IFRS 17 *Insurance Contracts* – risk mitigation Issues Paper

Objective

1 The objective of this paper is to describe the issues identified by EFRAG IAWG members in relation to the application of risk mitigation when applying IFRS 17 *Insurance Contracts.*

IFRS 17 requirements

“B115 To the extent that an entity meets the conditions in paragraph B116, it may choose not to recognise a change in the contractual service margin to reflect some or all of the changes in the effect of financial risk on the entity’s share of the underlying items (see paragraph B112) or the fulfilment cash flows set out in paragraph B113(b).

B116 To apply paragraph B115, an entity must have a previously documented risk-management objective and strategy for using derivatives to mitigate financial risk arising from the insurance contracts and, in applying that objective and strategy:

(a) the entity uses a derivative to mitigate the financial risk arising from the insurance contracts.

(b) an economic offset exists between the insurance contracts and the derivative, i.e. the values of the insurance contracts 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.

(c) credit risk does not dominate the economic offset.

B117 The entity shall determine the fulfilment cash flows in a group to which paragraph°B115 applies in a consistent manner in each reporting period.

B118 If any of the conditions in paragraph B116 ceases to be met, an entity shall:

(a) cease to apply paragraph B115 from that date; and

(b) not make any adjustment for changes previously recognised in profit or loss.”

Issues identified by EFRAG IAWG members

No risk mitigation solution for indirect participation contracts

2 EFRAG IAWG members noted that the risk mitigation solution provided for in IFRS 17 is limited in scope to contracts accounted for under the variable fee approach and is not available for contracts with indirect participation contracts (i.e. contracts accounted for in accordance with the general model). They additionally noted that the IASB’s project on dynamic risk management is not finalised yet and

that applying IFRS 9 *Financial Instruments* hedge accounting is not practical because of the dynamic macro nature of the existing hedge relationships.

No retrospective application of risk mitigation at transition

3 EFRAG IAWG members noted that at transition, risk mitigation is to be applied prospectively. Prospective application is considered to lead to a misstatement of equity at transition. It is noted that while – overall – little retrospective information may be available for insurance contracts, retrospective information is according to some EFRAG IAWG members available on hedge relationships at a general level. It is proposed that such general information can be used when retrospectively applying risk mitigation. It is acknowledged that this would lead to the use of hindsight but this is preferred above an equity amount that is determined without retrospective application of risk mitigation.

EFRAG Secretariat analysis

No risk mitigation solution for indirect participation contracts

Comparison of eligibility conditions IFRS 9 and IFRS 17

4 The following is a comparison of eligibility conditions of hedge accounting under IFRS 9 and risk mitigation under IFRS 17:

IFRS 9, paragraph 6.4.1	**IFRS 17, paragraphs B115 and B116**
At the inception of the hedging relationship there is formal designation and documentation of the hedging relationship and the entity's risk management objective and strategy for undertaking the hedge.	An entity must have a previously documented risk management objective and strategy for using derivatives to mitigate financial risk arising from the insurance contracts
The hedging relationship consists only of eligible hedging instruments and eligible hedged items.	The entity uses a derivative to mitigate the financial risk arising from the insurance contracts
There is an economic relationship between the hedged item and the hedging instrument.	An economic offset exists between the insurance contracts and the derivative, i.e. the value of the insurance contracts 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.
The effect of credit risk does not dominate the value changes that result from that economic relationship.	Credit risk does not dominate the economic offset.
The hedge ratio of the hedging relationship is the same as that resulting from the quantity of the hedged item that the entity actually hedges and the quantity of the hedging instrument that the entity actually uses to hedge that quantity of hedged item. The designation shall not reflect an imbalance between the weightings of the hedged item and the hedging instrument that would create hedge ineffectiveness.	

5 The EFRAG Secretariat notes that financial risk adjusts the contractual service margin for direct participation contracts whereas a derivative mitigating this risk is measured at fair value through profit or loss. This mismatch does not occur for indirect participation contracts which are accounted for relying on the general model as the effect of changes in financial risk is recognised in the statement of comprehensive income instead of the contractual service margin. Consequently, for

contracts with indirect participation contracts, IFRS 9 hedge accounting can be used when the financial risk component can be reliably identified and measured.

Results of the EFRAG IAWG Questionnaire

6 The EFRAG Secretariat notes that respondents indicated that the most commonly hedged risk components are interest rate risk, foreign currency risk, inflation risk, price risk, mortality and longevity risk.

Hedge accounting possibilities for risk components

7 Under IAS 39 *Financial Instruments: Recognition and Measurement,* the hedge accounting possibilities are limited as only foreign currency risk is an eligible hedged component of a non-financial item (or all risks of the non-financial item in their entirety). The portfolio fair value hedge of interest rate risk may not be a solution as it aims at hedging the interest rate risk of financial items (IAS 39, paragraph 81A).

8 Under IFRS 9, the hedge accounting possibilities for risk components significantly increase as risk components of a non-financial item can be designated as the hedged item in a hedging relationship, provided the risk component is separately identifiable and reliably measurable.

9 The EFRAG Secretariat acknowledges that in some circumstances it may be difficult to reliably identify and measure the risk component, so practical hurdles may have to be overcome in setting up a hedge accounting strategy. The EFRAG Secretariat does not expect the challenges for identification and measurement of risk components to be very different than for any other industry applying IFRS 9 hedge accounting.

10 Finally, the IASB's project on dynamic risk management is not finalised yet, however this situation is equally applicable to all industries.

No retrospective application of risk mitigation at transition

11 The EFRAG Secretariat notes that, similar to the hedging requirements in both IAS 39 and IFRS 9, the risk mitigation parts of IFRS 17 can only be applied prospectively from date of initial application. The EFRAG Secretariat notes that allowing retrospective application of the risk mitigation treatment could result in the use of hindsight. The EFRAG Secretariat is of the view that retrofitting data based on general information (i.e. lacking sufficient detail about what is being hedge accounted for) does neither result in reliable nor relevant information.

Question for EFRAG TEG

12 Does EFRAG TEG have questions on the issues discussed above?