# Interaction IFRS 9/IFRS 17 and hedge accounting

## Supporting material for the discussion in preparation of the Draft Endorsement Advice of IFRS 17

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Paper 04-03

EFRAG
European Financial Reporting Advisory Group

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# FOCUS OF EFRAG ANALYSIS FOR THE DEA

*RESOLUTION OF THE EUROPEAN PARLIAMENT ON IFRS 17 ENDORSEMENT*

- *Changes in valuation now occur on both the assets and the liabilities side of insurers' balance sheets, as investment assets are marked-to-market and the valuations of insurance contracts include forward-looking net cash flow estimates; calls on the EFRAG to assess the potential interaction and any mismatches between IFRS 9 and IFRS 17 (paragraph 9 of the Motion).*
- To collect input EFRAG Secretariat issued the **Hedge Accounting Questionnaire**.

*CONCERNS EXPRESSED BY CONSTITUENTS DURING THE CONSULTATION ON THE AMENDMENTS*

- The consultation run by EFRAG on the Amendments revealed as well concerns on the **interaction of IFRS 9 and 17**.

*EFRAG POSITION IN THE COMMENT LETTER*

- EFRAG has issued its comment letter on the Amendments to IFRS 17 on 24 September 2019. The letter reflects the positions taken by EFRAG after due process consultation, **including on implementation challenges** (i.e. the 25 issues analysed by the IASB in the re-deliberation process). With reference to risk mitigation and accounting mismatches EFRAG:
  - considers that the risk mitigation option should be extended to financial instruments at FVTPL;
  - is of the view that the retrospective application of risk mitigation option on transition is worthy of further attention;
  - notes that in applying the fair value approach, an option is available to set the accumulated OCI balance on insurance liabilities to nil on transition but no relief is available to assets measured at fair value through OCI. EFRAG considers that additional relief in IFRS 17 could alleviate concerns of entities (particularly those that believe they can apply only the fair value approach at transition).

*LONG TERM INVESTMENT IN EQUITY INSTRUMENTS*

- Refer to the work EFRAG is doing to respond to the **request for Advice** from the EC on the same topic

# HEDGE ACCOUNTING QUESTIONNAIRE

- **LESSONS LEARNT FROM THE QUESTIONNAIRE AND QUESTIONS TO IAWG MEMBERS**

# SOLUTIONS OFFERED BY IFRS 9/IAS 39 TO INSURERS

**Solutions offered**

- IFRS 9/IAS 39 requires measurement at FVTPL of
  - equity instruments (except when FVOCI no recycling option is elected),
  - of derivatives
  - of financial instruments held for trading
  - of financial instruments failing SPPI test

- IFRS 9/IAS 39 requires to classify FVOCI with recycling SPPI instruments in HTC business model

- IFRS 9/IAS 39 offers the option to classify at FVTPL SPPI instruments to reduce accounting mismatches

- IFRS 9/IAS 39 Hedge accounting offers offsetting of financial risks embedded in investments (assets)

<u>Questions</u>

1. Do you consider that IFRS 9/IAS 39 Hedge accounting offers offsetting of financial risks embedded in insurance liabilities? Do you consider that the risk components are separately identifiable and reliably measureable, i.e. when risk component is explicit in contract pricing and/or can be traced back in an active market?
2. Are non-distinct investment components under IFRS 17 eligible (ie separately identifiable) to apply IFRS 9 hedge accounting?
3. To what extent do you consider that IFRS 9 offers hedge accounting for non-financial insurance risks?
4. To what extent IAS 39 macrohedge is needed? May we anticipate that insurers would apply IFRS 9 to all hedge accounting instead of IAS 39?

