Implementing IFRS 17 in China

In preparation for the implementation of IFRS 17, this article will provide a summary on:

- Differences between reporting under PRC GAAP and reporting under IFRS 17
- Expected key challenges as part of implementing IFRS 17 in China

Background

The new accounting standard, IFRS 17 *Insurance Contracts*, was published on 18 May 2017 and has an effective date of 1 January 2021. The objective of the new accounting standard is to provide a uniform and consistent method for the accounting of insurance contracts and to provide greater transparency on insurers' earnings by making them more comparable to other industries. This new approach will provide up-to-date information about the entity's obligations and will reflect the characteristics of the contracts on a current market basis.

Key changes affecting China

When the Chinese Regulations on Accounting for Insurance Contracts ("Accounting for Insurance Contracts") was developed by the Ministry of Finance (MOF) in 2009, many of the concepts were borrowed from the International Accounting Standards Board's (IASB) Insurance Contracts Project at that time. However, there have been several developments in the past eight years and as a result, IFRS 17 is expected to bring significant change to financial reporting in China. This issue of Deloitte's 'Insurance Accounting Insights – Country in focus' series sets out the practical implications that insurers in China should consider as part of their implementation planning. Key technical differences between IFRS 17 and PRC GAAP are summarised in the Appendix.

Practical implications for insurers

Based on our work with insurers and on our own assessments, there are several key areas where we encourage insurers in China to conduct further analysis and assessments. These areas include:

- Lower level of aggregation creating greater granularity to produce reported results
- Alignment of life and non-life financial reporting
- Implications of unbundling where no longer permitted
- Risk Adjustment
- Changes in accounting estimates
- Reinsurance
- Presentation and disclosures

Lower level of aggregation creating greater granularity to produce reported results

The level of aggregation for insurance contracts when determining a group of contracts is different from current practice. A group will be a sub-set of a portfolio with contracts issued no more than 12 months apart and utilised to determine whether a group is onerous (i.e. loss recognition required) or whether the contractual service margin (CSM) will be reported as a separate, explicit component of an insurance contract's carrying amount.

At inception, an entity shall disaggregate the portfolio with insurance contracts issued no more than 12 months apart into groups of contracts that:

- are onerous, if any;
- have a significant risk of becoming onerous, if any; and
- are a group of the remaining contracts in the portfolio, if any.

An entity is permitted to divide portfolios into more groups than required above.

Under the current PRC GAAP, contracts are divided into two groups when measuring the residual margin as defined in PRC GAAP; contracts that are onerous, and contracts that are profitable. The onerous test is performed at a product level. Under the new requirements, this will have to be assessed at inception of the contract, prohibiting the offset of contracts that are individually profitable with those that are individually onerous at initial recognition date.

Alignment of life and non-life financial reporting

IFRS 17 will drive companies to look differently at the traditional classification of life and non-life insurance products for reporting purposes as it is based on a single measurement model, often referred to as the Building Block Approach (formally, the General Model) regardless of the type of insurance coverage. The same measurement model will also be applied to reinsurance contracts issued and applied.

For insurers with both life and general insurance businesses, there will be an implication on presentation and disclosures due to the need to align different terminologies under the current financial reporting regime to the consistent basis under IFRS 17. For example, “liability for remaining coverage” may end up being the common term used for “unearned premium reserve” in general insurance, and “best estimate liability” in life insurance.

Unbundling is prohibited unless proven to be required and new unbundling of distinct service components

Under PRC reporting, unbundling of non-insurance components is required when different components are distinct and separable. In practice, contracts with account balances are considered to have distinct and separable components. Therefore, universal life and unit-linked products are usually unbundled into investment, insurance and service components (generating management fee income).

Under IFRS 17, for an insurance contract with an account balance, if the right to insurance benefits provided under the insurance cover either lapses or matures at the same time as the account balance, the insurance and investment components are highly interrelated hence not distinct. In this scenario, the account balance would not be separated from the insurance contract and would be accounted for under IFRS 17.

In addition, IFRS 17 introduces a new unbundling requirement to separate those non-insurance service components that may be bundled in an insurance contract. When a distinct non-insurance service component exists it would have to be accounted for under IFRS 15. These non-insurance service components may include certain forms of asset management services and certain claims handling services that have not been commercially integrated in the overall insurance contract.

