STAFF PAPER

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Project	**Insurance contracts**		
Paper topic	Mitigating financial risks reflected in insurance contracts		
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Purpose of the paper

1. This paper discusses feedback from test participants[1] about the requirements in paragraph B104 of the draft IFRS 17 *Insurance Contracts* (draft IFRS 17). Those requirements relate to accounting for the effects of financial risk when an entity applies the variable fee approach and mitigates that risk with a derivative. Application of the variable fee approach created a potential mismatch because:
   (a) IFRS 9 *Financial Instruments* requires entities to measure derivatives at fair value with changes recognised in profit or loss (FVPL); and
   (b) draft IFRS 17 requires entities that apply the variable fee approach to recognise changes in the fulfilment cash flows resulting from financial risk against the contractual service margin.
2. The Board decided to enable this mismatch to be avoided by allowing entities to recognise specific changes in the fulfilment cash flows in profit or loss instead of in the contractual service margin when particular criteria are met.

[1] Please refer to agenda paper 2A *Methodology – external testing of draft IFRS 17* and 2B *Results - external testing of draft IFRS 17* for this meeting for more detailed information about external testing.

Staff recommendation

3. The staff recommend that the Board permit an entity that applies the variable fee approach and uses a derivative to mitigate financial risks arising from the insurance contract to exclude the effect of those changes in the financial risk from the contractual service margin when specified criteria are met. This extends the approach applicable to specific financial risks included in paragraph B104 of draft IFRS 17 to all financial risks reflected in the insurance contract.

Structure of the paper

4. Test participants[2] acknowledged that the requirement to not include the specific effects of the financial risks in the contractual service margin (most often financial options and guarantees) is helpful. However, the participants asked the Board to consider eliminating further accounting mismatches:

   (a) by broadening the approach to additional risks included in the insurance contracts described in paragraphs 5–21;

   (b) by eliminating the difference between measuring the derivative at fair value and the financial risk being mitigated using the fulfilment cash flow method described in paragraphs 22–27; and

   (c) by allowing prospective application at transition instead of retrospective application described in paragraphs 28–31.

Broadening the approach

5. Paragraph B104 of draft IFRS 17 states:

> B104. An entity may choose not to recognise a change in the contractual service margin to reflect the changes in some or all of the fulfilment cash flows set out in B102.b.iii, if, in accordance with a previously documented risk management objective and strategy for using derivatives to

[2] Risk mitigation activities are relevant only to some of the test participants. As a result, not all testing participants answered the questions related to risk mitigation in the testing questionnaire.

mitigate financial market risk[3] arising from those fulfilment cash flows:

a. the entity uses a derivative to mitigate the financial market risk arising from those fulfilment cash flows;

b. an economic offset exists between the specified fulfilment cash flows and the derivative, ie the fulfilment cash flows and the derivative generally move in opposite directions because they respond in a similar way to the changes in the risk being mitigated. An entity shall not consider accounting measurement differences in assessing the economic offset; and

c. credit risk does not dominate the economic offset.

Feedback

6. Some test participants reported that they mitigate risks not captured by the approach in paragraph B104 of draft IFRS 17 and were concerned that accounting mismatches could arise when accounting for those risk mitigation activities. In addition, these test participants stated that in some circumstances, these accounting mismatches might result in more volatility in the statement of profit or loss for an entity that mitigates financial risk comparing to an entity that does not mitigate those risks. These accounting mismatches arise because of the differences in the recognition of changes in:

(a) the derivative measured at fair value with changes recognised in profit or loss; and

(b) the insurance contract measured using the fulfilment cash flows with changes recognised in the contractual service margin or other comprehensive income (OCI).

[3] Paragraph B104 discusses “financial market risk” but the draft Standard defines “financial risk” used in other parts of the Standard. The staff propose to use only “financial risk” throughout the Standard including paragraph B104.