# SOLUTIONS OFFERED BY IFRS 17 TO INSURERS

Risk mitigation – applicable to the variable fee approach (VFA)

- **Prior to the ED** – The risk mitigation allows an offset in P&L between the change in FV of derivatives and the **effect of the financial risk** on the insurance liability (which would otherwise be recognised in CSM). An entity must have previously documented risk-management objective and strategy [B116 of IFRS 17]. This option allows for a consistent treatment between the changes in the cash flows of VFA contracts and the related hedging instruments (both in P&L).
- **ED proposal** - The ED proposes to extend this risk mitigation option to reinsurance contracts held. As a result there would also be an offset in P&L for **the effect of financial risk**.
- **EFRAG's proposals** – Agreed to extend to reinsurance contracts held. Considered that financial instruments at FVPL should also be eligible.
- **Other comments** – the IASB did not extend the risk mitgation option to non-VFA. This concern was not in the 6 issues considered by EFRAG in its comment letter to the IASB. The IASB in the basis for conclusions of IFRS 17 concluded that it would not be appropriate to develop a "bespoke" solution for all hedging activities for insurance contracts, noting that such a solution should form part of broader project and they didn't want to delay the publication of IFRS 17.

- <u>Questions</u>

5. Under the variable fee approach, entities may use hedge accounting under IFRS 9 or risk mitigation under IFRS 17. Do you consider that these tools would be used in different fact patterns?
6. To what extent IFRS 9 offers an alternative to risk mitigation for VFA contracts when hedging financial risks of the insurance liabilities?

# SOLUTIONS OFFERED BY IFRS 17 TO INSURERS

Reinsurance accounting

- **Prior to the ED** – Reinsurance contracts held, in general apply the same measurement as the underlying contracts, except for some modifications specified in the standard, eg, for reinsurance contracts held, the net cost on purchasing reinsurance is spread.
- **ED proposal** – The ED proposes that an entity adjust the CSM of a group of reinsurance contracts held that provides proportionate coverage, and as a result recognise income, when the entity recognises a loss on initial recognition of an onerous group of underlying insurance contracts, or on addition of onerous contracts to that group. Therefore, there would be an offset in P&L limited to proportionate coverage and for underlying onerous contracts
- **EFRAG's proposals** – EFRAG welcomed the ED proposal. Term 'proportionate' should be reconsidered to include other types of reinsurance contracts based on their economic substance.
- **Other comments**:
  - Reinsurance contracts held are not eligible for the VFA. EFRAG did not consider reporting this concern as it was not frequent in practice.
  - Reinsurance contracts held contract boundary: EFRAG did not consider this issue because reinsurance contract boundary (including and excluding contracts not yet recognised) have the same effects on the balance sheet and limited differences in P&L and disclosures.

Questions

7. We understand that reinsurance in the main risk mitigation tool for non-financial insurance risks. Do you agree?
8. We understand that IFRS 17 results in mirroring accounting approach between the underlying insurance contracts and reinsurance contracts held (other than VFA contracts): If terms of the underlying and of the reinsurance are different, these differences are visible accounting-wise. Do you agree with this?

# CONSEQUENCES OF THE TRANSITION PROVISIONS

Transition

- **Prior to the ED -** Prospective application from the date of initial application of IFRS 17 for the risk mitigation option
- **ED proposals**
  - Prospective application from transition date of the risk mitigation option
  - Contracts eligible to apply the full retrospective approach can instead apply FVA if specified criteria relating to risk mitigation are met
- **EFRAG proposal**
  - Prefers retrospective application of the risk mitigation approach provided that the entity meets the criteria of B115-B116 of IFRS 17 and they are able to prove that a risk mitigation strategy was in place from the inception the risk mitigation strategy.
  - Additional relief needed relating to the option available to set the accumulated OCI balance on insurance liabilities to nil because this may significantly distort equity at transition and future results.

