1. Brief IFRS 17 update

- Variable fee approach
- Illustrative example
04/05/2018

IFRS 17 Insurance Contracts development

Key IFRS 17 development milestones

2013 2nd ED issued
2010 1st ED issued
2017 IFRS 17 effective
2013 IFRS 17 Insurance Contracts started
2013 IFRS 17 Insurance Contracts working group

Key international development

USA
► Not to adopt IFRS 17
► US GAAP targeted improvements (2022)

Korea
► Industry is actively preparing for the IFRS 17 implementation

China
► PRC GAAP effective in 2009
► BEL, risk adjustment and residual margin are reflected in PRC GAAP

Europe
► EFRAG performed the industry case study; plans to give advice to EU
► Insurers focus on impact assessment, and gap analysis from Solvency II

HK
► 2018 Jan: Word by word adoption
► Active in Group/ regional office level

Malaysia
► Regulator requested high level plan for IFRS 17 adoption

Taiwan
► Potential 3 year delay

Why does this fundamental change in insurance accounting standards matter?

Current situation
- Mix of different local generally accepted accounting principles (GAAPs)
- Limited comparability between insurers and inconsistency with other industries
- Limited use for steering the business and understanding sources of profit
- Some key metrics used to inform investors and stakeholders are based on IFRS

Forthcoming practice
- Consistent adoption across geographies
- Current assumptions for each reporting period
- Impact likely more significant for life insurance products
- Exposure approach to recognition of profit and revenue – as insurance or investment services are provided
- Significant changes in disclosures
- Greater insight into sources of profit within the business (e.g. underwriting, expenses, investment returns)

Key transition steps
- Operational considerations
- Use case design principles
- Gap for efficient and cost-effective implementation; approaches
- Policy, process, data, systems and controls
- Compliance vs catalyst for change (Finance & Risk transformation)
- Accounting decisions
- Policy decision making and implementation
- Communication challenges
- Implications for external messaging
- Explain strategic choices
Enhanced accounting framework

IFRS 17 financial statements provide up-to-date market consistent information of financial obligations including value strip-offs & guarantees.

Underwriting revenue and expenses are recognized over time in a more comparable way to other non-insurance businesses.

Assumptions used in the valuation of insurance contract liabilities reflect the characteristics of the insurance contract rather than the risk related to asset and investment activities.

The time value of money is reflected.

The critical IFRS 17 components

- Definition & scope
- Separation
- Recognition
- Level of aggregation
- Measurement
- Reinsurance
- Onerous contract
- Initial / subsequent measurement
- Risk adjustment for non-financial risk
- Contractual service margin (CSM)
- Attributable expense
- Actuarial model / integrated solution

Transition Resource Group for IFRS 17

TRG meeting on 2 May 2018

The first TRG meeting was held in London on 2 May 2018 focusing on seven agenda items.

- Combination of insurance contracts
- Determining the risk adjustment for non-financial risk in a group
- Cash flows within the contract boundary
- Boundary of financial contracts with off-balance sheet
- Reporting on other shortcomings
- Determining the effective date for applying the standard
- Determining the benefits for using the transition resource group
2. Variable fee approach

VFA eligibility

- What is participating contracts?
  - Contracts that have a feature by which the entity shares additional risks and rewards with the policyholder, in some contracts subject to discretion of the entity
  - Profit sharing may be based on specific assets, groups of assets and liabilities, the profit made by a fund or company or an index
  - These are referred to as ‘underlying items’
  - Distinction between “direct” and “indirect” participating contracts
    - Only direct participating insurance contracts eligible for VFA

- Example of contracts that typically with participating features:
  - Unit linked contracts
  - Universal life contracts
  - Variable annuity contracts
  - Participating contracts
  - With profit contracts

Direct participating contracts – definition

- Substantially investment related service contracts: Insurance contracts with direct participation features are insurance contracts that are substantially investment related service contracts under which an entity promises an essentially investment related service.

