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

Meeting Summary
Hong Kong Insurance Implementation Support Group (HKIISG)
25 January 2019

Attendance
HKICPA representatives
Shelley So, Chair, Financial Reporting Standards Committee (FRSC)
Christina Ng, Director, Standard Setting
Kam Leung, Associate Director, Standard Setting

HKIISG members
Sai-Cheong Foong, AIA Group Limited
Ronnie Ng, China Overseas Insurance Limited
Kevin Wong, FWD Life Insurance Company (Bermuda) Limited
Alexander Wong, Hang Seng Insurance
Kenneth Dai, Manulife Asia
Candy Ding, Ping An Insurance (Group)
Carrie Yip (representing Nigel Knowles), Prudential Hong Kong Limited
Joyce Lau, Target Insurance Company Limited
Doru Pantea, EY Hong Kong
Francesco Nagari, Deloitte Hong Kong
Erik Bleekrode, KPMG China
Chris Hancorn, PwC Hong Kong

Absent
Kevin Lee, AXA China Region Insurance Company Limited

Discussion objectives:
Readers are reminded that the objective of the HKIISG is not to form a group consensus or decision on how to apply the requirements of HKFRS/IFRS 17 *Insurance Contracts*. The purpose of HKIISG is to share views on questions raised by stakeholders on the implementation of HKFRS 17. Refer to HKIISG terms of reference.

The meeting summaries of HKIISG discussions are solely to provide a forum for stakeholders to follow the discussion of questions raised. Stakeholders may reference HKIISG member views when considering their own implementation questions—but should note that the meeting summaries do not form any interpretation or guidance of HKFRS/IFRS 17.

1. Local submission: Loss Component (Paper 2)

Mr. Francesco Nagari presented paper 2 which discusses the accounting treatment for an onerous group of insurance contracts, where there are:

- experience adjustments from premiums received in the period that relate to future service; and consequently
- there is a subsequent reversal of the loss component from the same onerous group of insurance contracts.

The paper seeks to establish the accounting sequence of reversing a loss component in a financial period given that the premium experience adjustments relate to future service and the change in cash flows is consequential to those adjustments. Three views were presented:

a) View A, where the variance in premium received for future service and the changes in fulfilment cash flow that reverse the loss component are all presented in the income statement within the insurance service expense line. This appears to be in compliance with IFRS 17 paragraphs 48 and 49, but contrary to IFRS 17 paragraph B96(a) which states that premium variances for future services are adjusted through CSM.

b) View B, where the variance in premium received for future service and the changes in fulfilment cash flow that reverse the loss component adjusts the liability for remaining coverage, and appears to be in compliance with IFRS 17 paragraph B96(a) because it is not reported in the income statement. However, to reconcile insurance revenue with the requirements of IFRS 17 paragraph B120, which states that the total insurance revenue is the consideration for the contracts, the portion of loss component recognised in the liability for remaining coverage would need to be released into insurance revenue. This appears to be contrary to IFRS 17 paragraph 49 which states that any increases or reversals of the loss component are presented in the income statement as losses on onerous groups or reversals of losses on onerous groups, and are excluded from the determination of insurance revenue.

c) View C, where there is a policy choice between View A and View B.

General agreement that there is a contradiction within IFRS 17

Members generally agreed that there appeared to be a contradiction within IFRS 17, and that this fact pattern illustrated this contradiction. Members considered that it would be helpful to submit the paper to the IASB TRG for further clarification. Most members considered that a policy choice (view C) is reasonable if no further clarification is received.

Should the sequence of events be viewed as one or two events?

One member questioned whether the fact pattern should be viewed as two separate events, or instead viewed as holistically as a single event. That is, should an insurer: (i) receiving less premium than expected; and then (ii) changing its cash flow assumptions as a result; consider this as two separate events or a single event? This member noted that if it is considered a single event because the cash flow assumptions are changed as a direct result of receiving less premium, then the changes should be recognized in the CSM because it is related to future service (view B).

However, this member also commented that, in practice, if an insurer receives less premium than expected in the middle of the year, it may only change its assumptions at the end of the year. In this case, the insurer will automatically account for the fact pattern as two separate events, and therefore end up applying view A.

View A: Insurance service expenses (appears to contradict IFRS 17 paragraph B96(a))

Two members supported this view. One member commented that conceptually, the loss component is similar to CSM. Hence, view A, the release of the loss component should be recognized in the income statement (similar to how the release of CSM is recognized in the income statement).