<u>Question</u>

9. Do you have any comments or observations on these topics?

# CONSULTATION ON THE AMENDMENTS

- **CONCERNS REPORTED IN THE CONSULTATION OF IFRS 17 AMENDMENTS**

# JOINT LETTER CFO FORUM/INSURANCE EUROPE (1/3)

- *Risk mitigation is a critical element of insurance business. As such, our comments in the appendices propose an extension of the risk mitigation option to include non-derivative financial instruments and to* ***be applicable to all insurance contracts –not only contracts accounted for under the variable fee approach****.*

  - This concern was not in the 6 issues considered by EFRAG in its comment letter to the IASB. The IASB in the basis for conclusions of IFRS 17 concluded that it would not be appropriate to develop a "bespoke" solution for all hedging activities for insurance contracts, noting that **such a solution should form part of broader project and they didn't want to delay the publication of IFRS 17.**

- *We do not support the IASB's tentative decision not to amend IFRS 17 for the* ***contract boundary*** *of reinsurance contracts.*

  - EFRAG did not consider this concern in its comment letter to the IASB as the resulting implications on balance sheet were not material and the risk adjustment offered already a practical solution.

  - *Use of the* ***VFA for reinsurance contracts***

  - EFRAG did not consider this concern in its comment letter to the IASB as the use of reinsurance contracts held to mitigate risks of VFA contracts is not frequent in practice.

# JOINT LETTER CFO FORUM/INSURANCE EUROPE (2/3)

- *Hedge accounting requires the hedged item to be **separately identifiable and reliably measurable**, which is not possible where investment and insurance components of an insurance contract are highly interrelated.*

- *Insurers **generally hedge open portfolios** and, even in case of closed portfolios, hedging is regularly carried out dynamically. Consequently, both hedged items and hedging instruments constantly change over the hedge term.*

- *Policyholder behaviour and other future expectations (e.g. lapses, surrenders, new business sales, and mortality) are intertwined with the impact of financial market variables. **It is not evident how these items could be excluded from the hedging relationship**.*

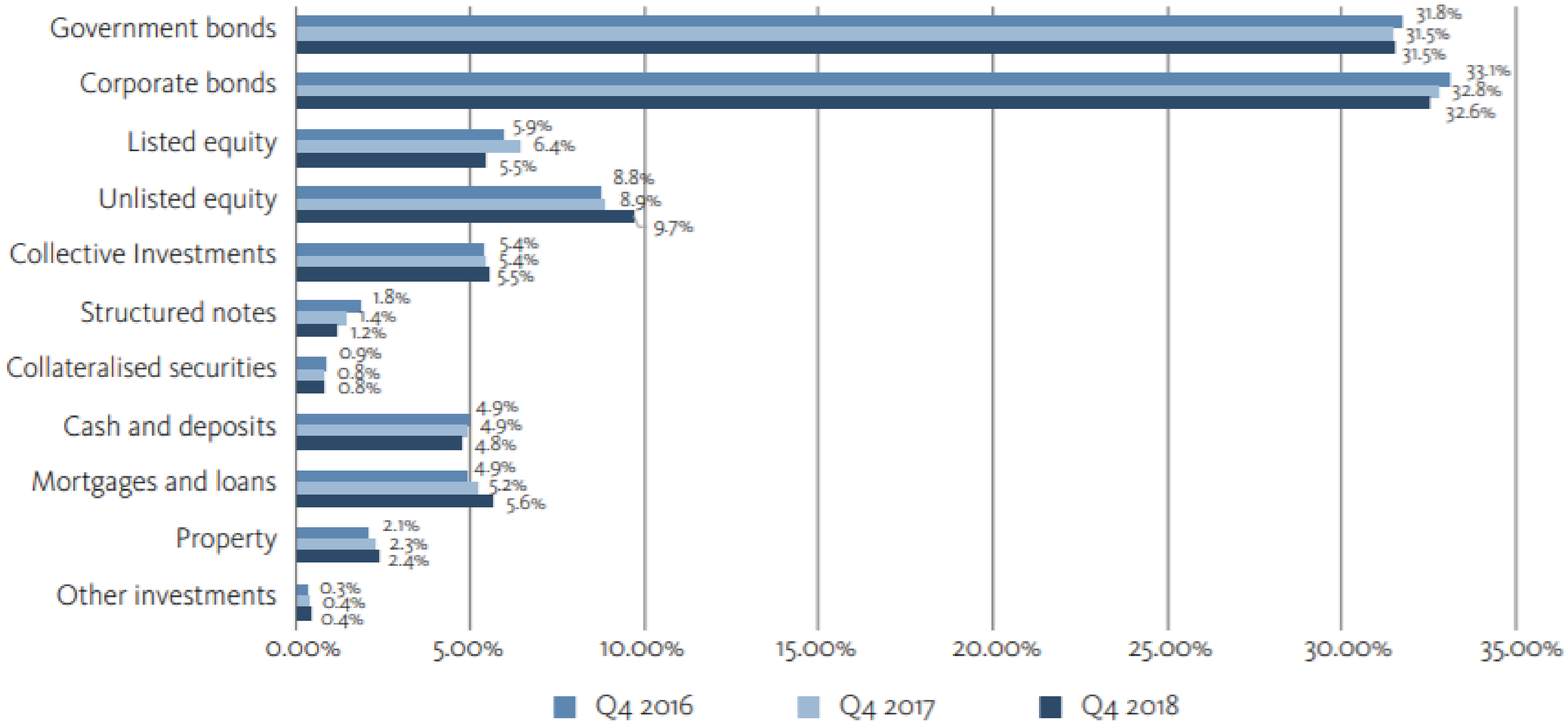
- *The hedge effectiveness requirements to qualify for hedge accounting are **operationally onerous to comply** with.*

