

STAFF PAPER

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This paper has been prepared for discussion at a public meeting of the IASB and does not represent the views of the IASB or any individual member of the IASB. Comments on the application of IFRSs do not purport to set out acceptable or unacceptable application of IFRSs. Technical decisions are made in public and reported in IASB *Update*.

Purpose of this paper

1. Agenda Paper 2B *Application of the general measurement model to contracts with participation features* for this meeting asks whether, in some circumstances, the IASB should modify its general measurement model for insurance contracts so that changes in the estimate of the fee the entity expects to earn from the contract are adjusted in the contractual service margin (referred to as the ‘variable fee approach’). If the IASB decides to modify its model in this way, the fee the entity expects to earn from the contract is equal to the value of the entity’s share of the expected returns on underlying items less any expected cash flows that do not vary directly with the underlying items.
2. One consequence of the variable fee approach would be that the contractual service margin would be adjusted by the effect of changes in financial market variables, for example interest rates, on the variable fee inherent in the measurement of insurance contracts. However, if, as part of its risk management activities, an entity hedged itself against (protected itself from) the risks arising from such financial market variables (financial market risks) using a derivative, an accounting mismatch would

arise because the effects of the changes in value of the derivative would be recognised in profit or loss in accordance with IAS 39 and IFRS 9¹.

3. As a result, the IASB needs to weigh the reasons supporting the modification to the general measurement model described in Agenda Paper 2B against:
 - (a) the potential accounting mismatches that would arise as a consequence of that modification when an entity undertakes hedging activities, such as described in paragraph 2, or
 - (b) the potential complexity of any additional requirements that the IASB might consider to address those mismatches.
4. Accordingly, this paper:
 - (a) describes the hedging activities relating to insurance contracts that an entity might undertake (for context, see paragraphs 6-12);
 - (b) describes the potential accounting mismatches that might arise when an entity undertakes hedging activities (paragraphs 13-17);
 - (c) considers the extent to which IAS 39 and IFRS 9 enable an entity to minimise or eliminate those accounting mismatches (paragraphs 18-30); and
 - (d) explores possible approaches to address accounting mismatches for the variable fee model that cannot be addressed by hedge accounting (paragraphs 31-47).
5. The paper is provided for information and does not ask the IASB for decisions.

Background: Hedging activities undertaken by entities that issue insurance contracts

6. As part of their risk management activities, some entities hedge their exposure to financial market risks, especially interest rate risks, which arise from insurance contracts. For example, entities may hedge the risks that arise because of the

¹ When an entity first applies IFRS 9 *Financial Instruments*, it may choose as its accounting policy to continue to apply the hedge accounting requirements of IAS 39 *Financial Instruments: Recognition and Measurement* instead of the hedge accounting requirements in IFRS 9.

difference in effect of changes in interest rates on insurance contracts issued and on the investments that the entity holds to enable it to fulfil the insurance contract. This paper considers the most common financial market risks components that entities hedge within:

- (a) duration mismatches;
 - (b) financial guarantees; and
 - (c) the entity's share in the underlying items.
7. The following paragraphs explain the risks and the hedging strategies that an entity might use to mitigate (or eliminate) these risks.

Duration mismatch

8. Some insurance contracts give rise to obligations which could potentially be very long term, for example insurance contracts that promise to pay an amount in the event of death of the policyholder, or promise regular payments as long as the policyholder lives. These insurance contracts typically promise a fixed payment or stream of payments at some future date. There is an implicit fixed rate of interest in these promises.
9. Insurance entities are frequently unable to find assets which match the long durations of those insurance contracts. Consequently, there may be a discrepancy between the duration of the promise to the policyholder and any investments held against that promise. This is commonly referred to as a duration gap, or duration mismatch. As a consequence of this duration mismatch, the entity is exposed to interest rate risk, arising from the uncertainty of the rate at which the entity will be able to reinvest the proceeds from the investments when they mature. To protect against (or minimise) that risk, an entity could purchase a derivative (for example a forward starting swap) that exchanges the uncertain future rate for a fixed future rate, similar to the fixed rate implicit in the promised payments to the policyholder. Changes in the value of the derivative arising from changes in interest rates would economically offset, partially or completely, any effect of changes in market variables on the measurement of the insurance contract.