View B: CSM and insurance revenue (appears to contradict IFRS 17 paragraph 49)

Two members supported this view:

- One member noted that the sequence of events should be viewed as a single event and hence the changes in assumptions relate to future service. As a result, the changes should be recognized in the CSM.
- One member agreed and noted that view B better reflects the economic substance of the fact pattern. This member does not support view A, that is, recognising the experience adjustment as additional onerous loss in the income

statement and then reversing it when there is a consequential change in cash flow assumptions. This is because it does not reflect the true economic substance of what occurred. In addition, this member thinks that view A is operationally more complex.

Other observations

One member noted that the final outcome of both view A and view B is the same. Another member noted that the fact pattern is not realistic because in practice, there is no two year term policy with a 100% mortality rate.

Action/Conclusion:
Members generally agreed that there appeared to be a contradiction within IFRS 17, and that it would be helpful to submit the paper to the IASB TRG for further clarification.

The submitter will consider whether to submit the paper to the IASB TRG.
[Post-meeting note: Staff understand that a version of the paper was submitted to the IASB TRG.]

2. Local submission: CSM Calculation (Paper 3)
Mr. Sai-Cheong Foong presented paper 3 which proposes a method for calculating the contractual service margin (CSM) for groups of contracts that have multiple services.

IFRS 17 paragraph B119 requires an amount of the CSM for a group of insurance contracts is recognised in profit or loss in each period to reflect the services provided under the group of insurance contracts in that period. The amount is determined by:
a) identifying the coverage units in the group. The number of coverage units in a group is the quantity of coverage provided by the contracts in the group, determined by considering for each contract the quantity of the benefits provided under a contract and its expected coverage period.
b) allocating the CSM at the end of the period (before recognising any amounts in profit or loss to reflect the services provided in the period) equally to each coverage unit provided in the current period and expected to be provided in the future.
c) recognising in profit or loss the amount allocated to coverage units provided in the period.

The paper proposed a method which first determines the CSM of each service component within a contract. These service component CSMs are then aggregated to arrive at a contract level CSM, which will then be further aggregated to determine the CSM for the group of contracts. Based on the submitter's analysis, this method—based on CSM—is deemed to be an appropriate proxy for reflecting the different services provided to the policyholder in each period for certain simple fact patterns.

The fact patterns are those where the individual service components:
a) are independent of one another, i.e. cash flows are not affected by each other;
b) have standalone pricing and the components are marketed together in a single contract for the convenience of policyholders, i.e. the premiums received can be allocated to each component without significant judgment.

The submitter noted that this method is not bifurcating a contract into components—it is the simple fact pattern which allows a summation of the CSMs of the service components to arrive at the contract level CSM.

The submitter thinks that this method is beneficial because of operational ease and enabling a more accurate calculation. In addition, as noted in the IASB TRG May 2018 meeting summary, IFRS 17 does not specify any particular approach to be used in calculating the CSM[1]. Rather, IFRS 17 requires that the outcome appropriately reflects the services being provided and suitable proxies are allowed if they achieve this objective.

Preliminary support for the method, but with some concerns

- A few members expressed preliminary support for the method because they think it:
  - provides an objective mathematical way to 'weigh' the different service components in a contract for the CSM calculation;
  - simplifies the operational complexity of calculating the CSM, making it easier for IT system development;
  - is only meant to be applied to simple fact patterns; and
  - entities are not required to use this method—they must select an appropriate method to calculate the CSM considering their facts and circumstances.
- Nevertheless, they also expressed concerns on whether the method meets IFRS 17 requirements and is consistent with the IASB TRG May 2018 meeting summary. Specifically, their concerns were:
  - why is CSM the proxy for reflecting the services provided by the contract? CSM is ultimately a profitability measure, and paragraph 35(h)(iv) of the IASB TRG May 2018 meeting summary notes that "the level of profitability in a contract does not affect the services provided by the contract."
  - it appears that the method results in the dissection of a contract into separate components, which is not what the IASB intended[2].

