Main Changes and Impact of the New Accounting Standards

April 2023

Foreword

In 2020, the Ministry of Finance of China issued the revised Accounting Standard for Business Enterprises ("ASBE") No. 25 - Insurance Contracts (Cai Kuai [2020] No. 20) (referred to as the “New Insurance Accounting Standard”), which will replace the previous ASBE No. 25 - Primary Insurance Contracts, ASBE No. 26 - Reinsurance Contracts and Rules on Accounting Treatment of Insurance Contracts (Cai Kuai [2009] No. 15) (collectively referred to as the “Old Accounting Standards”) in due course.

In 2017, the Ministry of Finance of China issued ASBE No. 22 - Recognition and Measurement of Financial Instruments, ASBE No. 23 - Transfer of Financial Assets, ASBE No. 24 - Hedge Accounting, and ASBE No. 37 - Presentation of Financial Instruments (collectively referred to as the “New Accounting Standards on Financial Instruments”).

This presentation will briefly introduce the contents of the aforementioned accounting standards and related rules mainly from the perspective of users of financial statements.

Caution: All the viewpoints expressed in this presentation represent only personal views of the author.

The accounting standards and relevant rules referred to in this presentation are highly complex, and cannot possibly be covered entirely due to the limited volume of this presentation. In addition, the introduction in the presentation may be interpreted differently in different circumstances. Therefore, this is for discussion purposes only, and shall not be used as a direct guide for specific issues and work in practice. Whenever necessary, you are advised to consult professionals.

Note: This is English translation of a Chinese presentation, if there is any difference between the Chinese and English versions, the Chinese version shall prevail.

Contents

Main changes and impact of the New Insurance Accounting Standard

Measurement of insurance contract liabilities under the New Insurance Accounting Standard - an overview of the general model

Insurance contract liabilities

Fulfil-ment cash flows

Building block 4: Contractual service margin (CSM)	Unearned profit that the entity will recognize as it provides insurance contract services
Building block 3: Risk adjustment for non-financial risk (RA)	The compensation an entity requires for bearing the uncertainty about the amount and timing of the cash flows that arises from non-financial risk as the entity fulfils insurance contracts
Building block 2: Adjustment for the time value of money and financial risk	Reflecting the time value of money and the financial risks, to the extent that the financial risks are not included in the estimates of the future cash flows
Building block 1: Estimates of future cash flows	Estimates of future cash flows directly related to fulfillment of insurance contracts

Additional information and analysis

- The general model is also referred to as the building block approach ("BBA")
- **CSM is not cash flow. It is unearned profit and cannot be negative** (i.e. it cannot be a debit balance, except for reinsurance contracts held)
- Under the Old Accounting Standards, the insurance contract liabilities may also be measured via 4 building blocks - expected future cash flows, adjustment for the time value of money, risk margin and residual margin. However, the measurement units and detailed rules on measurement and accounting treatment are different.

Changes in revenue under the New Insurance Accounting Standard (claims and expenses are also impacted)

Old Accounting Standards

Permanent difference:

"Deposit" components, such as surrender payments, maturity payments under endowment contracts, **will not be included in measurement of revenue (nor in expenses),** this constitutes a permanent difference between the old and new standards

Premium income

"Deposit" components embedded in insurance policies (formally known as - investment components which cannot be distinctly separated)

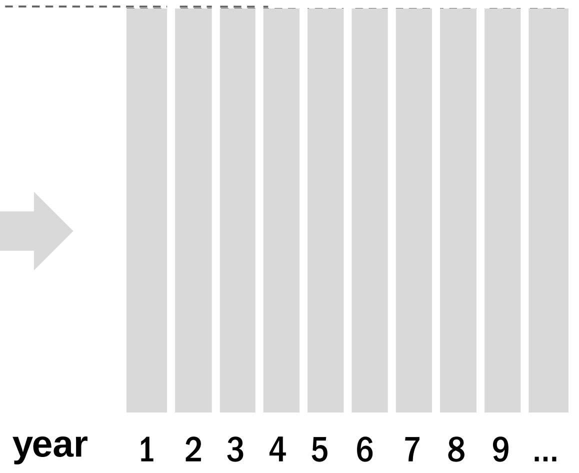
Expected payment of claims and expenses, and non-financial risk margin (fulfillment cash flows)