7. Consequently, the test participants asked the Board to consider broadening the approach to address situations in which an entity mitigates the following risks with a derivative:

   (a) financial risks reflected in contracts measured using the variable fee approach but not captured in paragraph B104 of the draft IFRS 17, ie changes in the entity's share in the underlying items;

   (b) financial risks applying the general model, for example when an entity uses OCI option; and

   (c) non-financial risks under the general model and variable fee approach for example when an entity mitigates insurance risks using mortality bonds or longevity swaps.

8. Some test participants noted that an entity, that uses variable fee approach to measure its insurance contract, does not always need to use paragraph B104 to avoid the accounting mismatch with the derivative measured at FVPL. This is because in some circumstances the derivative could be part of the underlying items which changes are recognised in the statement of comprehensive income (instead of the contractual service margin). This is for example, when the derivative is owned in a segregated fund, such as a unit trust.

Financial risks in the variable fee approach ie entity's share in the underlying items

9. Some test participants noted that, applying the variable fee approach, an entity's share in the underlying items[4], which is also subject to financial risks, is recognised in the contractual service margin. They state an accounting mismatch will occur when an entity mitigates the financial risk related to the entity's share in the underlying items with a derivative, in the same way as would occur with financial options and guarantees. This is because when the variable fee approach is applied an accounting mismatch occurs between:

   (a) the derivative used to mitigate the financial risk measured at FVPL; and

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[4] In variable fee approach, the entity shares the risks of the investment with a policyholder by being compensated for the services provided under the contract with a share of the investments (share in the underlying items). Consequently, the measurement of the contractual service margin reflects the financial risks reflected in the value of the entity's share in the underlying items.

(b) the effect of financial risks measured applying the variable fee approach recognised in the contractual service margin. Such effects include both the change in the value of the financial options and guarantees and the entity's share in the underlying items.

Financial risk in the general model ie OCI presentation

10. Some test participants were concerned that accounting mismatches could occur between derivatives measured at FVPL and the effect of the financial risk reflected in the insurance contract measured by applying the general model. The mismatch might occur when an entity chooses to present some part of the insurance finance income or expense in OCI instead of in profit or loss. This is because the effect of the changes in financial risk for insurance contract is recognised in OCI and for the derivative in profit or loss.

11. Test participants noted that presenting all the insurance finance expense in profit or loss would reduce the accounting mismatch to the extent that the financial risk is mitigated. However, it would also result in additional volatility in profit or loss from the effect of changes in other financial assumptions or to the extent that the particular risk is not mitigated.

Non-financial risks in the general model and variable fee approach

12. Most test participants noted they typically use derivatives to mitigate financial risk. However, a few were concerned about possible accounting mismatches that can be created when an entity mitigates non-financial risks for which the effects are not recognised in profit or loss, with derivatives measured at FVPL. The mismatch may occur, for example, when an entity mitigates insurance risk using mortality bonds or longevity risk with longevity swaps because the effect of changes in the insurance risk are recognised in the contractual service margin while the derivative is measured at FVPL.

13. Some test participants said that the hedge accounting requirements in IFRS 9 *Financial Instruments* are not applicable to all situations when insurance entities mitigate risks. For example, they believe that it would be impossible for them to apply cash flow hedge accounting when equities back insurance liabilities or when insurers mitigate risks on an aggregated level instead of on a contract-by-contract

basis. Consequently, those test participants would prefer a solution that specifically covers all hedging activities for insurance contracts.

Staff analysis

Background

14. The Board's decision related to risk mitigation in paragraph B104 of the draft IFRS17 was intended to address a specific consequence of the introduction of the variable fee approach. The variable fee approach requires an entity to adjust the contractual service margin for the effect of changes in financial risk on an insurance contract[5] while the general model requires the entity to recognise those changes in the statement of comprehensive income. Consequently, the Board noted that applying the variable fee approach to insurance contracts could create accounting mismatches—between such contracts and derivatives measured at fair value through profit or loss—which mismatch was not present in the general model.

15. In developing the requirement in paragraph B104 of draft IFRS 17, the Board intended to align the overall effect of the variable fee approach more closely to the general model, and in the process change one feature of the variable fee approach that caused negative consequences. The Board focused on the difference between the two models, namely the financial risk included in the fulfilment cash flows. The Board addressed this by permitting entities applying the variable fee model to recognise the effect of financial risks in profit or loss instead of in the contractual service margin under certain, specified circumstances.