10. A similar risk may arise if the policyholder pays premiums on a monthly basis over the life of contract (regular way premiums), rather than as a single premium at the beginning of the contract. At any point in time, the entity would not yet have received all the expected premiums, and consequently would not yet have the funds available to invest in assets. Nonetheless, the promise that arises from the contract may have a similar long duration to the single premium contract, and a similar implicit fixed rate. In this circumstance, the entity may choose to follow a risk mitigation strategy similar to that outlined in the previous paragraph to hedge risks over the uncertainty of the rate at which the entity will be able to reinvest the premiums when received.

Financial guarantee

11. Some insurance contracts contain financial guarantees that promise to pay to the policyholder at least a minimum return, regardless of the return from the assets that the entity invests in. This guarantee causes an economic mismatch between the obligation created by the insurance contract and the assets the entity holds by exposing the entity to the risk that it will need to pay the guaranteed amount to the policyholder if the assets perform below the guaranteed level. To protect against (or minimise) that risk, an entity could purchase a derivative that would result in the entity receiving the guaranteed amount if the assets perform below the guaranteed level. Changes in the value of the derivative could economically offset, partially or completely, any changes in the value of the guarantee included in the insurance contract.

Entity's share in the underlying items

12. Some insurance contracts promise to pay to the policyholder a share of the returns from invested premiums. The entity retains the remaining share of the returns from invested premiums as a variable fee. In some circumstances, entities issuing these contracts may protect themselves against the variability of fee by, for example, purchasing a derivative that promises to exchange the variable share of returns for a fixed amount. Changes in the value of the derivative would economically offset, partially or completely, any changes in the value of the variable fee.

Potential accounting mismatches arising from hedging activities

13. In the three scenarios described in paragraphs 8-12, there is a partial or complete economic offset between the effect of the change in the financial market variables on the derivative and the effect of the same change on the insurance contract. An accounting mismatch arises when the extent of that economic offset is not reflected in the accounting outcome.
14. In accordance with IAS 39 and IFRS 9, an entity would account for the changes in value of the derivatives described in the three scenarios at FVPL.
15. Applying the IASB's proposed general measurement model for insurance contracts, the effects of changes in interest rates, are recognised in profit or loss or other comprehensive income (OCI) in the period in which the change occurs. This means that:
 - (a) If an entity chooses an accounting policy that presents the effect of changes in interest rates on insurance contracts in profit or loss, then, to the extent that the derivatives have been effective in offsetting the risk, there is a natural accounting offset in profit or loss between the effects of those changes on the insurance contract and the derivatives that the entity purchases to reduce its exposure to risk.
 - (b) If an entity chooses an accounting policy that presents the effect of changes in interest rates in OCI, an accounting mismatch will arise. The entity could avoid this accounting mismatch by choosing to present the effect of changes in interest rates on the insurance contract in profit or loss.
16. Applying the variable fee approach described in Agenda Paper 2B, the effect of changes in financial market variables would result in an adjustment to the contractual service margin. This is because a change in financial market variables affects the amount of the variable fee that the entity expects to earn from the contract. As a result, there is an accounting mismatch because the effect of changes in financial market variables on the value of the derivative would be recognised immediately in profit or loss, while the effect of the same change for the insurance contract would be adjusted against the contractual service margin.
17. Furthermore, the staff note that for the variable fee approach:

- (a) when an entity does not hedge financial market variables, the effect of changes in those variables would not be reported in profit or loss immediately, but would be recognised in profit or loss over the coverage period as the contractual service margin is allocated to profit or loss. Despite the entity's economic exposure to market variables, there would be little volatility reported in profit or loss as a result of these changes.
- (b) when the entity does hedge financial market variables, the effect of changes in those variables would similarly not be reported in profit or loss immediately. However, the effect of changes in those variables on the value of the derivative would be reported in profit or loss. This would increase the volatility reported in profit or loss as a result of those changes, in spite of overall economic exposure having potentially been reduced.