- The ongoing assessment of the hedge accounting questionnaire will provide evidence on the issue of "separately identifiable and reliably measurable".
- EFRAG Secretariat observes that the issues of open portfolios, behavioural expectations and operational complexities are shared as well by entities applying IAS 39/IFRS 9 in banking.

# JOINT LETTER CFO FORUM/INSURANCE EUROPE (3/3)

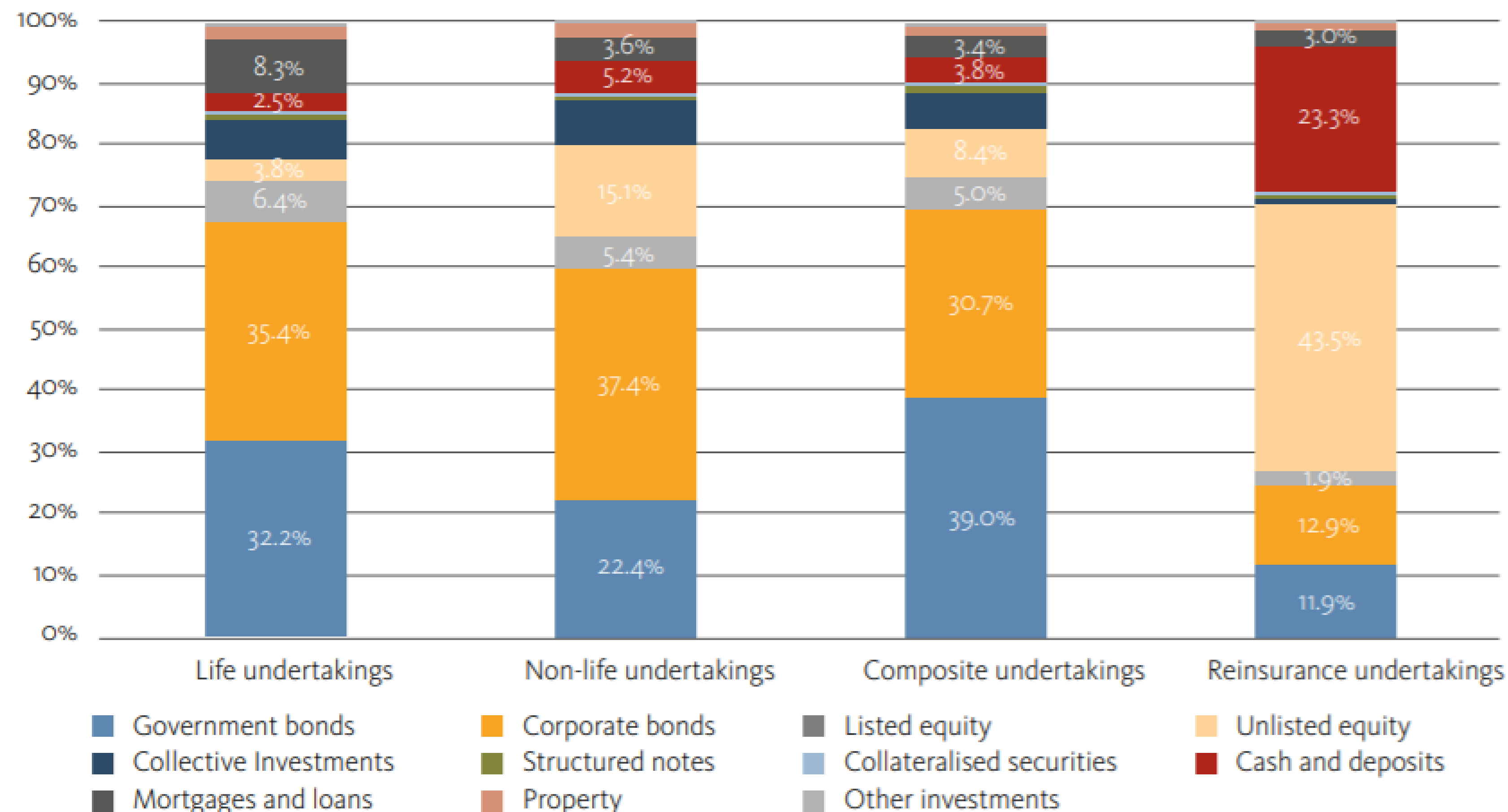
- *IFRS 9 hedge accounting is not well suited for the more macro approach that is common within the insurance industry, and the dynamic risk management project has, to date, not contemplated many of the issues of concern. Moreover, the dynamic risk management project will not be finalised for at least a few more y ears. Therefore we believe that additional changes to IFRS 17 are necessary. Since the mismatches described above result from the requirements of IFRS 17 (e.g. the variable fee approach and liability OCI accounting), it is appropriate that these are resolved within the IFRS 17 standard. The current IFRS 4 includes several mechanisms to reduce the accounting volatility in profit or loss (e.g. shadow accounting, accounting for the impact of guarantees at fair value through profit or loss, etc.) which are not available within IFRS 17.*

# INVESTMENT PORTFOLIOS AT EUROPEAN LEVEL
## Investment split Q42018




Source: EIOPA Quarterly Solo
Reference Date: Q4 2018
Note: Look-through approach applied. Assets held for unit-linked business are excluded. Equities include holdings in related undertakings.

# INVESTMENT PORTFOLIOS AT EUROPEAN LEVEL
## Investment split Q42018 by undertakings




Source: EIOPA Quarterly Solo