16. The Board did not consider, either at this stage of the project, or in previous stages, developing a bespoke solution for all hedging activities for insurance contracts, nor was such a solution requested or commented on as part of the previous phases of this project.

[5] Unless the change relates to the underlying items when the change in the obligation related to the value of the underlying items is recognised in the statement of comprehensive income, similarly to the general model.

Other financial risks in the variable fee approach ie entity's share in the underlying items

17. The staff acknowledge the comments of the test participants that financial risks reflected in the entity's share in the underlying items or an financial options and guarantees is accounted for differently in the variable fee approach and the general model. Those measurement differences of the financial risk between both measurement approaches result in similar accounting mismatches when an entity uses derivatives to mitigate this risk. This is because the financial risk adjusts the contractual service margin under the variable fee approach whereas a derivative that mitigates this risk is measured at FVPL. This mismatch does not occur for the general model where the effect of changes in the financial risk is recognised in the statement of comprehensive income instead of the contractual service margin.

18. Consequently, consistently with the objective described in paragraph 14 the staff recommend that paragraph B104 in draft IFRS 17 should be extended to include other changes in financial risks such as changes in the entity's share in the underlying items. Therefore, the entity will be permitted to exclude the effect of financial risk from the contractual service margin reflected for example in:

    (a) changes in the value of the financial options and guarantees included in the fulfilment cash flows (the entity would recognise those changes in profit or loss); and/or

    (b) changes in the value of the entity's share in the underlying items included in the investment (the entity's share in the underlying items will not affect the measurement of the insurance contract and profit or loss on the liability side).

19. In other words, the staff recommend that the Board extend the approach previously allowed for financial risk included in fulfilment cash flows to all financial risk included in the insurance contract accounted for using the variable fee approach. This approach would more closely align the general model and the variable fee approach.

Other risks related to insurance contracts

20. The Board has already considered the accounting for other risk mitigation activities in contracts that qualify for either the variable fee approach or the general model. The Board noted that entities could:

    (a) use the general hedge accounting requirements applying IFRS 9 (or IAS 39 *Financial Instruments: Recognition and Measurement*). In agenda paper 2D for the June 2015 meeting, the staff provided a summary of the possible hedge accounting strategies for risks related to interest rates. Please refer to the Appendix for more details.

    (b) avoid some accounting mismatches between insurance contracts and investments, including derivatives, by deciding whether, and for which group of contracts, it will present in OCI or in profit or loss certain changes in insurance finance income or expense.

21. The test participants did not identify any new issues that the Board did not previously consider. Therefore, the staff recommend the Board:

    (a) maintain its previous tentative decision about the accounting for other risk mitigation activities reflected in paragraph B104; and

    (b) consider clarifying the reasons for that decision in the Basis for Conclusions.

Differences in measurement basis

Feedback received

22. Draft IFRS 17 requires an entity to measure changes in the fulfilment cash flows related to the financial risk on a different basis from the derivatives used to mitigate that risk. Some test participants noted this measurement approach could cause a mismatch but they did not assess the mismatch as being significant. However, one test participant stated that there would be a significant accounting mismatch due to differences in the discount rates used to value hedging derivatives and the financial options and guarantees. This participant suggests the difference mainly relates to the liquidity premium included in the measurement of the insurance contract that is not used in the valuation of the derivatives.

Consequently, in that participant's view an entity that mitigates the financial risks in the financial options and guarantees using the accounting described in paragraph B104 of draft IFRS 17 could report greater volatility in profit or loss that an entity that did not mitigate that risk.

23. One testing participant suggested that this accounting mismatch could be eliminated by valuing the changes in fulfilment cash flows that are not adjusted in the contractual service margin at an amount equal to the change in the fair value of the derivative (ie accounting as if the risk was fully mitigated without regard as to whether this was in fact the case).