Profits expected to be earned (formally known as the contractual service margin)

New Insurance Accounting Standard

Insurance revenue

"Interest" accreted



Permanent difference:

The "interest" accreted on the liability for remaining coverage increases the liability, hence, the subsequent release of the liability **to revenue results in the revenue includes such "interest"**

Temporary difference:

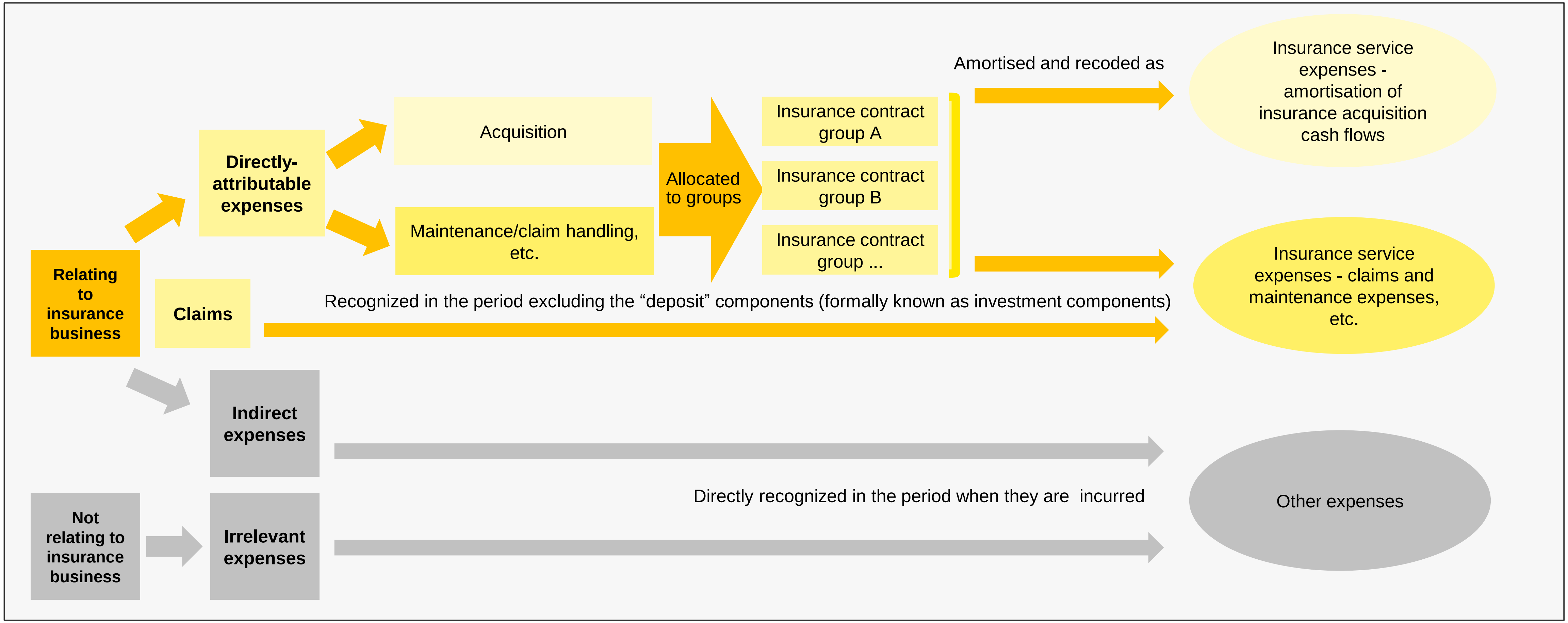
Revenue will be gradually recognised in the periods when services under insurance contracts are provided and the risks are released, this constitutes a temporary difference in revenue recognition between the old and new accounting standards