The new unbundling regime is likely to have some operational implications for PRC life insurance companies with large books of insurance contracts that are highly interrelated with the associated investment component. The unbundling of non-insurance service components is new and it would require a careful assessment of its potential impact. Insurers will need to analyse which insurance products will need to be accounted for as a bundled or unbundled contract and identify the financial reporting requirements to comply with the various accounting standards.

Risk Adjustment

IFRS 17 requires an explicit Risk Adjustment liability (RA) to reflect the compensation that the entity would require for bearing the uncertainty about the amount and timing of the cash flows.

Various techniques are possible but disclosures on translation of these techniques into a confidence level will be required. Such disclosure requirement would require insurers to perform additional calculations or even change the approach to measure the RA.

Changes in assumptions

Currently, PRC GAAP is silent on the treatment of changes in assumptions. In practice, assumptions are locked and not revised for the determination of the residual margins, as long as loss recognition is not required. Only traditional unearned premium liabilities are recognised by non-life insurers, as long as loss recognition is not required.

Under IFRS 17, the impact arising from changes in assumptions for the liability for remaining coverage has to be accounted for against the CSM component of the liability ('unlocking' the CSM). The unlocking of the CSM in the General Model is modified for other contract types where the cash flows are asset-dependent.

For non-participating contracts, the General Model requires the impact of changes in non-economic assumptions to be reflected as adjustments against the CSM when they relate to assumptions for cash flows within the coverage period; and against the income statements when related to incurred claims.

An accounting policy choice is provided to reflect the changes in discount rates and market variables which will be reflected in the income statement or split between the income statement and other comprehensive income, made at portfolio level.

A variable fee approach is used to modify the General Model for direct participating contracts. These are insurance contracts with direct participation features defined as insurance contracts for which:

- the contractual terms specify that the policyholder participates in a share of a clearly identified pool of underlying items;
- the entity expects to pay to the policyholder an amount equal to a substantial share of the fair value returns on the underlying items; and
- the entity expects a substantial proportion of any change in the amounts to be paid to the policyholder to vary with the change in fair value of the underlying items.

For insurance contracts with direct participating features, CSM is adjusted for change in estimates of the variable fee for future services as well as change in discount rate. This includes both financial and non-financial changes in assumptions.

Contracts that have asset-dependent cash flows but do not meet the definition of a direct participating contract are referred to as indirect participating contracts. Indirect participating contracts have their CSM unlocked for changes in financial variables that cause a change in the level of discretion affecting future asset-dependent cash flows. All other requirements of the CSM unlocking from the General Model apply without modification. An example of contracts with indirect participating features are certain types of universal life insurance contracts.

Reinsurance

PRC GAAP provides two different approaches for the assessment of the significant insurance risk for direct and reinsurance insurance contracts. The probability of occurrence of insured events has to be assessed for the reinsurance contracts.

IFRS 17 provides a single framework for assessing direct and reinsurance contracts issued and held. The insurance risk is significant if the payment to the cedant is significant in any scenario an insured event occurs, even if in some cases the insured event is extreme.

IFRS 17 also provides a single measurement framework for direct and reinsurance contracts issued and held.

However, there are some modifications to these requirements for reinsurance contracts held that could lead to differences in the measurement of such reinsurance contracts and the underlying direct contracts.

For instance, the RA asset of a reinsurance contract held to reinsure catastrophic risks can differ from the RA liability of the underlying portfolio. Moreover, the measurement of fulfilment cash flows of reinsurance contracts held has to take into account the risk of non-performance of the issuers. This estimate of credit losses is aligned with IFRS 9 impairment principles for life time credit losses.

PRC GAAP currently is not explicit on its impairment model in respect of reinsurance assets. In practice, an impairment model similar to IAS 39 in respect of financial assets measured at amortised costs are usually applied.

Presentation and disclosures

There are significant changes to what constitutes revenue and expenses arising from insurance contracts.

Under IFRS 17, revenue is the sum of the release of CSM, changes in RA and expected net cash outflows, excluding any investment components. The exclusion of any investment component from revenue recognition will have significant impacts on contracts being sold by life insurers in China. Although the investment component of a universal life contract and unit linked contract is unbundled under the current PRC GAAP, premium of many endowment and whole life insurance contracts with a large investment component are still recognized as revenue.

