounting mismatch between assets and liabilities. However, given the circumstances, they can support, and understand the need for, both approaches considering the diverse range of business segments within a reporting entity. If the IASB were to proceed with the overlay approach, the analysts request that the IASB standardizes the presentation format and the description of key items under both approaches to ease any further reporting incomparability.

Question 3—The overlay approach	
Paragraphs 35A–35F and BC32–BC53 describe the proposed overlay approach.	
(a)	Paragraphs 35B and BC35–BC43 describe the assets to which the overlay approach can be applied. Do you agree that the assets described (and only those assets) should be eligible for the overlay approach? Why or why not? If not, what do you propose instead and why?
(b)	Paragraphs 35C and BC48–BC50 discuss presentation of amounts reclassified from profit or loss to other comprehensive income applying the overlay approach. Do you agree with the proposed approach to presentation? Why or why not? If not, what do you propose instead and why?
(c)	Do you have any further comments on the overlay approach?

Summary of outreach feedback on Question 3

Those who may be likely to apply the overlay approach in Hong Kong are banks or asset management companies with insurance operations (collectively, "banking sector"). These entities told us that they are still evaluating the impact and effect of the overlay approach and no firm decision has been made yet for its use, in the event it becomes part of IFRS 4. Some insurance entities and some practitioners commented that they do not believe that the overlay approach provides a practical solution as its drawbacks relating to increased implementation costs ahead of assessing the full implications of the forthcoming insurance contracts standard would outweigh any benefits from reduced accounting mismatches or lowered temporary volatility.

The HKICPA acknowledges that while insurers could adopt IFRS 9 based on the existing IFRS 4 by using the overlay approach, in reality, the linkage between the assets and liabilities for an insurance business is so intertwined that implementation of IFRS 9 before understanding the full requirements of the forthcoming insurance contracts standard would be challenging from an operational, accounting and reporting perspective. Hence, the HKICPA believes that there is a stronger argument in providing the deferral approach for insurance entities to facilitate a well-thought out, effective and efficient implementation of both IFRS 9 and the forthcoming standard.

<u>(a) Eligibility of assets for the overlay approach</u>

The analysts and practitioners generally agreed with the IASB proposals relating to the eligibility of assets for the overlay approach.

Respondents from the banking sector generally agreed with the proposal in paragraph 35B(a) of ED/2015/11 to designate assets to which the overlay approach can be applied, but recommended:

(i) refining the eligibility requirements for the determination of qualified financial assets designated as relating to contracts that are within the scope of IFRS 4. A financial asset does not usually have a one-to-one relationship with an insurance contract, so the value of the asset may not be exactly equal to the insurance liability. Therefore, there may be an opportunity for entities applying the overlay approach to deliberately designate a greater value of assets associated with the insurance contract than it would be justified under a more precise designation basis.

(ii) adding substantiation requirements for financial assets transferred between insurance and non-insurance business segments so that it is challenging for entities to change the designation of their financial assets to achieve a favorable accounting outcome.

To this point, some practitioners are of the view that refining the eligibility requirements for the determination of qualified financial assets would be impractical. This is because surplus assets are often held to meet regulatory or rating agency requirements, over and above those held to directly support contracts in the scope of IFRS 4 . Furthermore, some practitioners emphasized that the current proposed requirements are already adequate and that there is no need to add further substantiation requirements for the transfer of financial assets between business segments.

The HKICPA did not receive any comments on the proposal in paragraph 35B(b) of ED/2015/11, but we believe that this is a sensible requirement for eligibility.

<u>(b) Presentation for amounts reclassified from profit or loss to other comprehensive income</u>

Most, if not all, of our respondents generally agreed with the proposed presentation of the reclassified amounts.

The analysts emphasized that the IASB should standardize the presentation format and the description of key items. They also urge that the presentation of the reclassification on the face of the Statement of Comprehensive Income should be simple and, if possible, presented as a one line item. Details relating to the reclassification should be provided in the notes.

