STAFF PAPER

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Project	**Amendments to IFRS 17 *Insurance Contracts***
Paper topic	Transition—Risk mitigation option and amounts accumulated in other comprehensive income on transition

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Purpose

1. This paper considers stakeholder feedback about the requirements in IFRS 17 *Insurance Contracts* relating to the prohibition of retrospective application of the risk mitigation option and the determination of the cumulative amount of insurance finance income or expenses recognised in other comprehensive income (OCI) on transition.

Summary of staff recommendations

2. The staff recommend the International Accounting Standards Board (Board):
    - (a) retain the requirements in IFRS 17 relating to the prohibition of retrospective application of the risk mitigation option on transition to IFRS 17; and
    - (b) retain the requirements in IFRS 17 with respect to the cumulative amounts included in other comprehensive income on transition to IFRS 17.

Structure of the paper

3. This paper discusses the following topics:

   (a) the prohibition of retrospective application of the risk mitigation option; and

   (b) the determination of the cumulative amount of insurance finance income or expenses recognised in OCI on transition.

4. For each topic, this paper provides:

   (a) an overview of the requirements in IFRS 17;

   (b) a summary of the Board's rationale for setting those requirements, including an overview of the Board's previous discussions;

   (c) an overview of the concerns and implementation challenges expressed since IFRS 17 was issued; and

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

Prohibition of retrospective application of the risk mitigation option

IFRS 17 requirements and Board's rationale

5. IFRS 17 applies to insurance contracts and IFRS *9 Financial Instruments* applies to financial assets and derivatives held by the entity. Accounting mismatches can arise because those Standards measure insurance contracts differently from financial assets and derivatives. In particular, the measurement of insurance contracts applying the variable fee approach results in the effects of changes in financial assumptions adjusting the contractual service margin of the group of insurance contracts, while the effect of those changes on financial assets and derivatives is recognised in profit or loss or other comprehensive income.

6. During the development of IFRS 17, the Board noted that entities may purchase derivatives to mitigate risks of changes in financial assumptions. An accounting mismatch arises because:

(a) the change in the fair value of the derivative would be recognised in profit or loss applying IFRS 9; but

(b) the change in the insurance contract, the risk of which was mitigated by the derivative, would adjust the contractual service margin applying IFRS 17, unless the contracts were onerous.

7. Hence, the Board included in IFRS 17 an option for the entity in specified circumstances to recognise the effect of some changes in financial risk in the insurance contracts in profit or loss, instead of adjusting the contractual service margin.

8. This risk mitigation option is permitted if:

(a) an entity has a previously documented risk-management objective and strategy for using derivatives[1] to mitigate financial risk arising from the insurance contracts;

(b) in applying that objective and strategy it uses a derivative to mitigate the financial risk arising from the insurance contracts;

(c) an economic offset exists between the insurance contracts and the derivative, ie 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; and

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

9. Paragraph BC393 of the Basis for Conclusions on IFRS 17 explains that the documentation requirement is analogous to the documentation requirements for hedge accounting in IFRS 9. Consistent with the transition requirements for hedge accounting in IFRS 9, the Board concluded that retrospective application of the risk mitigation treatment would give rise to the risk of hindsight. In particular, the Board was concerned that because the application of the approach is optional, entities could choose the risk mitigation relationships to which it would apply with the benefit of

[1] In January 2019, the Board tentatively decided to amend IFRS 17 to expand the scope of the risk mitigation exception so that the exception applies when an entity uses a derivative or a reinsurance contract held to mitigate financial risk.

knowing at transition how that relationship had developed. Consequently, IFRS 17, consistent with the transition requirements for hedge accounting in IFRS 9, requires prospective application of the risk mitigation option from the date of initial application of the Standard.

Concerns and implementation challenges expressed since IFRS 17 was issued

10. Consistent with the feedback during the development of IFRS 17, some stakeholders continue to be concerned that the risk mitigation exception in IFRS 17 can only be used prospectively even though risk mitigation activities may have been in place before the date of initial application of IFRS 17. Given that the contractual service margin will be allocated to profit or loss in future periods, those stakeholders are concerned a contractual service margin that does not reflect risk mitigation activities from previous periods may distort:

    (a) the equity of entities on transition—because the effect of previous changes in the fair value of the derivatives will be included in the equity on transition, while the corresponding effect on the insurance contracts will be included in the measurement of the insurance contracts; 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.