Disclosures of reconciliations of the best estimates in cash flows, RA and CSM will be required.

Transition

Given the stated convergence with IFRS that the MOF has adopted for several years, Deloitte expects that IFRS 17 will be adopted as a Chinese accounting standard and the transition provisions will need to be analysed carefully.

In terms of transition requirements, insurers need to estimate the remaining CSM balance. There are three possible approaches:

- **Full retrospective** application of new requirements is required, unless impracticable;
- Where impracticable, the **modified retrospective approach** or the **fair value approach** can be applied.

The objective of the modified approach is to achieve the closest possible outcome to a full retrospective restatement using reasonable and supportable information available without undue cost or effort. Under this approach, an entity can group contracts issued more than one year apart in the same group if the entity does not have reasonable and supportable information to apply a retrospective approach.

Under the fair value approach, an entity is not required to group contracts issued more than one year apart in different groups unless it has reasonable and supportable information to make further divisions to ensure that contracts within a group are issued within the same 12 months.

As evidenced during the adoption of the new insurance contract measurement approach in 2009, many insurers in China were not able to identify all information required to perform a full retrospective restatement for all insurance contracts.

Both life and non-life insurers will face significant implementation costs

The current accounting standard for insurance contracts in China was developed with reference to IASB principles which were in development in 2009. Chinese insurers will find in IFRS 17 a number of similarities with their current accounting practices. However, as this article explains, there is greater complexity and granularity of reporting requirements under IFRS 17 than required under current Chinese accounting standards. For this reason, Deloitte expects that there will still be major changes required to Chinese insurance companies' actuarial and finance reporting processes, systems and data over the next three years.

Given IFRS 17 is published and its adoption into Chinese accounting standards is likely, Chinese insurers should start to manage the implementation of the new requirements immediately, by developing an adequate implementation plan built on the foundation of a comprehensive business and financial impact assessment. The key priorities we see for insurers in China over the next six months are:

- To understand the overall operating model and impact of IFRS 17 changes – training deeply a small implementation leadership team is essential to achieving this goal effectively;
- Make strategic decisions around adoption/implementation and the desired target state;
- Complete a business case and secure budget project approvals;
- Begin hiring and on-boarding the right number of people (actuarial, finance and technology) – experienced resources will be limited in the market for a substantial period of time;
- Educate senior management and shareholders;
- Future-proof in-flight and upcoming projects;
- Engage implementation partners to understand their ability to support the implementation work – consultants and technology vendors;
- Engage a broader range of stakeholders (e.g. HR, external auditors); and
- Start collecting information necessary to restate comparative financial information.

Appendix: Summary of key differences between PRC GAAP and IFRS 17

Below is a summary of key differences between PRC GAAP and IFRS 17. PRC GAAP embodies the requirements of accounting standards and interpretations issued by China's MOF, industry guidance developed by a number of bodies including regulators and industry organisations, as well as common practice developed over time.

	PRC GAAP	IFRS 17
Product classification	• Different product classification models: one for direct contracts and one for reinsurance contracts. For reinsurance contracts, probability of occurrence of insured events has to be considered. Quantitative guidance is given. • Contracts that do not transfer significant insurance risks are not within the scope of Accounting for Insurance Contracts.	• A single model of product classification. Insurance risk is significant if and only if an insured event could cause the issuer to pay amounts that are significant in any single scenario, excluding scenarios that have no commercial substance. The condition can be met even if some scenarios are highly unlikely. • Investment contracts (contracts that do not transfer significant insurance risk) with discretionary participation features are within the scope of IFRS 17.
Changes in insurance risks	• Significant risks should be assessed at the end of each reporting period for contracts an insurer has held and issued. Contracts have to be reclassified as investment contracts if the significant risk test fails.	• Once a contract is classified as an insurance contract, it remains an insurance contract until the rights and obligations of the contract are extinguished or the contract is de-recognised.
Options and guarantees	• Not explicitly valued.	• Sophisticated stochastic modelling is likely to be needed to satisfy the measurement objective.
Discount rates	• 750-day moving average yield curve of treasury bills issued by the MOF, plus a premium of not more than 120 basis points, when future benefits do not depend on assets. • Future investment yield of relevant investment portfolios, when future benefits depend on assets.	• Reflects the risk characteristics of cash flows (including asset-dependency) using either a top-down or bottom-up approach. The rates selected should be consistent with current market observable information.
Acquisition costs	• For non-life insurers: acquisition costs are recognised as expenses in profit or loss against an equal and opposite amount of premium being recognised as revenue. • For life insurers: acquisition costs form part of the expected future net cash outflows which are taken into account in measuring insurance contract liabilities.	• Acquisition costs directly attributable to the creation of a portfolio of insurance contracts must be included in the contractual cash flows expected from the contracts. The resulting accounting treatment is that they are allocated to the profit or loss over the coverage period and they are part of the of the best estimate liability on the balance sheet. • Acquisition costs associated with contracts that have a coverage period of 12 months or less and for which the insurer has elected to use the Premium Allocation Approach can be expensed as incurred by making that policy election.
Catastrophic reserves	• Catastrophic reserves are required for certain risks arising from the insurance of agricultural business.	• Catastrophic reserves are disallowed.
Contract Service Margin	• Residual margins (similar to CSM) are allocated to the income statements on a systematic basis, for instance sum assured, over the coverage period.	• CSM released according to transfer of services determined by allocation of coverage units, or the investment services transferred in the situation of investment contracts with discretionary participation features.