Reference Date: Q4 2018
Note: Look-through approach applied. Equities include holdings in related undertakings, which account for most equities held by reinsurers. Assets held for unit-linked business are excluded.

# CONCERNS AND PROPOSALS BY THE ANC AND UNESPA
## Equity investments

**ANC**

- Measuring their **whole portfolio at fair value through P&L (FVPL)** would present a volatility that would not reflect the long-term performance and stability of their ALM management.
- This would especially affect investments in equity instruments which is part of their business model as they **provide higher yields than investment in bonds** and therefore to propose more attractive tariffs to policyholders.
- **Only the VFA addresses the equity investment issue, provided that IFRS 9 assets are recorded at FVPL.**
    - Non-recycling OCI on equity investment and the accounting treatment of funds (UCITS, AIF) is an issue for all insurance contracts but those accounted for under the VFA.
    - This remains also an issue for an entity investing on its own.
- The equity investment issue is broader than IFRS 17 and may better be addressed at IFRS 9 level. In the frame of current European consultations, ANC suggests:

  (i) to introduce recycling,

  (ii) to define a robust and simple impairment solution for equity or equity type instruments (on a clearly defined and agreed upon basis),

  (iii) to extend the solutions retained for equity instruments to equity type instruments (defined in accordance with clear criteria via a test) and

  (iv) to consider if need be some specific situations or business models in respect to the general principles retained.