The Board interprets contracts as investment obligation to a policyholder in certain circumstances, specifically, by reference to the agreed and stated terms of the contract. The Board interprets contracts as creating an obligation to pay policyholders an amount equal in value to specified underlying items, minus a variable fee for service. That fee is an amount equal to the entity’s share of the fair value of the underlying items minus any expected cash flows that do not vary directly with the underlying items.

- Participating contracts which cannot satisfy all 3 criteria are referred to as indirect participating contracts — measured under GIIF
- Assessments for indirect participation of contracts, no re-assessment needed (unless contract is modified). Criteria for VFA to be assessed for each group of contracts
Direct participating contracts – definition

• No need to hold the underlying items to meet criteria 1 as long as they are clearly identified by the contract:
  - Can comprise any items, for example a reference portfolio chosen, the net assets of the entity, or specified subset of the net assets of the entity, as long as they are clearly identified by the contract.
  - Anually need not hold the identified pool of underlying items (the measurement of insurance should not depend on actual items the entity holds).
  - The Board decided the underlying items do not need to be separate from financial assets. They can comprise items such as the net assets of the entity or subsidiary within the group. This in the reporting entity.

• Contract can be implied by an entity’s customary business practice:
  - A contract is an agreement between two or more parties that creates enforceable rights and obligations. Enforceability of the rights and obligations in a contract is a matter of law.
  - Contracts can be written, oral or implied by an entity’s customary business practices [2].
  - Implied terms in a contract include those that are imposed by law or regulation.
  - The practice of establishing contracts varies across jurisdictions, industries and entities, and even within an entity, depending on the class of customer.

• There is no clearly identified pool of underlying items when:
  - Entity can change the UI with retrospective effect; OR
  - No UI identified even the return is based on entity’s overall performance and expectation, or the performance and expectation of a subset of assets the entity holds. An example of such a return is a crediting rate or dividend payment set at the end of the period to which it relates. In this case, the obligation to the policyholder reflects the crediting rate or dividend amounts the entity has set, and does not reflect identifiable underlying items.
  - Don’t preclude entity’s discretion, however the link to the underlying items must be enforceable.

  A share referred to in paragraph (c)(iii) does not preclude the existence of the entity’s discretion to vary the amounts paid to the policyholder. However, the link to the underlying items must be enforceable (see paragraph 2.105).

• Substantial
  - To be interpreted in the context of contracts providing investment-related services.
  - Where the entity is compensated by a fee that is determined by reference to underlying items.
  - No clear market practice has developed yet, as a working hypothesis, a ‘range’ might be applied.
  - Within this ‘range’, products would be assessed based on their specific features and circumstances (e.g. fee structures, profit sharing conditions, level of discretion).

• Variability
  - To be assessed over the duration of the group of contracts, and on a present value probability-weighted average basis for example, a proportion of minimum return (§104).

04/05/2018
Direct participating contracts – definition

- Contract specifies a determinable fee:
  - For this to be the case, the contract needs to specify that the policyholder participates in such a clearly identified pool of underlying items which expresses a percentage of identifiable returns.
  - This, together with the determination of the amount of these returns (the pooled underlying items) in the future, enables the insurance company to calculate the policyholder’s share of returns as they become available.

- Not for reinsurance issued or held:
  - Reinsurance contracts issued or held cannot be insurance contracts with direct participation features for the purpose of IFRS 17.

- Assess the variability over the duration, and on a PV probability-weighted average basis, not a best or worst outcome basis:
  - Assess the variability in paragraphs B101(b) and B101(c): (i) over the duration of the group of insurance contracts; and (ii) on a present value probability-weighted average basis, not a best or worst outcome basis (see paragraphs B37–B38).