Question 4—The temporary exemption from applying IFRS 9	
As described in paragraphs 20A and BC58–BC60 the Exposure Draft proposes that only entities whose predominant activity is issuing contracts within the scope of IFRS 4 can qualify for the temporary exemption from applying IFRS 9.	
(a)	Do you agree that eligibility for the temporary exemption from applying IFRS 9 should be based on whether the entity's predominant activity is issuing contracts within the scope of IFRS 4? Why or why not? If not, what do you propose instead and why?
As described in paragraphs 20C and BC62–BC66, the Exposure Draft proposes that an entity would determine whether its predominant activity is issuing contracts within the scope of IFRS 4 by comparing the carrying amount of its liabilities arising from contracts within the scope of IFRS 4 with the total carrying amount of its liabilities (including liabilities arising from contracts within the scope of IFRS 4).	
(b)	Do you agree that an entity should assess its predominant activity in this way? Why or why not? If you believe predominance should be assessed differently, please describe the approach you would propose and why.
Paragraphs BC55–BC57 explain the IASB's proposal that an entity would assess the predominant activity of the reporting entity as a whole (ie assessment at the reporting entity level).	
(c)	Do you agree with the proposal that an entity would assess its predominant activity at the reporting entity level? Why or why not? If not, what do you propose instead and why?

Summary of outreach feedback on Question 4

Entities that are likely to qualify for the use of the deferral approach are those whose main business, as a single entity and/or as a group, is to issue contracts within the scope of IFRS 4. We understand that some group reporting entities whose main business is issuing insurance policies (including those that are investment-linked and/or unit-linked) may not qualify for the deferral approach because of the 75% hurdle implied by the predominance test.

All respondents emphasized that the IASB should consider more principle-based eligibility criteria for the deferral approach that includes quantitative as well as qualitative conditions.

The HKICPA agrees with its respondents that the eligibility and assessment of the deferral approach at the reporting entity level should be principle-based with qualitative considerations included. This is so that each company can make an accurate assessment of predominance within the diverse range of circumstances specific to individual entities. While we consider that entities which are regulated by a local insurance regulator could be regarded as a sensible qualitative factor as it would align the regulatory and accounting identification of insurers, we also acknowledge that adding this as a qualitative factor would not solve the accounting mis-match that ED/2015/11 is trying to address.

Overall, the HKICPA strongly encourages the IASB to consider more principle-based eligibility criteria for the deferral approach that includes qualitative as well as quantitative conditions. We are aware that the larger accounting firms as well as some insurance entities will be providing some alternative approaches in response to Questions 4(a) to 4(c) below, as well as quantitative and qualitative factors for the IASB's consideration. We have not formed a view on any of those alternative approaches yet.

(a) Eligibility for the deferral approach based on IFRS 4 definition of insurance contracts

The Hong Kong insurance regulator, some insurance entities and some practitioners commented that there are a number of insurers in Hong Kong that issue investment-linked and/or unit-linked insurance policies which may not qualify as insurance contracts liabilities under IFRS 4. However, these entities are subject to the same insurance regulation as 'pure' insurance entities. They therefore would not be opposed to expanding the eligibility of entities applying the deferral approach to all entities that are regulated by the insurance regulator in Hong Kong. For example, this would mean that in applying the predominance test to a consolidated group, all liabilities from legal entities regulated as insurers should qualify (not only those liabilities relating to contracts within the scope of IFRS 4). In this case, liabilities from banking or other non-insurance subsidiaries within the group would continue to be excluded from the numerator of the liabilities test. Similarly, the analysts we reached out to also emphasized the need to align the regulatory and accounting identification of insurers. However, some practitioners emphasized that regulation by a local insurance regulator should not be a qualitative factor. This is because insurance liabilities related to investment-linked contracts are already measured at fair value through profit or loss and do not cause the accounting mis-match that ED/2015/11 is trying to address.

(b) Assessment of the predominance test hurdle

Respondents who were in favor of the deferral approach generally support the predominance assessment by way of a liabilities test as described in paragraph 20C and BC62 – BC66 of ED/2015/11. However, as commented in the overall response to Question 4, all respondents and the HKICPA believe that the IASB should consider more principle-based eligibility criteria for the deferral approach.

In addition, respondents from the banking sector commented that if the IASB has no intention to provide a specific quantitative threshold in the predominant assessment, the IASB should remove the example in paragraph BC65 (i.e. the 75% hurdle) to allow for a more principle-based application of the predominance test. If it is the IASB's intention to require a specific quantitative threshold, the example should be included in the main content of the Standard. The HKICPA agrees with this suggestion.

With respect to the liabilities test, the majority of respondents questioned whether it is appropriate for the denominator to be the entity's total liabilities. Some of them gave examples of liabilities which are not fully representative of the underlying business operations. For example:

(i) debt financing is more representative of the entity's funding and capital structure, and not indicative of its business operations, and

(ii) pension obligations and tax obligations which are also not indicative of the entity's business activities.

