

This paper provides the technical advice from EFRAG TEG to the EFRAG Board, following EFRAG TEG's public discussion. The paper does not represent the official views of EFRAG or any individual member of the EFRAG Board. This paper is made available to enable the public to follow the EFRAG's due process. Tentative decisions are reported in EFRAG Update. EFRAG positions as approved by the EFRAG Board are published as comment letters, discussion or position papers or in any other form considered appropriate in the circumstances.

IFRS 17 Insurance Contracts

Prohibition to apply the risk mitigation approach retrospectively on transition

Introduction and Objective

- 1 In January 2020, the IASB tentatively decided to retain unchanged the prohibition in IFRS 17 from applying the risk mitigation option retrospectively.
- 2 The EFRAG Secretariat requested for input from EFRAG IAWG and EFRAG CFSS on the impact of this decision. This was then discussed at the February EFRAG IAWG meeting.
- 3 EFRAG TEG was provided with an update of the January IASB Staff papers in its January meeting. Members commented on the prohibition of the retrospective application of the risk mitigation approach, a decision that is not aligned with the final comment letter of EFRAG. Members noted that implications for the endorsement advice have to be assessed. They acknowledged the IASB concerns about hindsight. They suggested that materiality of the remaining issue should be assessed.
- 4 The objective of this paper is to provide a summary of the input received, as a basis for EFRAG TEG's assessment of the remaining issues.
- 5 The Appendix provides a summary of comments received on EFRAG's draft comment letter on the IASB ED Amendments to IFRS 17 relating to prohibition to apply the risk mitigation approach retrospectively on transition.

Summary of the discussion at February EFRAG IAWG

- 6 The comments from EFRAG IAWG members reflected the outcome of the outreach: the issue was significantly impacting the FVA portfolios of some insurers (especially when being funded by equity instruments and when the derivatives or reinsurance contracts used as mitigating instruments are not part of the underlying items of the VFA assessment) but not significant for other insurers.
- 7 Members observed that the risk of hindsight in case of reinsurance contracts was not comparable (lower or not applicable) to the perceived risk of hindsight in case of derivatives. Members considered that the IASB was putting the bar of the required documentation particularly high for this topic compared to what was done for other topics.
- 8 Members observed that the prohibition of retrospective application was limiting the benefit from the IASB's recent decision to allow financial instruments at FVTPL to qualify for the risk mitigation approach.

IFRS 17 Insurance Contracts – Prohibition to apply the risk mitigation approach retrospectively on transition

- 9 Some EFRAG IAWG members noted that they had documentation available about former mitigation strategies, but there were challenges as with regard to completeness and how far back in time it was traceable.

Inputs received from EFRAG IAWG members and National Standard Setters

- 10 The EFRAG Secretariat received 11 (of which one collected three individual) responses.
- 11 The volumes of variable fee approach contracts that would apply the FVA at transition and their relevance varies depending on specific circumstances of the entities, going from being negligible to being applied in all the circumstances.
- 12 Some respondents confirmed that they are planning to use the FVA at transition other than the reason of impracticability to apply the full retrospective approach. They are analysing whether they would use FVA in cases such as:
- (a) The entity uses reinsurance contracts held to mitigate financial risk of underlying VFA insurance contracts; and
 - (b) In case where mutualisation was applied, where old and new portfolios were being combined.
- 13 Respondents confirmed that, depending on individual facts and circumstances, the prohibition of the retrospective application of the risk mitigation may result in a change of the preferred transition approach (from MRA/FRA to FVA). Other respondents confirmed that the only meaningful approach for the relevant portfolios was to apply retrospectively the risk mitigation, so the FVA was not offering a viable alternative.

Question for EFRAG Board

- 14 Does the Board agree with the contents of this paper and the conclusions for the DEA?

Appendix: EFRAG comment letter to the ED Amendments to IFRS 17 – Question 8B – Transition relief for risk mitigation

- 1 EFRAG assesses that the amendment to extend the option in paragraphs B115 to B116 of IFRS 17 is a step in the right direction; as a result of this amendment the risk mitigation relief is applicable prospectively as from the IFRS 17 transition date.
- 2 However, EFRAG considers that entities should apply this risk mitigation relief retrospectively for contracts under the variable fee approach, provided that (1) the entity met the criteria in paragraphs B115 to B116 for the risk mitigation accounting in the relevant past reporting periods and that (2) they are able to prove using reasonable and supportable information that a risk mitigation strategy was in place before the application of IFRS 17, starting from the inception of the mitigation strategy.
- 3 EFRAG considers that the application of risk mitigation is optional in nature, however once, elected, such retrospective application should be applied mandatorily to all the risk management strategies that existed in the relevant periods; entities would refer to information from their prudential or risk committee reporting.
- 4 EFRAG notes that without retrospective application there would be accounting mismatches in periods prior to transition where a retrospective method is applied as it will result in a contractual service margin that does not reflect risk mitigation activities from previous periods, which would distort:
 - (a) the equity of entities - because the effect of previous changes in the fair value of the derivatives will be included in the equity, while the corresponding effect on the insurance contracts will be included in the measurement of the insurance contracts (through the contractual service margin); and
 - (b) the revenue recognised for these groups of contracts in future periods - because the contractual service margin includes the changes in financial risks that would have been excluded had the risk mitigation option been applied retrospectively.
- 5 EFRAG acknowledges that applying risk mitigation retrospectively gives rise to the risk of hindsight being used, as entities could select which strategy would be designated retrospectively and which would not. However, EFRAG considers that, provided that appropriate documentation on risk management strategies exists prior to the transition and that entities may prove with reasonable and supportable information that the conditions in paragraph B116 were met in the relevant past periods, there are no conceptual reasons not to allow retrospective application; in addition in such circumstances the risk of hindsight is reduced.
- 6 EFRAG considers that, in these circumstances, the benefit in avoiding distorted financial information would overcome the risk of hindsight.
- 7 Therefore, in this instance EFRAG is supportive of retrospective application of hedge accounting under IFRS 17 even though EFRAG did not support such a position with the retrospective application of hedge accounting under IFRS 9. This is because EFRAG considers that risk mitigation under IFRS 17 is different from IFRS 9 retrospective application of hedge accounting as under IFRS 17 the choice to exercise the risk mitigation option influences the determination of the contractual service margin which could have long-term impacts on the financial statements.
- 8 EFRAG observes that the wording in the ED is unclear as to whether retrospective application of the risk mitigation according to paragraph B115 is allowed when using reinsurance for risk mitigation purposes.