Note: The diagram only illustrates the approximate relationship between premiums and revenue. The shape and relative size of the elements in the diagram do not necessarily provide additional information

Accounting treatment of expenses and claims under the New Insurance Accounting Standard

Under the Old Accounting Standards, expenses, claims, surrender payments, maturity payments and policyholders' dividends are recognized in profit or loss (P/L) as incurred; acquisition costs generally are effectively deferred as they are included in the measurement of reserves

Under the New Insurance Accounting Standard, insurance service expenses (including claims and expenses) would be treated as follows:



Presentation of pofit sources of insurers under the New Insurance Accounting Standard

The New Insurance Accounting Standard enables the users of financial statements to analyze the profit sources into insurance service, investment and other operations

Insurance service results – Profits calculated as **insurance revenue** arising from insurance business less **insurance service expenses** and **service results from reinsurance contracts held**

Investment profits - Profits calculated as **investment income** less "cost of funds" (calculated under the New Insurance Accounting Standard) included in the P/L (formally known as the **finance income/expenses for insurance**) for funds generated from premiums, etc. that can be invested

Other income and expenses -
Income and expenses generated by other business of insurance companies

Pre-tax profits ＝ Insurance service results ＋ Investment profits ± Other income and expenses

Please also note that a portion of "cost of funds" may also be included in other comprehensive income (OCI)

Changes in the P/L statement under the New Insurance Accounting Standard

Simplified P/L statement (the Old Accounting Standards)

Net premiums earned (Gross written premiums, less premiums ceded to reinsurers and net change in unearned premium reserves)	X
Investment income/gains (losses) from changes in fair value	X
Operating income	**X**
Surrenders	(X)
Claims	(X)
Commission and brokerage expenses	(X)
Operating and administrative expenses	(X)
Changes in insurance contract reserves	(X)
Operating expenses	**(X)**
Other income/(expenses), income tax, etc.	X
Net profit	**X**
OCI - changes in fair value of financial assets	X
Change in insurance contract liabilities (shadow accounting)	(X)
Total comprehensive income	**X**

It is the changes in the balances of reserves from beginning to end of the period. What information does it provide?

If (pre-tax) profit is lower than investment income, does it mean the company's profits depends solely on investments?

Simplified P/L statement (the New Insurance Accounting Standard)

Insurance service revenue	X
Interest income/investment income/gains (losses) from changes in fair value	X
Total operating income	**X**
Insurance service expenses	(X)
Allocation of reinsurance premiums	(X)
Recoveries of insurance service expenses from reinsurers	X
Finance expenses for insurance contracts issued	(X)
Reinsurance finance income for reinsurance contracts held	X
Total operating expenses	**(X)**
Other income/(expenses), income tax, etc.	X
Net profit	**X**
OCI - changes in fair value of financial assets	X
OCI - Insurance finance income/(expenses) for insurance contracts issued that will not be reclassified to P/L	(X)
OCI - Insurance finance income/(expenses) for insurance contracts issued that will be reclassified to P/L	(X)
OCI - Reinsurance finance income/(expenses) for reinsurance contracts held that will be reclassified to P/L	X
Total comprehensive income	**X**

It excludes "deposit" component and is recognized as services are provided

It includes claims, expenses, losses/gains from onerous contracts, but does not include "deposit" component

"costs of funds" included in the P/L for funds (available for investment) from underwriting operations

Effects of changes in financial assumptions (may also be considered as part of "cost of funds") can be elected to be recognized as OCI, and thus resulting changes in insurance liabilities may not have a direct impact on profits