Direct participating contracts – measurement

[B104] The conditions in paragraph B101 ensure that insurance contracts with direct participation features are contracts under which the entity’s obligation to the policyholder is the net of:

a) the obligation to pay the policyholder an amount equal to the fair value of the underlying items; and
b) a variable fee (see paragraphs B110–B118) that the entity will deduct from (a) in exchange for the future service provided by the insurance contract, comprising:

(i) the entity’s share of the fair value of the underlying items; less
(ii) fulfilment cash flows that do not vary based on the returns on underlying items.

Changes in variable fee adjust against CSM and therefore spread over remaining coverage.

Variable fee approach

- Changes in the variable fee are recognized immediately in comprehensive income (within CSM) and updated for current interest rate and viewed through the basis of coverage.
- If the insurer is permitted to recognize changes in OCI for reporting changes in the basis of coverage, the P&L interest charge is equal to the P&L investment income on the underlying items.
- Risk mitigation: option to report changes in embedded guarantees in P&L if certain criteria and documentation requirements are met.

Summary key difference between GM and VFA

<table>
<thead>
<tr>
<th>Measurement metric</th>
<th>Changes in direct cash inflows/outs to the changes in financial variables</th>
<th>Interest income/expense</th>
</tr>
</thead>
<tbody>
<tr>
<td>GM</td>
<td>All changes in discount rates and other financial variables (also non-interest rate and other regulatory income/expense) performed over CSM as per the contract terms</td>
<td>The interest expense on the contractual service margin is explicitly accounted for using rates determined at the contract inception</td>
</tr>
<tr>
<td>VFA</td>
<td>The contractual service margin is adjusted to reflect the changes in a variable, which includes changes in the returns on the underlying investments and other financial variables</td>
<td>The interest expenses are implicit in the changes in the insurer’s variable liability, regardless of whether the cash flow needed to fund the contract</td>
</tr>
</tbody>
</table>

04 May 2018
Concept checking…

(1) What is a clearly identified pool of underlying items?

- The pool of underlying items can comprise any items, for example a reference portfolio of assets, the net assets of the entity, or a specified subset of the net assets of the entity, as long as they are clearly identified by the contract. An entity need not hold the identified pool of underlying items because the measurement of insurance contracts should not depend on what assets the entity holds. The underlying items do not need to be a portfolio of financial assets. They can comprise items such as the net assets of the entity or a subsidiary within the group that is the reporting entity.

Concept checking…

(2) What is the definition of “contract” and “contractual terms” when defining the clearly identified pool of assets?

- A contract is an agreement between two or more parties that creates enforceable rights and obligations. Enforceability of the rights and obligations in a contract is a matter of law. Contracts can be written, oral or implied by an entity’s customary business practices. Contractual terms included in a contract, explicit or implied, included in a contract include those imposed by law or regulation.

- There are certain features which may not satisfy VFA criteria: (i) different portfolios of participating contracts (direct or indirect) share the same pool with a notionally separated assets in the entity’s general account, and (ii) the segregated assets are only managed internally without enforceability or proper disclosure to the policyholders. While “ring-fenced asset” may better meet the criteria, there are also discussions on the “accounting designation” or “entity’s governance framework and its基调” meets the criteria. Advocates argue that commercial communication, i.e., materials presented or disclosed to the policyholders, can form part of the enforceability and the entity should consider these factors for the assessment of the clearly identified pool of assets. In any case, the definition of the “underlying items” should be documented clearly and the entity cannot change the underlying items with retroactive effects.

Concept checking…

(3) Does “a share of a clearly identified pool of underlying items” preclude the entity’s discretion to vary the amounts paid to the policyholder?

- No, but the link to the underlying items must be enforceable.
Concept checking…

4. How to interpret the word “substantial” in VFA criteria II and III?
   - The IASB does not provide a concrete definition for the term “substantial” as noted in the VFA criteria II and III. This is to allow entities to apply IFRS 17 for their particular circumstances without being limited by any quantitative rules. Market consensus may be formed with potential help from TRG discussion. However, a range of sharing percentages may still be expected from various jurisdictions due to different product offerings, and comparability with the fee structures of the investment products offered. An individual entity needs to perform its own assessment, and verify its conclusion with its respective auditor.