Applying hedge accounting in IAS 39 and IFRS 9

- 18. As described in paragraph 17, accounting mismatches may appear to be created in situations when an entity mitigates the economic risks with hedging activities. There are two types of hedge accounting in IFRS 9 (and IAS 39) that can assist in addressing these accounting mismatches:
 - (a) Fair value hedge – a hedge of exposure to changes in the fair value of specified hedged items that is attributable to a particular risk and could affect profit or loss; or
 - (b) Cash flow hedge – a hedge of the exposure to variability in cash flows attributable to a particular risk associated with specified hedged items and could affect profit or loss.
- 19. To qualify for the application of IFRS hedge accounting, an entity designates in the hedging relationship:
 - (a) A qualifying instrument, usually a derivative used to protect against the risk as a hedging instrument;
 - (b) Qualifying hedged items which can be:

- (i) a recognised asset or liability or a highly probable forecast transaction;
- (ii) a single item or groups of items (or component of those).

Fair value hedge accounting

20. Subject to qualifying criteria, an entity may be able to use fair value hedge accounting to eliminate or minimise the accounting mismatch between financial market risks related to the insurance activity and the derivative used to hedge those risks in both the general measurement model and the variable fee approach. If an entity applied fair value hedge accounting to, for example, the interest rate risk inherent in an insurance contract, an entity would:
- (a) characterise the economic hedge as a protection of the changes in fair value of the interest rate risk inherent in the insurance contract and consequently designate the interest rate component of the insurance contract as the hedged item and the derivative as the hedging instrument.
 - (b) recognise changes in the fair value of the interest rate component of the insurance contract in profit or loss to offset, in whole or in part, changes in the value of the derivative recognised in profit or loss.
21. The staff note that to be eligible for designation as a hedged item, a risk component must be a separately identifiable component of the insurance contract, and the changes in the fair value of the item attributable to changes in that risk component must be reliably measurable.
22. The staff observe that the requirements in the forthcoming insurance contracts Standard would require that an entity separate all distinct investment components from the host insurance contracts and account for them in accordance with IFRS 9 (often referred to as unbundling). Thus, investment components included in insurance contracts that give rise to financial market risk are not distinct. This means that the cash flows of such components are highly interrelated with the cash flows of the insurance component, and the entity would not be able to measure one without considering the other.

23. Accordingly, risk components in the insurance contract which are not required to be unbundled according to the forthcoming insurance contracts Standard may not meet the separately identifiable and reliably measurable requirement in IFRS 9 (or IAS 39). The staff note that risk components which are unbundled will constitute derivatives in their own right, will accordingly be measured at fair value through profit and loss, and therefore no potential accounting mismatch will arise.

Cash flow hedge accounting

24. In the proposed general measurement model for insurance contracts, an accounting mismatch arises when:
- (a) the effect of changes in interest rates on the value of the derivative is recognised immediately in profit or loss; and
 - (b) the effect of changes in the same interest rates on the insurance contracts is recognised in OCI, in accordance with the entity’s accounting policy.
25. In the variable fee model, an accounting mismatch arises when:
- (a) the effect of changes in financial market variables on the value of the derivative is recognised immediately in profit or loss; and
 - (b) the effect of changes in financial market variables on the insurance contract is recognised as an adjustment to the contractual service margin.
26. Subject to qualifying criteria, an entity may be able to use cash flow hedge accounting to reduce these accounting mismatches. Applying cash flow hedge accounting, an entity would:
- (a) characterise the hedge as a protection against the variability of future cash flows related to the investment and consequently designate the investment, or a future investment still to be made as the hedged item and the derivative as the hedged instrument.
 - (b) recognise changes in the fair value of the derivative in OCI until the entity recognises changes that arise from hedged risk of the investments in profit or loss.
27. The staff note that the cash flow hedge according to IFRS 9:

- (a) will defer changes in the value of the derivative in OCI if the hedged item is measured at FVOCI or amortised cost². However, the staff note that, for the variable fee approach, cash flow hedge accounting would defer changes in the derivative in OCI but there may not be a perfect offset of changes recognised in profit or loss over time because:
 - (i) the changes in the market interest rate inherent in the insurance contract would be recognised according to the release pattern for the contractual service margin; and
 - (ii) the changes in the value of the derivative would be recycled to profit or loss from OCI when changes arose from hedged risk in the investment affects profit or loss.
- (b) would not usually be beneficial to use if the hedged item is measured at FVPL. This is because the amount deferred in OCI has to be immediately recycled to profit or loss.

