IFRS

STAFF PAPER

January 2020

IASB® meeting

Project	**Amendments to IFRS 17**		
Paper topic	Transition—the prohibition from applying the risk mitigation option retrospectively		

CONTACT(S)	Hyejin Lee	hlee@ifrs.org	+44 (0)20 7246 6453
	Laura Kennedy	lkennedy@ifrs.org	+44 (0)20 7246 6437

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

Purpose of the paper

1. This paper discusses staff analysis and recommendations about the feedback from respondents to the Exposure Draft *Amendments to IFRS 17* relating to the prohibition from applying the risk mitigation option retrospectively on transition to IFRS 17 *Insurance Contracts*. This paper follows the tentative decision of the International Accounting Standards Board (Board), at its November 2019 meeting, to consider further the feedback from outreach and comment letters on this topic.

Summary of staff recommendations

2. The staff recommend the Board retain, unchanged, the prohibition from applying the risk mitigation option retrospectively.

Structure of the paper

3. This paper provides:

    (a) background on the topic;

    (b) an overview of the feedback; and

    (c) the staff analysis, recommendations and questions for Board members.

The International Accounting Standards Board is the independent standard-setting body of the IFRS Foundation, a not-for-profit corporation promoting the adoption of IFRS Standards. For more information visit www.ifrs.org.

Background

4. The risk mitigation option in IFRS 17 permits an entity to recognise immediately in profit or loss some or all of the changes in the effect of financial risk on insurance contracts with direct participation features that usually adjust the contractual service margin. In other words, the risk mitigation option 'switches off' the variable fee approach to the extent that financial risk is mitigated.

5. To apply the risk mitigation option, an entity must have a previously documented risk-management objective and strategy for mitigating financial risk arising from the insurance contracts using derivatives or reinsurance contracts held[1] and, in applying that objective and strategy:

    (a) the entity mitigates the financial risk arising from the insurance contracts using a derivative or a reinsurance contract held.[2]

    (b) an economic offset exists between the insurance contracts and the derivative or reinsurance contract held, ie the values of the insurance contracts and the derivative or reinsurance contract held generally move in opposite directions because they respond in a similar way to the changes in the risk being mitigated. An entity does not consider accounting measurement differences in assessing the economic offset.

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

6. IFRS 17 prohibits an entity from applying the risk mitigation option for periods before the date of initial application of IFRS 17. Consistent with the transition requirements for hedge accounting in IFRS 9 *Financial Instruments*, the Board concluded that retrospective application of the risk mitigation option in IFRS 17 would give rise to the risk of the use of hindsight.

7. When developing the Exposure Draft, the Board considered a suggestion from stakeholders to permit retrospective application of the risk mitigation option. In those

[1] The Board, at its December 2019 meeting, tentatively decided to finalise an amendment to IFRS 17 that would permit an entity to apply the risk mitigation option when it mitigates financial risk arising from insurance contracts with direct participation features using reinsurance contracts held.

[2] At a future meeting the Board will consider further feedback from respondents who suggested the Board extend the risk mitigation option to apply when an entity uses non-derivative financial instruments (see Agenda Paper 2D *Redeliberation Plan* of the November 2019 Board meeting).

stakeholders' view, retrospective application of the option would enhance comparability of information before and after the date of initial application of IFRS 17. However, the Board disagreed with that suggestion because permitting application of the option retrospectively would create opportunities for entities to decide the risk mitigation relationships to which to apply the option based on the known accounting outcome. Therefore, the credibility of information presented would be reduced.

8. The Board considered a suggestion by stakeholders to amend IFRS 17 to permit an entity to apply the risk mitigation option if, and only if, the entity applies the option for all risk mitigation relationships that would meet the conditions in paragraph B116 of IFRS 17. While in principle this would address the concern about applying the option based on a known accounting outcome, the Board concluded that such an amendment would not be appropriate because it would not be possible to assess the completeness of such an approach in practice. Historically, no other IFRS Standard has required an entity to document such risk mitigation relationships as specified in paragraph B116 of IFRS 17.

9. Despite concluding that an entity should not be permitted to apply the risk mitigation option retrospectively, the Board sought to address stakeholders' concerns by proposing in the Exposure Draft that an entity:

   (a) apply the risk mitigation option for insurance contracts with direct participation features prospectively from the transition date, rather than the date of initial application. An entity would be required to designate risk mitigation relationships at or before the date it applies the option.