Strong concerns about the method

- A few members did not support the method as they think that it does not meet IFRS 17 requirements because :
  - CSM is unlikely to be an appropriate proxy for reflecting the services provided and should not be used (unless it can be demonstrated that it is appropriate); and
  - it introduces an unbundling or separation of coverages within a contract, which may ultimately lead to structuring of the contract to manipulate the allocation of profit. This is because a contract should only have a single profit pattern, but the method would introduce multiple profit patterns. In addition, it was

1 Paragraph 33 of the IASB TRG May 2018 meeting summary: TRG members also observed the determination of coverage units is not an accounting policy choice but involves judgment and estimates to best achieve the principle of reflecting the services provided in each period. Those judgments and estimates should be applied systematically and rationally.

2 Paragraphs 7 and 8 of the IASB TRG February 2018 meeting summary noted that the lowest unit of account is generally at the legal contract level, unless specific facts and circumstances support otherwise.

questioned what would happen if one component was loss-making (i.e. the rider) and another component was profitable (i.e. the base contract), for example, would the loss-making portion of the contract recognise a loss component?

- One member advocated developing an alternative method based on paragraph 35(h)(iii) of the IASB TRG May 2018 meeting summary "a method based on the amount the entity expects the policyholder to be able to validly claim in each period if an insured event occurs", as described in the 12 September 2018 HKIISG meeting summary item 3. The method is based on the expected cash outflows used in calculating the fulfillment cash flows (before assessing the probability of payout). This method is preferable because all of the data is already available since it is estimated during contract measurement, and there is no question of whether it meets the requirements of IFRS 17 or is consistent with the IASB TRG May meeting summary. Economically, it also represents the quantity of benefits the policyholder is entitled to and hence reflects the services provided.
- Another member agreed and found the alternative method a viable one to explore further. This member noted that the IASB did not intend for the CSM to be componentised—that is, the CSM is, in substance, a residual profit amount after the measurement of the contract. This member noted that algorithms are likely to be developed in the future which can deal with all types of contracts/scenarios and can calculate the CSM based on the data available, without having to componentise the contract.

Other observations

- Some members observed the following:
  - The method will not work for complex products, such as:
    - an accidental death benefit rider included in a life insurance policy that can provide an additional payment if death occurs as the result of an accident, which is often double the standard benefit payable for example if the insured died of natural causes. In these cases, the premiums received are likely to be considerably higher than premiums for the base policy (i.e. without the rider). Therefore, simply summing up the CSM of the rider and base will not reflect the economic substance.
    - a policy with multiple coverages that arise from two or more packaged products with different lapse dates but where only one premium is received. The premium would need to be allocated to each product coverage, meaning the CSM of each component cannot be easily calculated.
  - The specific fact pattern where this method would work is where the service component coverages are substantially independent of each other but just marketed together. Hence calculating the CSM at the contract level would be the same as calculating CSMs at the component level and them summing them up.

Action/Conclusion:
Members agreed that there is more than one method that can be used to calculate coverage units under IFRS 17 paragraph B119. Some members appreciate the operational ease of the proposed method, but believe that more justification is needed to demonstrate compliance with the requirements of IFRS 17. Some other members expressed concerns as to whether the proposed method meets the requirements of IFRS 17.

The submitter will consider the feedback from the discussion and consider whether to submit a paper to the IASB TRG. *[Post-meeting note: Staff understand that the submitter decided not to submit the paper to the IASB TRG. The submitter will consider whether to bring a revised paper back to HKIISG for discussion.]*

3. Local submission: Investment Component (Paper 4)

Ms. Candy Ding introduced paper 4 which asks if an indirect participating insurance product which pays annual dividends to policyholders is considered to have an investment component.

- If viewed as yes, the paper asks if the dividend payment experience adjustments arising from changes in financial risks in the current period can be recognized in the insurance finance income and expenses (IFIE) instead of the contractual service margin (CSM).
- If viewed as no, the paper asks how the dividend payments (and its related experience adjustments) should be accounted for.

Ms. Candy Ding commented that the product is quite common in Mainland China, and is similar to the universal participating products that are common in North America. The basic feature of the product is that annual dividends are required to be paid to policyholders based on the surplus performance of the participating portfolio. If the performance of the underlying assets of the participating portfolio is below a specified level, the entity does not need to pay the dividend to the policyholder.

If the policyholder dies or surrenders the policy, or if the insured event happens in the middle of the year, a proportional amount of the annual dividend will be paid out based on the dividend level announced in the current year.