Concept checking…

5. What is the “variable fee”?
   - A variable fee that the entity will deduct in exchange for the future service provided by the insurance contract, comprises: (i) the entity’s share of the fair value of the underlying items; less (ii) fulfilment cash flows that do not vary based on the returns on underlying items. Contracts eligible for VFA should specify a determinable fee which can be expressed as a percentage of portfolio returns or asset values rather than only as a monetary amount. Without a determinable fee, the share of returns on the underlying items the entity retains would be entirely at the discretion of the entity, and this would not be consistent with that amount being equivalent to a fee.

Concept checking…

6. Can the VFA be applied to reinsurance contract?
   - No. Reinsurance contracts issued and reinsurance contracts held cannot be insurance contracts with direct participation features for the purpose of IFRS 17 [B109]. Hence, the VFA cannot be applied.
Concept checking…

(7) When should the VFA eligibility assessment be conducted?

- In general, the assessment should be conducted at inception only. An entity shall assess whether the conditions in paragraph B101 are met using its expectations at inception of the contract and shall not reassess the conditions afterwards, unless the contract is modified, applying paragraph 72 (B102). The variability over the duration should be assessed, and on a PV probability-weighted average basis, not a best or worst outcome basis (B101(b)(v)).

Concept checking…

(8) Is there an option not to apply the VFA?

- The IASB provides the general accounting model, and two modifications as known as the VFA and the premium allocation approach (PAA) for different types of contracts. While applying the PAA is an optional simplification when certain criteria are met for short-term contracts, applying the VFA is not an option nor an accounting choice. The entity should apply the VFA if the VFA eligibility assessment is passed.

3. Illustrative example
Given: product features

- A simple 5-year investment-linked product is created to illustrate the CSM differences between VFA and GM:
  - Death benefit (sum assured) = fixed 500 + account value (AV)
  - Maturity benefit = AV
  - Level annual premium = 500
  - 2% asset management charge (AMC)
  - Cost of insurance charge (COI charge)
  - 100 identical policies issued

Given: cash flow projection

<table>
<thead>
<tr>
<th>BE projection/Year</th>
<th>Yr1</th>
<th>Yr2</th>
<th>Yr3</th>
<th>Yr4</th>
<th>Yr5</th>
<th>Yr6</th>
</tr>
</thead>
<tbody>
<tr>
<td>No. survival(BOY)</td>
<td>100</td>
<td>99</td>
<td>97</td>
<td>94</td>
<td>90</td>
<td>85</td>
</tr>
<tr>
<td>No. deaths(EOY)</td>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
<td>-</td>
</tr>
<tr>
<td>Premium(BOY)</td>
<td>50,000</td>
<td>49,500</td>
<td>48,500</td>
<td>47,000</td>
<td>45,000</td>
<td>-</td>
</tr>
<tr>
<td>Commission(BOY)</td>
<td>5,000</td>
<td>5,000</td>
<td>5,000</td>
<td>5,000</td>
<td>5,000</td>
<td>-</td>
</tr>
<tr>
<td>Expenses(EOY)</td>
<td>200</td>
<td>198</td>
<td>194</td>
<td>188</td>
<td>180</td>
<td>-</td>
</tr>
<tr>
<td>Death outgo(EOY)</td>
<td>1,000</td>
<td>3,030</td>
<td>6,186</td>
<td>10,638</td>
<td>16,667</td>
<td>-</td>
</tr>
<tr>
<td>Survival outgo(BOY)</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>240,833</td>
</tr>
<tr>
<td>Net CF</td>
<td>43,800</td>
<td>43,797</td>
<td>41,150</td>
<td>36,174</td>
<td>28,153</td>
<td>(240,833)</td>
</tr>
</tbody>
</table>