   (b) be permitted to apply the fair value approach to a group of insurance contracts with direct participation features if it meets specified criteria relating to risk mitigation, even if it can apply IFRS 17 retrospectively to that group.

Feedback

10. Overall, respondents expressed support for the proposed amendments described in paragraph 9 of this paper. The Board tentatively decided to finalise those proposed amendments at its December 2019 meeting.[3]

11. Some respondents that commented on the proposed amendments also commented on the Board's decision to retain, unchanged, the requirements in IFRS 17 that prohibit an entity from applying the risk mitigation option retrospectively.

12. Some respondents continued to suggest the Board amend IFRS 17 to permit an entity to apply the risk mitigation option retrospectively, either in addition to, or instead of, the proposed amendments. In their view, the benefit of reflecting risk mitigation activities in the amounts recognised at transition in a consistent way with the accounting for risk mitigation activities after the transition date would outweigh the risk of the entity using hindsight to apply the option based on a known accounting outcome.

13. Some of those respondents noted that in their view:
    (a) although the risk of the use of hindsight would exist, an entity's primary motive for applying the risk mitigation option retrospectively would be to reflect risk mitigation activities consistently before and after the transition date, rather than to achieve a specific desired result; and
    (b) the requirements for applying the risk mitigation option provide sufficient conditions for permitting retrospective application of the option. IFRS 17 requires that:
        (i) to apply the risk mitigation option, an entity must meet the conditions in paragraph B116 of IFRS 17 (see paragraph 5 of this paper); and
        (ii) an entity would cease to apply the risk mitigation option for a risk mitigant if, and only if, the conditions in paragraph B116 of IFRS 17 cease to be met.

[3] The Board's decision regarding the topic in this paper would not affect the Board's tentative decision to finalise the transition reliefs proposed in the Exposure Draft.

14. A small number of respondents suggested that, should the Board agree that it would be appropriate for an entity to apply the risk mitigation option retrospectively, the Board could reduce the risk of an entity using hindsight to apply the option based on a known accounting outcome. They suggested the Board could do this by reconsidering permitting an ‘all or nothing’ approach to applying the risk mitigation option retrospectively (see paragraph 8 of this paper).

15. Some of those respondents acknowledged the Board’s concern about the ability to assess the completeness of an ‘all or nothing’ approach in practice. However, those respondents expressed the view that an entity might have historical documentation of its overall risk-management objective and strategy prior to the date of transition to IFRS 17 that would meet the conditions in paragraph B116 of IFRS 17. In their view, that documentation would demonstrate completeness. Those respondents explained that an entity might hold such documentation for regulatory purposes or for internal purposes such as risk committee reporting.

16. Those respondents suggested that an entity be permitted to apply the risk mitigation option if, and only if, it applies the option to all risk mitigation relationships and the following conditions are met:

    (a) documentation of an entity’s risk-management objective and strategy relating to risk mitigation relationships before the date of transition to IFRS 17 exists at the transition date; and

    (b) the entity can prove with reasonable and supportable information that the conditions in paragraph B116 of IFRS 17 were met in the relevant past periods.

17. In contrast to the feedback described in paragraphs 12–16 of this paper, a small number of respondents, including three auditors, a regulator and a national standard-setter, agreed with the Board’s decision not to amend IFRS 17 to permit an entity to apply the risk mitigation option retrospectively. Two of those respondents expressed the view that the amendments proposed by the Board strike the right balance between preventing the use of hindsight and allowing entities an option to reflect risk mitigation activities in a consistent way before and after transition to IFRS 17.

Staff analysis and recommendations

18. The staff note that the amendments tentatively finalised by the Board, as described in paragraph 9 of this paper, would address stakeholder concerns that a contractual service margin at transition does not reflect risk mitigation activities from previous periods, as follows:

    (a) the amendment that would permit an entity to apply the option prospectively from the transition date rather than the initial application date would address concerns about inconsistency between the first reporting period applying IFRS 17 and the restated comparative information.

    (b) the amendment that would permit an entity to apply the fair value approach for the groups of insurance contracts with risk mitigation relationships, even if an entity is able to apply IFRS 17 retrospectively, would result in any past gains or losses on derivatives and any effects of past changes in financial risk on the group of insurance contracts being reflected in opening retained earnings, thereby avoiding any accounting mismatches.

19. However, in the light of the feedback that continues to suggest the Board permit retrospective application of the risk mitigation option, the staff have further analysed whether the Board could allow a retrospective application of the risk mitigation option.