Staff analysis

24. As noted in paragraph 14, the objective of developing the requirements in paragraph B104 of IFRS 17 was to more closely align the general model and the variable fee approach. The staff suggest that the requirements in B104 meet this objective by allowing an entity to reverse such negative consequences ie to recognise specific effects of the changes in the financial risks in profit or loss similarly to the requirements in the general model.

25. The staff note that changes to the proposed approach would extend the outcome beyond the Board's original objective of aligning the two models. In the staff's view any general concerns related to accounting for risk mitigation activities should be addressed using the hedge accounting requirements in IFRS 9 (or IAS 39).

26. Furthermore, the staff note that the suggestion outlined in paragraph 23 was considered, and rejected in the development of IFRS 9. In particular, the staff note that in developing IFRS 9 the Board was clear that when applying hedge accounting, the measurement of changes in the hedged item arising from changes in the hedged risk cannot include features that only exist in the hedging instrument but not in the hedged item ie it cannot be assumed that movements in the hedged item is automatically equal and opposite to movements in the hedging derivative[6].

[6] See paragraphs BC6.290-BC6.292 of IFRS 9 for more details.

27. The test participants did not identify any new issues that the Board did not previously consider. Consequently, the staff recommend the Board maintain its previous tentative decision on the measurement basis for the purposes of paragraph BC104 of draft IFRS 17.

Retrospective application at transition

Feedback received

28. Some respondents stated that requiring paragraph B104 of draft IFRS 17 to be applied prospectively at transition could lead to significant accounting mismatches and, as a result, misstatements of shareholders' equity at the date of transition and future profits after transition. A prospective application results in a different net income in the comparative years, as well as a different value of the contractual service margin at the date of initial application compared to if paragraph B104 had always been applied.

29. Test participants had the following suggestions for modifying the requirements to allow an entity to retrospectively apply paragraph B104:

    (a) if the entity can demonstrate that its risk mitigation strategy has been well defined in the past periods, and the financial impact audited;

    (b) if the entity's existing risk mitigation program meets the requirements of paragraph B104;

    (c) from the beginning of the earliest period presented when adopting IFRS 17.

Staff analysis

30. Consistent with its conclusions in IFRS 9, the Board previously decided it is not possible to designate risk mitigation relationship retrospectively without using hindsight. When discussing the issue previously, the Board was particularly concerned about an entity 'cherry picking' only the favourable outcome for designation and the auditability of retrospective application. The issue of 'cherry picking' the favourable outcome is particularly worrying because of the optional application of paragraph B104 of draft IFRS 17, similarly to hedge accounting in

IFRS 9 (IAS 39). The staff note that the Board specifically rejected making this approach mandatory because of the additional complexity it introduces. Consequently, IFRS 17 consistently with IFRS 9, prescribes prospective application of the risk mitigation option from the date of the first application of the Standard.

31. The test participants did not identify any new issues that the Board did not previously consider. Consequently, the staff recommend the Board maintain its previous tentative decision on the prospective approach to financial risk mitigation at transition.

Question: Mitigating financial risk in insurance contracts
Does the Board agree to permit an entity that applies the variable fee approach and uses a derivative to mitigate financial risks arising from the insurance contract to exclude the effect of those changes in the financial risk from the contractual service margin when specified criteria are met? This extends the approach applicable to specific financial risks included in paragraph B104 of draft IFRS 17 to all financial risks reflected in the insurance contract.

Appendix A: Copy of the relevant paragraphs in agenda paper 2D from June 2015

Summary of existing approaches to address accounting mismatches

A1. 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 accounting[7].

(b) Provided that fair value hedge accounting criteria are met and the risk component being hedged is separately identifiable and reliably measureable, choose to recognise the effect of changes in the fair value of the identified risk component in the insurance contract in profit and loss.

A2. 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.

A3. 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.

[7] Please note that 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.

Applying hedge accounting in IAS 39 and IFRS 9

A4. 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.

A5. 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

A6. 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.

A7. 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.

A8. 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.

A9. 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

A10. 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.

A11. 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.

A12. 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.

A13. 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 cost[8]. 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

[8] 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.

(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.