Changes in the balance sheet under the New Insurance Accounting Standard

Certain items under the Old Account Standards may not exist or may be materially impacted under the New Insurance Accounting Standard
Assets
Premium receivables, reinsurance receivables
Reinsurer's share of unearned premiums, reinsurers' share of claims reserves
Reinsurers' share of life insurance contract liabilities, reinsurers' share of long-term health insurance contract liabilities
Policy loans
Liabilities
Reinsurance payable
Claims payable, policyholder dividend payable
Policyholders' deposits and investment contract liabilities
Unearned premiums reserve, claims reserve
Life insurance contract liabilities, long-term health insurance contract liabilities
Separate account liabilities

Items under the New Insurance Accounting Standard (excluding those irrelevant to insurance contracts)
Assets
Insurance contract assets *
Reinsurance contract assets *
Liabilities
Insurance contract liabilities *
Reinsurance contract liabilities *

Note*: The presentation of the above balance sheet items are based on assets and liabilities arising from insurance contracts aggregated at the level of portfolio of insurance; the carrying amount of the assets for insurance acquisition cash flows are included in the carrying amount of the related portfolio of insurance contracts.

Note：

- Please note that other balance sheet items may also be impacted by the New Insurance Accounting Standard.

Key financial impact of the New Insurance Accounting Standard

- Measurement of present value using current interest rates (including premium reflecting characteristics of insurance contracts) - may lead to increased volatility of the carrying amounts of insurance contract liabilities, however, use of “OCI option” may cushion the impact on net profits
- CSM has a special “absorption” mechanism which mitigates the impact on current period P/L of the changes in accounting estimates (relating to future service) of the profitable contracts other than those using Premium Allocation Approach (PAA)
- The Variable Fee Approach (VFA) is introduced to help to mitigate the accounting mismatch between financial assets and related insurance liabilities, which in turn reduces the volatility of net profits and net assets due to changes to financial assumptions for those insurance contracts (eligible for VFA)
- Each group of insurance contract is a measurement unit, and the insurance contract liabilities are measured as the sum of fulfillment cash flows and CSM - changes in scope and accounting treatment of fulfillment cash flows, changes in the amortization of CSM, etc. may impact the way the revenue and P/L are recognized
- Presentation
  - The exclusion of “deposit” components (formally known as “investment components” under the New Insurance Accounting Standard) from P/L and amortization of premiums and expenses will reduce the amounts (arising from long-term insurance contracts) of such P/L items as insurance service revenue and insurance service expenses, etc.
  - The separation of insurance service results from insurance finance income/expenses in the P/L statements and the addition of requirement for note disclosure of reconciliation of carrying amounts of insurance contract liabilities, provides information similar to analyses of profit sources and experience variances
  - If the time value of money is taken into account in the application of PAA, insurance service results may increase as a portion of the “cost of funds” is included in the insurance finance income/expenses rather than deducted from the insurance service results
  - The combination of many balance sheet items into the insurance contract liabilities/assets (or reinsurance contract liabilities/assets) may lead to lower total assets and total liabilities

Key impact on other aspects of insurance companies

Personnel, policies and processes

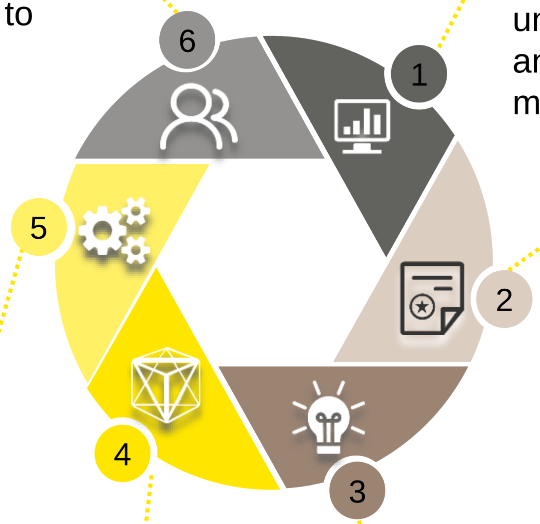
Higher requirements for quality and skills of personnel; in addition, accounting, actuarial, investment, IT systems, etc. and other related policies, internal control and processes need to updated properly