20. As explained in paragraphs 12–13 of this paper, some respondents continued to suggest the Board permit retrospective application of the risk mitigation option without adding any conditions beyond those required by paragraph B116 of IFRS 17. The staff note that, generally, those stakeholders disagreed with the Board's cost-benefit analysis when comparing the risk of the use of hindsight to the benefit of reflecting risk mitigation activities before and after transition to IFRS 17 consistently.

21. Those respondents agreed that the risk of the use of hindsight would exist and did not suggest ways to reduce that risk. The staff note that applying paragraphs B115–B116 of IFRS 17 an entity chooses to apply the risk mitigation option on an individual derivative basis (or an individual reinsurance contract held basis). As such, without further constraint an entity could freely decide the extent to which to reflect risk mitigation activities in the contractual service margin based on a known accounting

outcome. Furthermore, the entity could do this in a way that would not reflect how the entity would have applied the option in previous periods, without hindsight, had it been applying IFRS 17.

22. In the Board's view, permitting retrospective application of the risk mitigation option would come at a significant cost. The risk of the use of hindsight would affect the credibility of information presented on transition to IFRS 17 and in the subsequent periods in which those groups of insurance contracts continue to exist. Even if an entity applied the requirements retrospectively without using hindsight, it would be impossible for a user of financial statements to tell the difference between that entity and another which had used hindsight. The Board considered the costs and benefits when it decided not to propose an amendment to IFRS 17 to permit retrospective application of the risk mitigation option. The staff have not identified any new information for the Board to consider with regards to the costs and benefits.

Modified retrospective approach

23. Paragraph 114 of IFRS 17 requires an entity to provide disclosures which enable users of financial statements to identify the effect of groups of insurance contracts measured at the transition date applying the modified retrospective approach or the fair value approach on the contractual service margin and insurance revenue in the subsequent periods those insurance contracts continue to exist. In contrast, such disclosures are not required for groups of insurance contracts measured applying a full retrospective approach.

24. The staff considered whether, in response to feedback, the Board could permit retrospective application of the risk mitigation option only in the modified retrospective approach and not in the full retrospective approach. The risk of the use of hindsight would exist in the same way that it would exist in the full retrospective approach. However, the contractual service margin for those groups of insurance contracts (ie to which hindsight may have been applied in determining the contractual service margin at transition) would be ring-fenced and disclosed separately in all subsequent reporting periods those insurance contracts continue to exist.

25. In the staff view, disclosure of the contractual service margin to which hindsight may have been applied is not sufficient to address the Board's concern about the risk of the

use of hindsight based on a known accounting outcome. Retrospective application of the risk mitigation option could have a significant impact on the amount of the contractual service margin at transition, and therefore on insurance revenue recognised in profit or loss in future reporting periods.

26. Disclosure would flag amounts that may have been determined using hindsight, but would not alleviate any doubt as to whether and how hindsight had or had not been applied.

27. Therefore, the staff think the Board should not amend IFRS 17 to permit retrospective application of the risk mitigation option—in either the full retrospective approach or the modified retrospective approach—without adding conditions beyond those required by paragraph B116 of IFRS 17.

All or nothing approach

28. As explained in paragraph 14 of this paper, a small number of respondents suggested the Board reconsider permitting an entity to apply an 'all or nothing' retrospective application of the risk mitigation option to reduce the risk of the use of hindsight.

29. The staff note that some of those respondents provided additional information about why they think any entity could reasonably ensure the completeness of such an approach. Specifically, those respondents noted that an entity may have historical risk-management objective and strategy documentation for purposes other than financial reporting.

30. The analysis in paragraphs 31–38 of this paper considers what an 'all or nothing' approach would require. The analysis is split as follows:

    (a) what would 'all' mean in an 'all or nothing' approach?

    (b) what documentation would be required?

    (c) how would an entity apply the measurement requirements retrospectively?

What would 'all' mean in an 'all or nothing' approach?

31. In the staff view, it is necessary that 'all' is assessed at a reporting entity level. If it were assessed at a level lower than a reporting entity level (for example, at the level of a portfolio of insurance contracts or group of insurance contracts) the risk of the use

of hindsight would still exist, albeit that risk would be lower than it would be if the entity were permitted to apply the option retrospectively on an individual risk mitigation relationship basis.