11. Some stakeholders suggested the Board should amend the transition requirements of IFRS 17 in one of the following ways:

    (a) allow entities to apply the risk mitigation option fully retrospectively, or prospectively from the transition date[2] rather the date of initial application;

    (b) allow entities to apply the risk mitigation option retrospectively provided that they can demonstrate that they had a previously documented risk-management

[2] For the purposes of the transition requirements in IFRS 17: (a) the date of initial application is the beginning of the annual reporting period in which an entity first applies IFRS 17; and (b) the transition date is the beginning of the annual reporting period immediately preceding the date of initial application.

objective and strategy for using derivatives to mitigate financial risk arising from the insurance contracts; or

(c) an approach similar to the one proposed by paragraph 11(b) of this paper, except that the entity would be required to apply the risk mitigation option for all circumstances that a previously documented risk-management objective and strategy exist (ie an 'all or nothing' approach).

Staff analysis and recommendation

12. The staff observe that the risk mitigation option is by nature prospective because:

(a) it can only be applied after an entity has a documented risk-management objective and strategy for using derivatives to mitigate financial risk arising from the insurance contracts;

(b) once the entity determines the fulfilment cash flows in a group to which the risk mitigation option applies, it applies this determination in a consistent manner in each future reporting period; and

(c) if any of the conditions for applying the risk mitigation option cease to be met, the entity ceases using the option without making any adjustments for changes previously recognised in profit or loss.

13. The staff think that applying the risk mitigation option retrospectively without using hindsight is challenging. The entity would have to determine what amounts it would have recognised in profit or loss for the mitigated risks. The staff also think that retrospectively applying *an option* that is prospective by nature gives rise to 'cherry picking' opportunities. Retrospective application of the risk mitigation option could also lead to unjustified inconsistency with the requirements for hedge accounting in IFRS 9 that prohibits the retrospective application of hedge accounting for the same reason.

14. To illustrate, if the Board were to permit the risk mitigation option to be applied retrospectively, entities that have a previously documented risk-management objective and strategy for using derivatives to mitigate financial risk arising from the insurance contracts could, for example:

(a) choose retrospectively the risk mitigation relationships to which they apply the option based on the outcome known at the effective date;

(b) determine the fulfilment cash flows in a group to which the risk mitigation option applies retrospectively based on the outcome known at the effective date; and

(c) determine when to start applying the risk mitigation option based on the outcome known at the effective date, even if the derivative had the same risk mitigating effect in previous periods.

15. The staff think that a benefit of an option that is prospective by nature is that it reflects management decisions in the most neutral way—at the point in time an entity makes a decision to apply a risk mitigation option not knowing what will be its outcome, and therefore provides the most useful information to users of financial statements about this decision and its consequences over time. While a retrospective application that would not use hindsight may also provide useful information to users of financial statements about risk mitigation activities that took place in previous periods, it is hard to see how the option could be applied retrospectively without the use of hindsight, and the use of hindsight would significantly reduce the value of this information. The staff observe that any of the proposed approaches described in paragraph 11 of this paper may have this effect.

16. The staff acknowledge that the equity and future profitability reported by entities would be different if they had been able to apply the risk mitigation option retrospectively. However, the staff note that allowing entities to choose to which relationships to apply the risk mitigation option with the benefit of hindsight effectively enables entities to choose the amount of the contractual service margin on transition and thus the future profit to be recognised in profit or loss.[3]

17. The staff also note that IFRS 9 allows entities on initial application to designate financial assets as measured at fair value through profit or loss when doing so mitigates an accounting mismatch (fair value option), and that IFRS 17 allows entities

3 Some suggest the 'all or nothing' approach in paragraph 11(c) of this paper could avoid the use of hindsight and resulting cherry picking. However, the staff observe that, in the absence of required documentation for existing financial reporting purposes, it could be difficult to ensure that the information used is complete and valid.

to make that designation on first applying IFRS 17 to the same extent as they could on first applying IFRS 9. That designation of financial assets under the fair value option is made on the basis of the facts and circumstances that exist at the date of initial application and the measurement is applied retrospectively. The staff considered whether allowing retrospective application of the risk mitigation option in IFRS 17 could be justified as being similar to the retrospective application of the measurement under the IFRS 9 fair value option.