Given: account value roll forward

<table>
<thead>
<tr>
<th>BE projection/Year</th>
<th>Yr1</th>
<th>Yr2</th>
<th>Yr3</th>
<th>Yr4</th>
<th>Yr5</th>
<th>Yr6</th>
</tr>
</thead>
<tbody>
<tr>
<td>AV(BOY)</td>
<td>49,500</td>
<td>98,470</td>
<td>146,814</td>
<td>194,362</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Premium(BOY)</td>
<td>50,000</td>
<td>49,500</td>
<td>48,500</td>
<td>47,000</td>
<td>45,000</td>
<td>-</td>
</tr>
<tr>
<td>COI charge(BOY)</td>
<td>(500)</td>
<td>(1,000)</td>
<td>(1,500)</td>
<td>(2,000)</td>
<td>(2,500)</td>
<td>-</td>
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<tr>
<td>Investment income(EOY)</td>
<td>1,490</td>
<td>4,460</td>
<td>8,940</td>
<td>15,022</td>
<td>22,876</td>
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<td>AMC(EOY)</td>
<td>(990)</td>
<td>(1,960)</td>
<td>(2,909)</td>
<td>(3,836)</td>
<td>(4,737)</td>
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<tr>
<td>Death outgo from AV(EOY)</td>
<td>(500)</td>
<td>(2,030)</td>
<td>(4,686)</td>
<td>(8,638)</td>
<td>(14,167)</td>
<td>-</td>
</tr>
<tr>
<td>AV(EOY)</td>
<td>49,500</td>
<td>98,470</td>
<td>146,814</td>
<td>194,362</td>
<td>240,833</td>
<td>-</td>
</tr>
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</table>
Step 1: define the CFs for FCF calculation

<table>
<thead>
<tr>
<th>Step (1): CFs for FCF calculation</th>
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<tbody>
<tr>
<td><strong>Premium</strong></td>
</tr>
<tr>
<td>---------</td>
</tr>
<tr>
<td>Premium</td>
</tr>
<tr>
<td>Commission &amp; Expense</td>
</tr>
<tr>
<td>Underwriting expenses</td>
</tr>
<tr>
<td>Profit (loss)</td>
</tr>
<tr>
<td>Net CF (NCF)</td>
</tr>
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</table>

Step 2: initial measurement and initial CSM

<table>
<thead>
<tr>
<th>Step (2): FCF calculation</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Inception</strong></td>
</tr>
<tr>
<td><strong>BEL</strong></td>
</tr>
<tr>
<td><strong>RA</strong></td>
</tr>
<tr>
<td><strong>FCF</strong></td>
</tr>
</tbody>
</table>

Step 3: define the coverage unit

<table>
<thead>
<tr>
<th>Step (3): Coverage unit</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Inception</strong></td>
</tr>
<tr>
<td><strong>Yr1</strong></td>
</tr>
<tr>
<td>---------</td>
</tr>
<tr>
<td>SCP</td>
</tr>
<tr>
<td>RA</td>
</tr>
<tr>
<td>Coverage unit</td>
</tr>
</tbody>
</table>
### Step 4: CSM roll-forward under GM

#### CSM under GM

<table>
<thead>
<tr>
<th></th>
<th>Yr1</th>
<th>Yr2</th>
<th>Yr3</th>
<th>Yr4</th>
<th>Yr5</th>
<th>Yr6</th>
</tr>
</thead>
<tbody>
<tr>
<td>CSBM(BOY)</td>
<td>3,200</td>
<td>2,913</td>
<td>2,472</td>
<td>1,858</td>
<td>1,047</td>
<td>-</td>
</tr>
<tr>
<td>Interest accretion</td>
<td>66</td>
<td>132</td>
<td>132</td>
<td>160</td>
<td>181</td>
<td>181</td>
</tr>
<tr>
<td>Amortization</td>
<td>230</td>
<td>210</td>
<td>170</td>
<td>207</td>
<td>235</td>
<td>235</td>
</tr>
<tr>
<td>CSBM(EOY)</td>
<td>2,913</td>
<td>2,472</td>
<td>1,858</td>
<td>1,047</td>
<td>-</td>
<td>-</td>
</tr>
</tbody>
</table>