32. Assume a group presents consolidated financial statements and has two subsidiaries. One subsidiary has the information required to apply an 'all or nothing' approach. The other subsidiary does not have the information require to apply an 'all or nothing' approach. The group as a whole would not meet the conditions to apply an 'all or nothing' approach in the consolidated financial statements.

33. In the staff view, it is necessary that 'all' mean all risk mitigation relationships that meet the criteria in paragraph B116 of IFRS 17 for all groups of insurance contracts with direct participation features that exist at the transition date. That includes all *past and current* derivatives and reinsurance contracts held that are at the transition date, or were in any previous reporting period, used to mitigate financial risks on those groups of insurance contracts.

34. The staff think that if 'all' were to mean only derivatives and reinsurance contracts held that exist at the transition date, risk mitigation activities prior to the transition date using derivatives or reinsurance contracts held that expired before the transition date would be reflected in the contractual service margin on transition inconsistently with risk mitigation activities that exist at the transition date. Therefore, stakeholder concerns about inconsistency in the treatment of risk mitigation activities would not be addressed.

What documentation would be required?

35. Some respondents expressed the view that an entity would already, for purposes other than IFRS 17, hold historical risk-management objective and strategy documentation that would meet the requirements in paragraph B116 of IFRS 17. In the staff view, to meet the requirements in paragraph B116 of IFRS 17 and to prove completeness for an 'all or nothing' approach that documentation, at a reporting entity level, must:

    (a) specify all of the derivatives or reinsurance contracts held that are currently used, or have previously been used, to mitigate financial risks from all insurance contracts with direct participation features that exist at the transition date; and

(b) specify the financial risks in the insurance contracts that are, or have previously been, mitigated using all of the derivatives and reinsurance contracts held identified in (a);

(c) demonstrate that an economic offset exists, or existed, between the insurance contracts and all of the derivatives and reinsurance contracts held identified in (a); and

(d) demonstrate that credit risk does not dominate the economic offset.

36. In the staff view, to apply the requirements in paragraphs B115–B116 of IFRS 17 retrospectively, that documentation must have existed at the beginning of the first reporting period that the entity would have met the conditions to apply the option in paragraph B115 of IFRS 17. Paragraph B116 of IFRS 17 requires that, to apply paragraph B115 of IFRS 17, an entity must have a *previously documented* risk-management objective and strategy. The staff think that, if the Board were to permit retrospective application on an 'all or nothing' basis, requiring documentation to exist at the transition date would not be sufficient because it would not ensure that the documentation existed in the relevant prior reporting periods. For example, if the transition date is 1 January 2021, documentation prepared on 31 December 2020 would not be sufficient evidence of a risk mitigation relationship that existed between 2017–2020.

How would an entity apply the measurement requirements retrospectively?

37. In addition to meeting all of the conditions discussed in paragraphs 31–36 of this paper, to apply the risk mitigation option retrospectively to all current and past risk mitigation relationships, an entity would also need to be able to measure all groups of insurance contracts with direct participation features that exist at the transition date retrospectively, including determining the effect of applying the option. In the staff view, the Board should not permit any reliefs or modifications for measuring the effect of applying the option in the full retrospective approach, because doing so would be inconsistent with that approach.

38. As a consequence, if an entity has used many derivatives to mitigate financial risks on many insurance contracts over a period of, say, 20 years prior to the transition date, the entity would be required to determine the effect of applying the risk mitigation

option for all of those derivatives. If there was one derivative for which the entity could not measure the effect, the entity would not meet the conditions of an ‘all or nothing’ approach. The entity would therefore be prohibited from applying the risk mitigation option to reflect any of the derivatives used in the 20-year period.

Overall staff view on ‘all or nothing’ approach

39. The staff think that applying an ‘all or nothing’ approach to retrospective application of the risk mitigation option, as set out in paragraphs 31–38 of this paper, would be impracticable in almost all cases. Meeting the conditions necessary to apply an ‘all or nothing’ approach would be a high hurdle that would likely be met in only a narrow set of circumstances. The staff think that amending IFRS 17 to permit an ‘all or nothing’ approach might risk implying that such an approach would address stakeholders’ concerns when in fact it would be unachievable in most cases.

Staff recommendation

40. Considering the analysis in paragraphs 18–39 of this paper, the staff recommend the Board retain, unchanged, the prohibition from applying the risk mitigation option retrospectively.

Question for Board members
Do you agree the Board should retain, unchanged, the prohibition from applying the risk mitigation option retrospectively?