The analysts agreed that considering an entity's liabilities would be a good starting point for the predominance test but did not agree nor disagree with using total liabilities as the denominator.

(c) <u>The predominance test at the reporting entity level</u>

In general, our respondent's preference is to apply the predominance test below the reporting entity level. If the IASB proceeds in its proposal to apply the predominance test at the reporting entity level, then our respondents see merit in reconsidering the quantitative threshold and to add qualitative factors for consideration when assessing predominance. As mentioned above in the overall response to Question 4, all respondents and the HKICPA would prefer a principle-based application of the predominance test.

Respondents from the insurance sector (particularly those that are subsidiaries of large multinational insurers) are in favor of the deferral approach on a reporting entity level. This is mainly to eliminate the additional operational and reporting complexities and costs.

Respondents from the banking sector consider that the predominance test should be performed below the reporting entity level as it would more accurately reflect the true substance of their operations. Under the current proposals, an insurance subsidiary held by a banking parent entity will have to prepare another set of financial statements under IFRS 9 for its parent's consolidated financial statements, regardless of whether it chooses to apply the deferral approach at the stand-alone level for simplicity. Therefore, it makes choosing the deferral approach a moot point for the subsidiary and indirectly increases implementation costs and efforts for that subsidiary as compared to its peers in the industry sector. These respondents also commented that if the IASB's key concern with applying the predominance test below the reporting entity level relates to the possibility of manipulating the deferral and managing earnings by transferring assets between related parties within a group, this could be addressed by adding restrictions and requirements for asset reclassifications among related parties.

The analysts agreed with using a liability test as the general approach to assess predominance. They also broadly agreed with applying the predominance test at the reporting entity level and think that the proposed disclosures under the deferral approach would be an improvement from disclosures currently provided.

The analysts further commented that, in an ideal situation, the financial statements of insurers should be highly comparable and consistent. However, the analysts acknowledge the difficulty for entities to move from IAS 39 to IFRS 9 without understanding the full implications of the forthcoming insurance contracts standards to be issued. Given this misalignment in effective dates, they commented that for the interim period they would not be opposed to a group entity consisting of 50% insurance operations and 50% banking/asset management operations applying the deferral approach at the reporting entity level.

The analysts re-emphasized that clear and effective communication about the implications arising from the misalignment in effective dates to users of financial statements should be required in financial reports.

Question 5—Should the overlay approach and the temporary exemption from applying IFRS 9 be optional?

As explained in paragraphs BC78–BC81, the Exposure Draft proposes that both the overlay approach and the temporary exemption from applying IFRS 9 would be optional for entities that qualify. Consistently with this approach, paragraphs BC45 and BC76 explain that an entity would be permitted to stop applying those approaches before the new insurance contracts Standard is applied.

(a) Do you agree with the proposal that the overlay approach and the temporary exemption from applying IFRS 9 should be optional? Why or why not?

(b) Do you agree with the proposal to allow entities to stop applying the overlay approach or the temporary exemption from applying IFRS 9 from the beginning of any annual reporting period before the new insurance contracts Standards is applied? Why or why not?

Summary of outreach feedback on Question 5

(a) Optional approaches

The majority of our respondents including our insurance regulator supports providing the overlay and deferral approaches as optional so that companies can assess which approach is a better fit for their circumstances. The HKICPA agrees with this proposal.

(b) Timing of approaches

No major issue was raised surrounding the proposal to allow entities to stop applying the overlay or deferral approaches from the beginning of any annual reporting period before the new insurance contracts standard is applied. The HKICPA also does not take any issue.

Question 6—Expiry date for the temporary exemption from applying IFRS 9
Paragraphs 20A and BC77 propose that the temporary exemption from applying IFRS 9 should expire at the start of annual reporting periods beginning on or after 1 January 2021. Do you agree that the temporary exemption should have an expiry date? Why or why not? Do you agree with the proposed expiry date of annual reporting periods beginning on or after 1 January 2021? If not, what expiry date would you propose and why?

Summary of outreach feedback on Question 6

Some of our respondents do not support having an expiry date on the deferral approach for the time being. These respondents would prefer that the expiry date is set when the forthcoming insurance standard is issued.

Other respondents commented that the IASB could address this issue by clarifying in the draft standard or the amendments to IFRS 4 that the IASB will revisit the timing of the sunset clause if the issuance of the forthcoming insurance contracts standard is delayed. The HKICPA would support this approach.