Only continuous improvement of business/actuarial/accounting systems, and consistency of business data and accounting data, can meet the large and complicated computational demand as a result of the New Insurance Accounting Standards; at the same time, system performance, maintenance and cost issues should also be taken into account

IT systems

The high requirements set by the new insurance guidelines urge insurers to improve data quality, data consistency, data extraction/processing efficiency and data governance, etc. Better data quality and granularity will also promote performance analysis and operation management

Data



Performance evaluation and budgeting

Since important metrics such as revenue, expenses, underwriting profit, net profit, net assets and CSM may change under the New Insurance Accounting Standard, performance analysis, performance evaluation, and financial budgeting, etc. may also change

Product and business development

New external competition landscape may emerge, internal performance evaluation may change, and New Insurance Accounting Standard will present a clearer view of operating results, those may require a revisit of product development, pricing, and sales. These aspects of operation management need to be handled properly

The possible volatility brought about by the new accounting standards will reflect and test companies' risk management capabilities; the interaction between those new accounting standards will also call for enhanced ALM

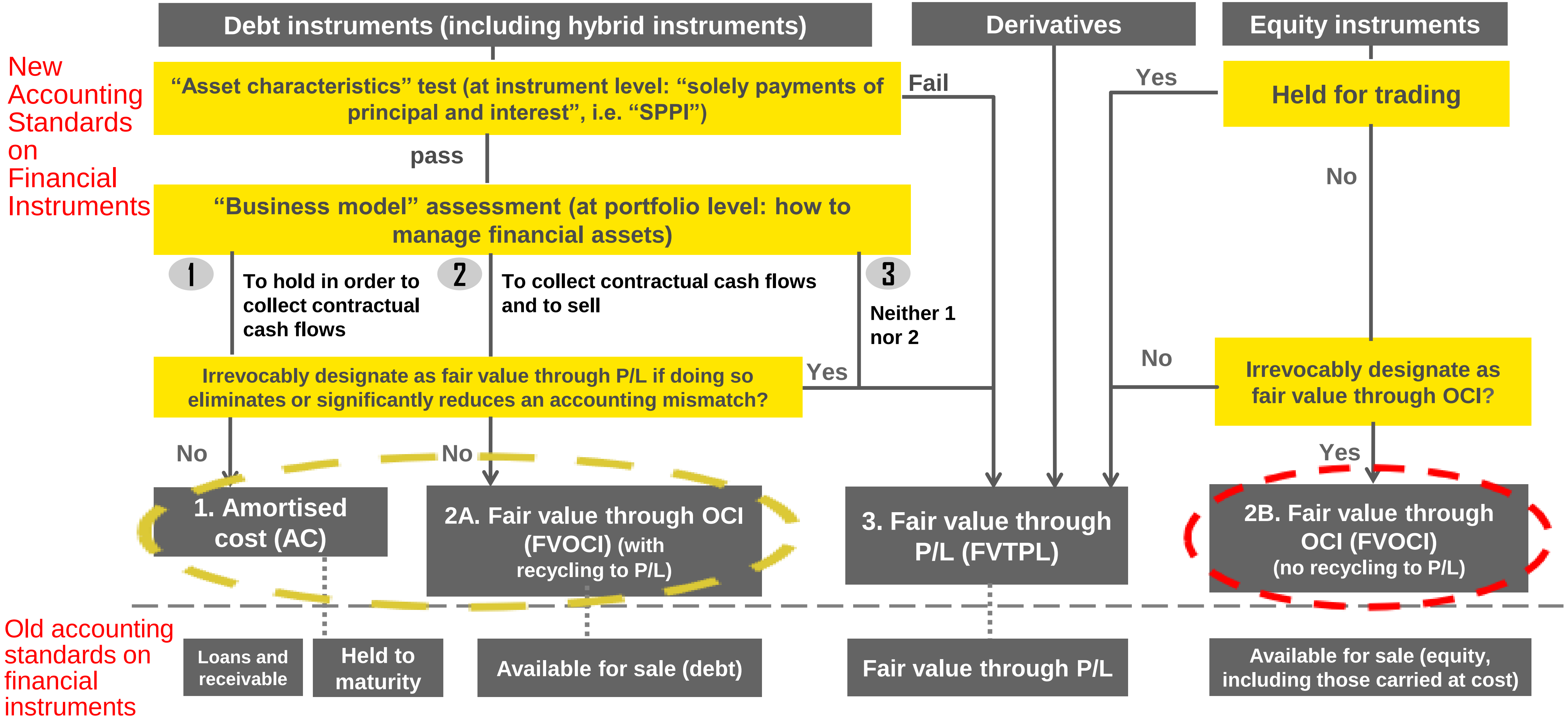
Risk Management and Asset-Liability Management (ALM)