18. The staff concluded that retrospective application of the risk mitigation option differs from the retrospective measurement under the IFRS 9 fair value option because although the designation at fair value is optional (assuming the relevant criterion is met at the date of initial application), once that choice is made, there is no choice about how the resulting measurement applies retrospectively. In contrast, retrospective application of the risk mitigation option would require entities to decide what risk mitigation relationships the option would have applied to in previous periods and the extent of the risk mitigation covered by the option.

19. The staff therefore think that an amendment to IFRS 17 to permit retrospective application of the risk mitigation option would cause significant loss of useful information relative to that which would be provided by IFRS 17 for users of financial statements. Accordingly, the staff recommend that the Board retain the requirements in IFRS 17 relating to the prohibition of retrospective application of the risk mitigation option.

Question 1 for Board members
Do you agree that the Board should retain the requirements in IFRS 17 relating to the prohibition of retrospective application of the risk mitigation option on transition to IFRS 17?

Determination of the cumulative amount of insurance finance income or expenses recognised in other comprehensive income on transition

IFRS 17 requirements

20. When an entity chooses to disaggregate insurance finance income or expenses between profit or loss and OCI, it may be permitted or required to determine the cumulative amount of insurance finance income or expenses recognised in OCI at the transition date as nil in the following circumstances:[4]

    (a) permitted when applying the fair value approach (paragraph C24(b) of IFRS 17);

    (b) permitted when applying the modified retrospective approach for groups of insurance contracts that include contracts issued more than one year apart (paragraph C18(b) of IFRS 17); and

    (c) required when applying the modified retrospective approach for groups of insurance contracts that do not include contracts issued more than one year apart for insurance contracts for which changes in assumptions that relate to financial risk have a substantial effect on the amounts paid to the policyholders (paragraph C19(b)(ii) of IFRS 17).[5]

21. An entity is permitted to apply the specified modifications included in paragraphs 20(b) or 20(c) of this paper only to the extent that an entity does not have reasonable and supportable information to apply a retrospective approach.

22. When an entity applies any of the requirements included in paragraph 20 of this paper, it is required to disclose a reconciliation from the opening to the closing balance of the cumulative amounts included in other comprehensive income for financial assets measured at fair value through other comprehensive income related to these groups of insurance contracts, for all periods in which amounts determined applying these

[4] Except for insurance contracts with direct participation features for which the entity holds the underlying items.

[5] On the basis that the assumptions that relate to financial risk that applied at the date of initial recognition are those that applied on transition date. Applying the discount rate at the transition date for determining insurance finance income or expenses presented in the statement of profit or loss is the same as assuming that accumulated other comprehensive income is nil in respect of the relevant contracts.

requirements exist. The reconciliation includes for example, gains and losses recognised in other comprehensive income in the period and gains or losses previously recognised in other comprehensive income in previous periods reclassified in the period to profit or loss.

Board's rationale

23. When setting the transition requirements discussed in paragraph 20 of this paper the Board decided to provide a simplified approach to determine the cumulative amount of the insurance finance income or expenses recognised in OCI at transition when an entity chooses to disaggregate the insurance finance income or expenses between profit or loss and OCI—by permitting or requiring this amount to be nil.

24. The effect of setting the cumulative amount recognised in OCI at nil compared to a retrospective approach depends on the difference between interest rates when the contracts were written and interest rates at transition:

    (a) if transition interest rates are lower than interest rates when the contracts were written, the cumulative amount recognised in OCI applying the IFRS 17 requirements retrospectively would be a debit balance, resulting in a higher insurance finance expense in reporting periods after transition compared to an approach that set the cumulative amount recognised in OCI at nil; and

    (b) if transition interest rates are higher than interest rates when the contracts were written, the cumulative amount recognised in OCI applying the IFRS 17 requirements retrospectively would be a credit balance, resulting in a lower insurance finance expense in reporting periods after transition compared to an approach that set the cumulative amount recognised in OCI at nil.