	PRC GAAP	IFRS 17
Risk Adjustment	• Determined differently by life and non-life insurers: – Life insurers use a scenario comparison approach – Non-life insurers resort to industry data and a survey performed by the China Actuarial Society (the latest at the time of writing being 2011 data).	• RA is measured as the compensation that the entity requires for bearing the uncertainty about the amount and timing of future cash flows that arises from non-financial risk. • IFRS 17 does not specify the estimation technique(s) to be used to determine RA but requires disclosure on translation of the technique used into confidence level.
Changes in Estimates	• Although not explicitly stipulated, most insurers adopted the approach that assumptions are locked and not revised for determination of the residual margins, as long as loss recognition is not required.	• For contracts under the General Model: – Non-economic assumptions are reflected as adjustments to the CSM when they relate to assumptions for cash flows within the coverage period and to the income statements when related to incurred claims. – Discount rates and market variable changes will be reflected in the income statement or split between the income statement and other comprehensive income by accounting policy choice made at portfolio level. • For direct participating contracts, the CSM is adjusted for change in estimates of the variable fee for future services as well as change in discount rate. This includes both financial and non-financial changes in assumptions. • For indirect participating contracts, the CSM is unlocked for changes in financial variables that cause a change in the level of discretion affecting future asset-dependent cash flows. All other requirements of the CSM unlocking from the General Model apply without modification.
Reinsurance	• Limited guidance on the measurement of reinsurance assets. • No official guideline as to the "Day One Gain/Loss" treatment for reinsurance contracts held. In practice, measurement of reinsurance assets usually mirror those of the corresponding reinsured insurance liabilities. • Reinsurance commissions are presented as a separate income item. • Impairment is assessed in line with financial assets measured at amortised costs.	• Fulfilment cash flows need to consider the risk of non-performance of the contract of the issuer of the reinsurance contract. • Net cost on purchasing reinsurance contracts can be a CSM (CSM can be positive or negative), unless it is related to events that occurred prior to the purchases of the reinsurance contracts. • RA of reinsurance contracts held may not mirror that of the underlying contracts. • Reinsurance commission is either presented as a deduction of outward reinsurance premiums or claim recoveries, if it is, or not, contingent on reinsured claim occurrence.
Premium Allocation Approach	• Does not specify a simplified approach for measuring liabilities of remaining coverage but in practice, all non-life insurers account for their liabilities of remaining coverage using the traditional unearned premium approach.	• A simplified approach to measure the liabilities of remaining coverage is optional if it can produce a measurement which approximates the results produced by the standard method. This is known as the Premium Allocation Approach (PAA). The PAA is different from the traditional unearned premium approach in terms of measurement of remaining coverage, in particular when premiums have not yet been received.

Deloitte technical assistance and insights

Please visit www.deloitte.com/ifrsinsurance for more of our insights on IFRS 17 and how it will impact your business.

Deloitte's technical updates on the IASB's Insurance Contracts project are available at our dedicated page on IASPlus, the #1 website for global accounting news.

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