Interaction of the New Insurance Accounting Standard and the New Accounting Standards on Financial Instruments

Changes in classification of financial assets (hedge accounting not considered)

For insurers generally, the most impactful change under the New Accounting Standards on Financial Instruments is the change in the classification of financial assets:

- New classification rules may result in more financial assets being classified as FVTPL, which may cause increased volatility of net assets and net profits (but the accounting treatment under the New Insurance Accounting Standard can eliminate or reduce volatility if accounting treatments are properly matched)
- Disposal gains/losses from FVOCI equity instruments are not recognized in P/L



Transition with the New Accounting Standards on Financial Instruments - reclassification of financial assets

The following are the treatments, at the date of initial application of the New Insurance Accounting Standard, for an entity that had applied the New Accounting Standards on Financial Instruments before that date:

1. The entity may reassess the business model of financial assets and determine their classification, except for those financial assets held in respect of an activity that is unconnected with contracts within the scope of the New Insurance Accounting Standard
2. The entity shall revoke its previous designation (before the date of initial application of the New Insurance Accounting Standard) of a financial asset as measured at FVTPL if the condition for such designation is no longer met because of the application of the New Insurance Accounting Standard
3. A financial asset may be designated as measured at FVTPL if the condition for such designation is met because of the application of the New Insurance Accounting Standard
4. The entity may designate, or revoke its previous designation of, an investment in an equity instrument as at FVOCI

The above treatment shall be on the basis of the **facts and circumstances that exist at the date of initial application** of the New Insurance Accounting Standard, and <u>**the opening retained earnings or other component of equity at that date shall retrospectively adjusted**</u>. The entity is **not required to restate** the comparative information of prior periods.

If the entity restates comparative information of prior periods, the requirements of the Accounting Standards on Financial Instruments should be followed or the “classification overlay approach” may be applied.

Additional information and analysis

An entity that first applies New Insurance Accounting Standard and the New Accounting Standards on Financial Instruments at the same time shall follow the transition requirements of ASBE No. 22 - Recognition and Measurement of Financial Instruments (Cai Kuai [2017] No. 7) and related rules:

- **Article 74 is similar to Point 1 above, and Article 78 similar to the items No. 2-4 above**
- Retrospective adjustment is required. The standard is not applicable to an item derecognized before the date of initial application of the standard
- The entity is **not required to restate** the comparative information of prior periods. If the entity restates comparative information of prior periods, the requirements of the Accounting Standards on Financial Instruments should be followed or the “classification overlay approach” may be applied (according to the Implementation Guidance for the New Insurance Accounting Standard)

Interaction of the New Insurance Accounting Standard and the New Accounting Standards on Financial Instruments