25. The Board noted that these effects on the insurance finance expense will combine with the investment income from financial assets held by the entity to give an investment margin. The Board observed that users of financial statements need to understand the effect of transition on the investment margin. Therefore, for contracts that determine a cumulative amount recognised in OCI on transition, the Board decided to require entities to disclose a reconciliation from the opening to the closing

balance of the cumulative amounts included in other comprehensive income for related financial assets measured at fair value through other comprehensive income (FVOCI).

Concerns and implementation challenges expressed since IFRS 17 was issued

26. Some stakeholders raise concerns that the outcome of applying the transition requirements of IFRS 17, as described in paragraph 20 of this paper, would result in determining the accumulated amount of insurance finance income or expenses recognised in OCI as nil, while the amount accumulated in OCI for the related assets would not be nil. They think this effect could significantly distort equity on transition to IFRS 17 and on the investment margin reported in profit or loss in future periods, until the related assets are no longer held. The Board had noted similar concerns when setting these requirements as discussed in paragraphs 24–25 of this paper.

27. Some stakeholders have suggested the Board should amend the requirements of IFRS 17[6] to either:

    (a) permit an entity to deem the accumulated amount of finance income in OCI related to related assets as nil at transition to IFRS 17; or

    (b) permit an entity to deem the accumulated amount of insurance finance income or expenses in OCI for these insurance contracts at the same amount as the accumulated amount of finance income in OCI on the related assets at transition.

28. Given that the assets are not held as underlying items for insurance contracts with direct participation features, and may therefore not be clearly identified with the insurance contracts, some stakeholders suggest that the related assets should be identified consistently with the entity's existing asset liability management policies and practices. If the entity's existing asset liability management policies and practices do not provide an indication of which assets are related to the relevant insurance

[6] Or IFRS 9.

contracts, those stakeholders suggest an entity should allocate a pro-rata part of the general account assets to the relevant insurance contracts.

Staff analysis and recommendation

29. IFRS 17 provides entities with a choice about whether to disaggregate insurance finance income or expenses between profit or loss and OCI. An entity is not required to apply this choice and can make this choice for portfolios of insurance contracts considering for each portfolio of contracts the assets that the entity holds and how it accounts for them. The staff observe that an entity can consider the outcome discussed in paragraphs 24–25 of this paper when making this policy choice.

30. Permitting entities to deem the cumulative amount in OCI related to corresponding assets as nil at transition to IFRS 17, as suggested in paragraph 27(a) of this paper, would involve an amendment to IFRS 9. The staff think this makes the transition requirements in IFRS 9 more complicated, and would significantly reduce the comparability of information related to the financial assets held between (a) insurers applying that amendment and (b) entities other than insurers and insurers that do not apply the amendment.

31. The staff also observe that a component of the cumulative amount recognised in OCI applying IFRS 9 for FVOCI financial assets relates to expected credit losses. Hence it would not be possible to set that component of the cumulative amount at nil because of the effect on the accounting in future periods for expected credit losses.

32. Permitting entities to deem the cumulative amount of insurance finance income or expenses recognised in OCI for insurance contracts at transition at the same amount as the cumulative amount in OCI relating to related assets, as suggested in paragraph 27(b) of this paper, would affect the insurance finance income or expense that will be recognised in future reporting periods. The insurance finance income or expense recognised in profit or loss in future periods would reflect the historical discount rate for the assets held at transition date that the entity determines to be related to the

insurance contracts.[7] The staff think that this suggested approach would reduce the usefulness of information provided on the performance of the insurance contracts because:

(a) that information will be affected by the assets an entity holds so may significantly reduce comparability between entities issuing similar contracts but holding different assets; and

(b) of the potential subjectivity involved in determining which assets relate to which insurance contracts.

33. The staff consider that the disclosure requirements discussed in paragraph 22 of this paper are adequate to provide useful information to users of financial statements on the related assets,[8] and therefore recommend that the Board should not amend IFRS 17 with respect to the cumulative amounts included in other comprehensive income.

Question 2 for Board members
Do you agree that the Board should retain the requirements in IFRS 17 with respect to the cumulative amounts included in other comprehensive income on transition to IFRS 17?

[7] This is because the amount recognised in the OCI cumulatively over the duration of the groups of contracts is required to total zero.
[8] The staff will discuss in a future Board paper whether this disclosure should be extended to cover the insurance finance income or expenses of such contracts.