**UNESPA** raised a concern that the lack of recycling would show a mismatch in cases of experience adjustments

# CONCERNS AND PROPOSALS BY THE ANC
# ‘IFRS 17 implies fair value measurement of assets’ (1/2)

- Applying the VFA to an insurance contract, liabilities are reflected at their current value regardless of the measurement retained on the asset side. In order for changes in fair value of assets to be properly matched (in P&L or OCI), a measurement of assets at current value is promoted. Applying historical costs instead would automatically generate a mismatch either in the P&L or in the OCI. Accordingly, applying the VFA, creates a disincentive to choosing another measurement of assets than fair value, regardless of the business model that would best fit applying IFRS 9 solely.
- The effects of this preference may not be limited to VFA contracts. If an asset covers several types of insurance contracts (some being VFA others not), applying historical cost measurement to assets will create a mismatch in the VFA part, whereas applying fair value may create undesired volatility in the non-VFA part. This situation may happen to financial assets in a general fund or even to non-financial assets such as investment property (applying IAS 40).
- This issue has been exacerbated by:
  - The limitation to the application of the FVOCI applying IFRS 9 business models. For instance, investing in a SPPI Held-to-collect debt instrument, an entity will be enticed to apply fair value (because of IFRS 17) but prevented from applying FVOCI (because of the IFRS 9 business model) which eventually may lead to apply the FVPL.
  - The existing prohibition to disaggregate investment property (IAS 40.32B)

# CONCERNS AND PROPOSALS BY THE ANC
# ‘IFRS 17 implies fair value measurement of assets’ (2/2)

- Since insurance contracts are measured at current value, any corresponding asset is best matched when also measured at current value, i.e. fair value. This core principle in IFRS 17 leads to application issues (for instance by segregating assets into ring-fenced pools or accepting the created mismatch) that can hardly be solved by standard setting.

- However, **targeted improvements are possible in facilitating the alignment of the measurement of underlying assets with the measurement of the insurance contract (at current value, possibly with OCI option):**
  - by allowing measuring loans at FVOCI even if the IFRS 9 business model is held-to collect i.e. adding a FVOCI option similar to the existing FVPL in IFRS 9.4.1.5;
  - by splitting investment property providing returns to different types of contracts (amending IAS 40.32A and IAS 40.32B)

<u>Questions</u>

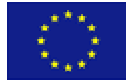
10. According to the progresses of the implementation projects, how the assets backing insurance liabilities will be classified under IFRS 9 categories (HtC, HtCS, FVTPL)? Is the pattern different for VFA and non VFA contracts?

# CONCERNS AND PROPOSALS BY THE ANC and others
## Locked-in Discount rate

- Participating contracts not meeting the VFA criteria require to follow in the accounting IT-systems a "locked-in" discount rate in addition to the current rate for the purpose of CSM calculation.
- In addition, this accounting treatment might generate temporary OCI-volatility

- CFO Forum and Prudential also mentioned this as a concern for contracts under the general model. According to them, it adds to the complexity of IFRS 17 and may distort the financial results in a given period.

  - This concern was not in the 6 issues considered by EFRAG in its comment letter to the IASB. The IASB in the basis for conclusions of IFRS 17 concluded that the contractual service margin does not represent future cash flows; it represents the unearned profit in the contract, measured at the point of initial recognition and adjusted only for specified amounts.



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# THANK YOU

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