Summary of existing approaches to address accounting mismatches

28. Consequently, an entity could avoid an accounting mismatch between the measurement of financial market risk included in an insurance contract and a financial instrument used to hedge that risk in one of two ways, as follows:
- (a) Provided the investments are not measured at FVPL and are not equity instruments and the other cash flow hedge accounting requirements are met, choose to recognise the effect of changes in financial market variables on the insurance contract in OCI and defer changes in the value of the derivative in OCI by applying cash flow hedge accounting³.
 - (b) Provided that fair value hedge accounting criteria are met and the risk component being hedged is separately identifiable and reliably

² The staff note that an entity would not be able to apply cash flow hedge accounting for equity instruments measured at FVOCI because changes in fair value of such equity instruments do not affect profit or loss.

³ Please note that, as described in paragraph 27(a), cash flow hedge accounting could reduce but not eliminate accounting mismatch when used with the variable fee approach. This is because of different recognition patterns in profit or loss of the effect of changes in market variables on insurance contracts comparing to effect of those changes on investments.

measurable, choose to recognise the effect of changes in the fair value of the identified risk component in the insurance contract in profit and loss.

29. In addition, in the proposed general measurement model, an entity could also avoid an accounting mismatch between the measurement of financial market risk included in an insurance contract and the derivative by electing to recognise the effect of changes in the interest rate on the insurance contract immediately in profit or loss to offset changes in the value of the derivative recognised immediately in profit or loss.
30. The proposed variable fee approach does not allow the entity to elect to recognise the effect of changes in the financial market variables on the insurance contract immediately in profit or loss to offset changes in the value of the derivative recognised immediately in profit or loss.

How could the IASB address accounting mismatches created by the variable fee approach

31. As explained in paragraphs 18-30, an entity applying the variable fee approach might have significant additional accounting mismatches that could not be eliminated using hedge accounting.
32. In the following section, the staff explore how the IASB could address these mismatches if the insurance contracts Standard were to require the variable fee approach as recommended in Agenda Paper 2B. The approaches the staff considered for addressing accounting mismatches are:
 - (a) Approach 1: Limited application of the variable fee approach;
 - (b) Approach 2: Recognition of changes in the value of the guarantee and entity's share in the underlying items in profit or loss instead of the contractual service margin;
 - (c) Approach 3: Designation of the derivative as an underlying item.
33. In paragraphs 44-47 the staff consider whether an entity should be allowed to use Approaches 1-3:
 - (a) on an unconditional basis; or
 - (b) conditional on specified criteria based on the hedging relationship.

Description of approaches

Approach 1: Limited application of the variable fee approach

34. In Approach 1, the variable fee approach would not be applied and the general measurement model would apply instead.
35. Consequently, Approach 1 would allow an entity that hedges risk related to insurance activity to:
- (a) use the variable fee approach and accept the accounting mismatch that arises if the entity uses derivatives to hedge risks and cannot apply hedge accounting; or
 - (b) recognise changes related to the guarantees and the entity's share in the underlying items according to the general measurement model. This means that an entity has more options to limit or avoid accounting mismatches related to hedging activities (see paragraphs 28-30).
36. The staff note that the general measurement model might not provide a perfect offset in the profit or loss between the changes in the value of the derivative recognised in profit or loss and the effect of changes in the guarantee recognised in profit or loss to the extent they do not relate to future services. According to the general measurement model, changes related to the future service are recognised in the contractual service margin.

Approach 2: Recognition of changes in the value of the guarantee and entity's share in the underlying items in profit or loss instead of the contractual service margin

37. In Approach 2, an entity would be able to choose to recognise in profit or loss the effect of changes in financial market risks on the guarantee included in the insurance contract and/or on entity's share in the underlying items. The effect of those changes would otherwise have been recognised as an adjustment to the contractual service margin. Recognising the effect of such changes in profit or loss would offset, partially or completely, the changes in the value of the derivative. However, the staff note that under Approach 2, the profit or loss from remeasuring the derivative may not fully offset the profit or loss from remeasuring the guarantee even when the derivative

provides a perfect economic offset. This is because under this approach the derivative is measured at FV and the guarantee is measured using the fulfilment cash flow model.