The product may not qualify for the variable fee approach and hence for this fact pattern, it is assumed that the product does not meet the criteria for VFA. As such, it is accounted for under the general model. Accordingly, if the product is considered to have an investment component, there will be an accounting mismatch because the dividend payment experience adjustments due to changes in financial risk in the current period are recognized in CSM, and amortised to the income statement in subsequent years. The income statement would therefore not reflect the market fluctuations in the current period.

Finally, Ms. Candy Ding emphasised that the dividend payment experience adjustments will not change future assumptions or asset yields and are not the result of discretionary changes by the company.

The paper provided two views:

- View 1 whereby the product does not have an investment component
- View 2 whereby the product has an investment component and that related experience adjustments due to financial risk are recognized in IFIE

View 1: Product does not meet the definition of an investment component
Appendix A of IFRS 7 defines investment component as "The amounts that an insurance contract requires the entity to repay to a policyholder even if an insured event does not occur."

One member thought that the dividend feature of the product does not meet this definition. This member thought that because the product only pays annual dividends based on the surplus performance of underlying assets it is not a repayment to the policyholder. This is because 'repayment' implies that the policyholder has deposited an amount with the insurer, and the insurer has an obligation to repay the amount to the policyholder. In addition, this member noted that whether and how much dividend is paid is a result of financial market changes—it is not a guaranteed payment based on contract terms.

Another member observed that based on this argument the investment component is the refund of premiums, whilst everything else such as the return on surplus asset performance is in a third undefined category for which IFRS 17 does not specify the accounting. Further, this member observed that IFRS 17 paragraph B96(c) discusses experience adjustments in relation to investment components, but that Appendix A does not define what is an experience adjustment in relation to dividend payments. As such, it is arguable that such undefined experience adjustments do not need to adjust CSM. Nevertheless, this member does not believe the basis of this argument is strong.

View 2: Product likely meets definition of having a non-distinct investment component to be recognised in CSM, including the related experience adjustments

Members generally expressed support for the view that the product has an investment component. These members think that since the dividends have to be paid to the policyholder under almost all scenarios, those dividends meet the definition of investment component in Appendix A of IFRS 17. As such, the experience adjustments on the dividend payments will adjust CSM.

In addition, these members view that IFRS 17 paragraph B96(c): *"For insurance contracts without direct participation features, paragraph 44(c) requires an adjustment to the contractual service margin of a group of insurance contracts for changes in fulfilment cash flows that relate to future service. These changes comprise: …differences between any investment component expected to become payable in the period and the actual investment component that becomes payable in the period, measured at the discount rates specified in paragraph B72(c)..."*, does not allow for the separate accounting treatment of investment component experience adjustments related to changes in financial risk versus non-financial risk. That means, that all experience adjustments related to an investment component should be recognized in the CSM.

Finally, one member commented that an insurance contract must be assessed holistically for the existence of an investment component. For example, if an insurer receives premiums for its insurance contract issued, then the insurer needs to assess upfront if that insurance contract has an investment component or not. Therefore, dividend payments should not be isolated from the insurance contract and separately assessed for its accounting or labeled as an item to recognize in IFIE.

Other observations

Other members noted that:
- If the product could qualify for the variable fee approach, the mismatch issue would not arise.
- All contractual and legal terms and commercial substance should be assessed. For example: are there any scenarios where a company can decide not to pay the dividend, which may indicate that it is different from a guaranteed coupon? Is the dividend payment linked to the insured event, which may indicate that it is not an investment component?

- Experience adjustments arising from features of an insurance contract, for example, dividend payment experience adjustments arising from changes in financial risks in the current period, should be recognized as changes in the estimated cash flows of the insurance contract; and not IFIE. IFIE only comprises the change in the carrying amount of the group of insurance contracts arising from: (a) the effect of the time value of money and changes in the time value of money; and (b) the effect of financial risk and changes in financial risk.
- Although the principle of paragraph B96 is that only experience adjustments related to future service should adjust the CSM; there is no provision in paragraph B96(c) which states that differences between any investment component expected to become payable in the period and the actual investment component that becomes payable in the period should be separately identified and accounted for as financial differences.

Action/Conclusion:
There appears to be general support amongst members that there is a non-distinct investment component in the fact pattern provided, and that changes in the investment component should be adjusted in the CSM according to IFRS 17. A few members expressed interest in further debate of whether there is an alternative perspective, and questioned whether a fact pattern with a multiple-year example should be discussed.