	Key interaction of the two new standards	Responsive measures that insurers may consider
Debt investments	▶ Under the New Accounting Standards on Financial Instruments, SPPI test may result in more debt investments being classified as FVTPL, which may lead to increased volatility of profits ▶ "OCI option" under the New Insurance Accounting Standard matches the accounting treatment with FVOCI debt investments to some extent, and this can reduce volatility of profits ▶ The VFA under the New Insurance Accounting Standard (applicable to insurance contracts meeting certain conditions) can reduce volatility of profits and net assets	▶ The economic (e.g., duration) matching of assets and liabilities is more important because economic mismatch may be more evident in the financial statements ▶ Proper accounting match may reduce the volatility of profits and net assets, e.g: ▶ Proper matching of FVOCI debt investments with OCI Option ▶ Proper application of VFA
Equity investments	▶ Rules on distinction between debt and equity investments under the New Accounting Standards on Financial Instruments may result in investments considered to be "equity-type" from economic perspective (e.g. most fund investments) being classified as FVTPL debt investments, which may lead to increased volatility of profits ▶ Disposal gains/losses from FVOCI equity investments are not recognized in P/L, and this will lead to companies facing a trade-off between the amount of profit and its volatility ▶ The VFA under the New Insurance Accounting Standard (applicable to insurance contracts meeting certain conditions) can reduce volatility of profits and net assets	▶ The difficulty in economic matching of the insurance contracts ineligible for VFA and related equity investments, makes the accounting match difficult to achieve. Hence, companies with such insurance contracts and equity investments may generally face the volatility in net profits and net assets as a result ▶ An insurer generally determines whether to classify a non-trading equity investment as FVOCI only after careful analysis and trade-offs

Possible key financial indicators under the new accounting standards

Possible key financial indicators under the new accounting standards

	Possible key financial indicators under the new accounting standards	Main impact and remarks
Insurance business	1. Insurance revenue and its growth rate 2. Claims and expenses ratio 3. Underwriting profit 4. Composition of profits (profit sources)* 5. Contractual service margin (CSM)*, such as CSM from new business, closing balance of CSM, current period amortization of CSM	1. Life insurers' revenue may decrease under the New Insurance Accounting Standard, but this would present a more faithful view of the business performance, which is also consistent with the revenue recognition principles for banks 2. Claims are not required to be disclosed separately from expenses. But there will be separate disclosure of acquisition cost of new business, the payment and amortization of acquisition cost. Please note that expenses and revenue involve complex calculation/allocation, and hence the ratios computed may not be easy to interpret. 3. Under the New Insurance Accounting Standard, same as P&C insurance, information on underwriting profits/losses for life insurance will be provided 4. Sources of underwriting profits of life insurance, required to be disclosed, include amortization of CSM, release of risk adjustment for non-financial risk, current period experience adjustment, losses from onerous contracts initially recognized during the period, increase in (or reversal of) losses from onerous contracts, and claim development 5. CSM is unearned profit, which is indicative of future profits and may also be complementary to the embedded value
Investment	1. Investment income of various scope (net investment income, total investment income, or investment income including OCI) 2. Investment yields of various scope** 3. Cost ratio of insurance funds**	1. The New Accounting Standards on Financial Instruments may result in more investments being classified as FVTPL, which may lead to increased volatility of investment income 2. When comparing investment yields with rate of cost of insurance funds (i.e., regarding insurance finance income/expenses as "cost of insurance funds"), it is noteworthy that the rate of cost of fund could be historical interest rates that date back a long time ago.
Overall	1. Net assets; net profits 2. Return on net assets **	1. Under the new accounting standards, it is vital to ensure economic and accounting matching of assets and liabilities, especially for life insurers. Otherwise, the volatility of net assets and net profits may increase.

*Note *: Due to limited content of the quarterly reports, they may not be directly calculated from the quarterly reports.*
*Note **: As they may involve information other than that disclosed in financial statements or their accompanying notes (such as average balances), they may not be calculated directly from the financial statements.*

Q&A