38. This approach would:
- (a) enable an entity to address specifically the accounting mismatch created by unlocking the contractual service margin for the value of the guarantees or entity's share in the underlying items without changing other proposals related to the variable fee approach, and
 - (b) result in the recognition of the ineffectiveness of the hedge relationship in profit or loss.
39. The staff note that this approach has an advantage relative to Approach 1 because it changes only the recognition of changes in the value of the guarantee component of the contract, whereas Approach 1 changes the recognition of changes in the value of the whole contract. Thus, Approach 2 would result in greater comparability between the measurement of contracts with direct participation features where this approach has been applied, and those where it has not been applied. However, the staff believe that this approach may face the following difficulties related to the application to the guarantee:
- (a) The difficulty of defining and identifying the guarantee - the staff believe that there is diversity in views of what the guarantee is and therefore it might be difficult to define it for the purpose of this option. In addition, even if the staff were to be able to define the guarantees, that definition might include more than just the guarantees that are hedged; and
 - (b) The difficulty of measuring the guarantee in its own right.
40. The staff does not believe that there would be the same difficulties related to defining and measuring the entity's share in the underlying items.

Approach 3: Designation of the derivative as an underlying item

41. Under the variable fee approach, changes in the insurance obligation equal to changes in the value of the underlying items are recognised in the statement of comprehensive income. In Approach 3, an entity would designate a notional derivative that exactly

mitigates the entity's exposure to the identified financial market risk as part of the underlying items.

42. Thus, changes in the insurance obligation recognised in the statement of comprehensive income that equal changes in the value of the underlying items would include changes in the value of that notional derivative. Consequently, where the entity holds as assets the underlying items (including such a derivative), changes in the value of the insurance obligation and changes in the value of the assets would offset each other in the statement of comprehensive income.
43. The staff note that in order to apply Approach 3, the entity would need to identify and value a notional derivative that perfectly matches the promise to the policyholder. Although this may create some difficulties in modelling, the staff believe these difficulties can more easily be overcome than the difficulties arising under Approach 2. This is because modelling of the notional derivative is an established practice in hedge accounting under IAS 39 and IFRS 9.

Optionality – conditional or unconditional?

44. The three approaches described in paragraphs 34- 43 could be applied on an unconditional basis or conditional on specified criteria.

An unconditional option.

45. Allowing an entity an unconditional option would decrease comparability of the measurement of insurance contracts and the gains and losses recognised for insurance contracts. However, the IASB could explore ways to minimise the lack of comparability between contracts within an entity by, for example, making this choice irrevocable at inception and/or require that the option is applied in the same way for groups or portfolios of similar contracts.

An option conditional on specified criteria

46. As the objective of specifying any of Approaches 1, 2 or 3 is similar to the objectives of hedge accounting, the staff would propose using similar criteria to those in paragraph 6.4.1 of IFRS 9, modified to reflect the difficulties in applying hedge accounting for insurance contracts. The staff note that a particularly important and

relevant objective in IFRS 9 is that of reflecting the risk management activities of the entity. In developing modified criteria to use this approach based on IFRS 9, the staff would seek to ensure that:

- (a) different accounting for contracts with direct participation features is justified when that is consistent with an entity's risk management activities for hedging risks related to insurance activities; and
 - (b) insurance-specific criteria would be incorporated to ensure that common insurance risk management strategies are accommodated (such as potentially amending the criteria restricting open portfolios or the criteria requiring the component to be separately identifiable and reliably measured).
47. An advantage of allowing an entity to use any of approaches 1, 2 or 3 on a conditional basis is that an entity could be permitted to choose to modify the recognition of the gains and losses for its insurance activity only when doing so reduces an accounting mismatch that occurs when an entity hedges risks related to insurance activity. This is consistent with the hedge accounting outcome under IFRS 9, which creates an exception to the normal recognition and measurement in IFRSs to better reflect the economics of risk management activities. However, the scope for the conditional approach will be less restrictive (see paragraph 46(b)) than the scope in IFRS 9 and, therefore, it would address accounting mismatches for more insurance contracts.
48. The disadvantage of allowing an entity to use any of approaches 1, 2 or 3 on a conditional basis is that it might be difficult to develop relevant criteria described in paragraph 46. For example, to allow an entity to use approaches 1, 2 or 3 for open portfolios, the IASB will need to consider how to reflect changes in the hedging relationship (ie dynamic risk management) and its consequences on the accounting.

Questions to Board Members

Do you have any questions related to the analysis in this paper, in particular:

- do you agree with the staff's analysis on the applicability of hedge accounting to insurance activities?
- do you have any views on whether the staff should explore Approach 1, Approach 2 or Approach 3?
- do you have any views on whether the staff should explore approaches 1-3 to be unconditional or conditional based on criteria to be developed?