The submitter will take into account the views expressed in the meeting for consideration, but tentatively decided not to bring it back to HKIISG for discussion. Instead, the submitter will discuss internally within her organisation on possible next steps.

4. Staff update and questions for HKIISG

Staff updated HKIISG on:
- Meetings between representatives of HKICPA and the Insurance Authority and Hong Kong Federation of Insurers, respectively. The meetings explored possible ways to support smaller general insurers in implementing IFRS 17.
- The latest HKIISG meeting schedule: https://www.hkicpa.org.hk/en/Standards-and-regulation/Standards/New-and-major-standards/New-and-Major-Standards/HKFRS-17-Insurance-Contracts/Schedule-of-HKIISG-meeting
- Latest developments from the IASB, including tentative decisions on possible amendments (refer to the Annex on page 9). One member thought that the proposed amendments are generally positive and would be welcomed. Another member noted that whilst some of the proposed amendments are positive, the proposed amendment on CSM for indirect participating contracts would likely disrupt implementation because it is seen as a fundamental change to the requirements more than 20 months after the standard was issued. This member questioned if the effective date of IFRS 17 with a one year tentative deferral is still realistic.

Members shared their thoughts on what could be done to help software vendors given that there appears to be a gap in terms of what software vendors say they can do versus the current proof of concept:
- A few members observed that there are no shortcuts in developing systems. It is a process that requires entities to look at the gap between their system capability and IFRS 17 requirements and then consider how to address it. These members suggested that since IT vendors typically would have limited understanding of

IFRS 17 and the insurance industry, entities should ask their IT vendors to hire external consults familiar with IFRS 17 to help them develop software.

- A few members also observed that there is no single solution perfect for all entities/scenarios and that the entity's needs are a moving target—that is, entities themselves have yet to figure out what their needs are, for example, on how to calculate coverage units. Therefore, it is not possible for IT vendors to develop a stable and consistent solution yet. One member commented that an extra year for implementation (on top of the IASB's tentative proposal for a one year deferral) is needed as a result of these challenges.
- One member suggested it would be better for entities to use an IT vendor for the entire implementation process for continuity and for them to work through the decisions, needs, and solutions together—it will be necessary to do many trial runs of what solutions may work with vendors—and it is key is to ensure that the IT vendors understand what the entity needs.
- One member observed that successful transformation projects are typically those where the majority of the project time is spent on defining the requirements first, before tinkering with the IT systems.
- One member commented that general insurers typically rely on IT providers to provide a ready-made solution. This member noted that a few vendors are working together with actuarial firms to develop general insurance solutions but there is no proof of concept yet.
- One member noted that it is hard for business analysts to understand how calculations are derived and that communication between IT personnel and business analysts needs to be strong.

The IASB's expected timeline for amending IFRS 17 was also discussed, and the following was summarised by the Staff:

- The IASB exposure draft (ED) of proposed amendments to IFRS 17 is anticipated to be published in Q2 of 2019, for example, late June. The comment period is not yet known, but a few members expect it to be 60 days, which is typically the time allowed for a limited re-exposure of the standard.
- The IASB will then deliberate the comments received on the ED, which may take a few months. After these deliberations, the drafting of the amendments will take place and the final amendments are likely to be published 3-6 months after the IASB completes deliberations.
- This could mean that final amendments to IFRS 17 are published, at the earliest, in the first half of 2020.

As a result of the above timeline, a few members expressed concerns about the timing left for implementing a 'stable' standard. One member also observed that the European Financial Reporting Advisory Group will continue its endorsement process of the standard only when IFRS 17 is considered 'stable'.

Staff commented that after the IASB ED is published, the HKICPA will commence a public consultation on the IASB's ED. Staff strongly encouraged HKIISG members and other Hong Kong insurers to respond to the HKICPA's and/or the IASB's consultation documents by writing or speaking to HKICPA or IASB representatives. HKICPA is considering roundtable forums for stakeholders to voice their views. HKICPA will deliberate whether to issue the amendments to Hong Kong's equivalent insurance standard, HKFRS 17, once it hears the feedback of Hong Kong stakeholders including insurers and investors, and once the IASB makes its final decisions.

[Post-meeting note: The IASB meeting summaries for December 2018, January 2019 and February 2019 are available here*,* here*, and* here *respectively.]*