### Step 5a: define the entity’s share of the UI

#### Entity’s share of the fair value of the underlying items (ES of UI)

<table>
<thead>
<tr>
<th></th>
<th>Yr1</th>
<th>Yr2</th>
<th>Yr3</th>
<th>Yr4</th>
<th>Yr5</th>
<th>Yr6</th>
</tr>
</thead>
<tbody>
<tr>
<td>BOY</td>
<td>18,584</td>
<td>18,084</td>
<td>16,638</td>
<td>13,935</td>
<td>9,882</td>
<td>4,320</td>
</tr>
<tr>
<td>Paid to entity (BOY)</td>
<td>(500)</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Change in ES of UI</td>
<td>544</td>
<td>757</td>
<td>856</td>
<td>774</td>
<td>417</td>
<td>-</td>
</tr>
<tr>
<td>Paid to entity (EOY)</td>
<td>(1,990)</td>
<td>(3,460)</td>
<td>(4,909)</td>
<td>(6,336)</td>
<td>(4,737)</td>
<td>-</td>
</tr>
<tr>
<td>EOY</td>
<td>18,084</td>
<td>16,638</td>
<td>13,935</td>
<td>9,882</td>
<td>4,320</td>
<td>-</td>
</tr>
</tbody>
</table>

### Step 5b: define the FCF that do not vary with UI

#### FCF that do not vary based on the return on underlying items (FCF non UI)

<table>
<thead>
<tr>
<th></th>
<th>Yr1</th>
<th>Yr2</th>
<th>Yr3</th>
<th>Yr4</th>
<th>Yr5</th>
<th>Yr6</th>
</tr>
</thead>
<tbody>
<tr>
<td>BOY</td>
<td>15,384</td>
<td>10,184</td>
<td>7,318</td>
<td>5,487</td>
<td>4,136</td>
<td>2,280</td>
</tr>
<tr>
<td>Paid by entity (BOY)</td>
<td>(5,200)</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Change in FCF non UI</td>
<td>307</td>
<td>333</td>
<td>337</td>
<td>324</td>
<td>220</td>
<td>-</td>
</tr>
<tr>
<td>Paid by entity (EOY)</td>
<td>(3,173)</td>
<td>(2,164)</td>
<td>(1,688)</td>
<td>(2,180)</td>
<td>(2,500)</td>
<td>-</td>
</tr>
<tr>
<td>EOY</td>
<td>10,184</td>
<td>7,318</td>
<td>5,487</td>
<td>4,136</td>
<td>2,280</td>
<td>-</td>
</tr>
</tbody>
</table>
Step 6: CSM roll-forward under VFA

<table>
<thead>
<tr>
<th>Year</th>
<th>CSM(BOY)</th>
<th>Change in ES of UI</th>
<th>Change in FCF non UI</th>
<th>Amortization</th>
<th>CSM(EOY)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yr1</td>
<td>3,200</td>
<td>544</td>
<td>(307)</td>
<td>(399)</td>
<td>3,038</td>
</tr>
<tr>
<td>Yr2</td>
<td>3,038</td>
<td>757</td>
<td>(333)</td>
<td>(653)</td>
<td>2,810</td>
</tr>
<tr>
<td>Yr3</td>
<td>2,810</td>
<td>856</td>
<td>(337)</td>
<td>(971)</td>
<td>2,358</td>
</tr>
<tr>
<td>Yr4</td>
<td>2,358</td>
<td>774</td>
<td>(324)</td>
<td>(1,341)</td>
<td>1,467</td>
</tr>
<tr>
<td>Yr5</td>
<td>1,467</td>
<td>417</td>
<td>(220)</td>
<td>(1,664)</td>
<td>-</td>
</tr>
</tbody>
</table>

Q&A

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