IFRS

STAFF PAPER

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Project	**Amendments to IFRS 17 *Insurance Contracts***		
Paper topic	Transition requirements—Risk mitigation option		

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Purpose

1. At its February 2019 meeting the International Accounting Standards Board (Board) tentatively decided to retain in IFRS 17 the prohibition of retrospective application of the risk mitigation option.

2. This paper responds to the Board's request that the staff explore alternative proposals that would address stakeholders' concerns about the results of not applying the option retrospectively.

Summary of staff recommendations

3. The staff recommend the Board amend the requirements of IFRS 17 to:

   (a) permit an entity to apply the risk mitigation option prospectively from the IFRS 17 transition date provided that the entity designates its risk mitigation relationships to apply the risk mitigation option no later than the IFRS 17 transition date; and

   (b) permit an entity that can apply IFRS 17 retrospectively to a group of insurance contracts with direct participating features to use the fair value transition approach for the group, if they:

      (i) choose to apply the risk mitigation option to the group prospectively from the transition date; and

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(ii) have used derivatives or reinsurance contracts held to mitigate financial risk arising from the group before the transition date.

Structure of the paper

4. This paper discusses the following topics:

   (a) IFRS 17 requirements and Board's rationale;

   (b) summary of the Board's discussion from its February 2019 meeting; and

   (a) staff analysis, recommendation and questions for Board members.

IFRS 17 requirements and Board's rationale

5. IFRS 17 applies to insurance contracts and IFRS *9 Financial Instruments* applies to an entity's financial assets and derivatives. 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 fair value changes of financial assets and derivatives are recognised in profit or loss or other comprehensive income (OCI).

6. During the development of IFRS 17, the Board noted that entities may purchase derivatives to mitigate financial risks. 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 an entity in specified circumstances to recognise the effect of some changes in financial risk in the

insurance contracts in profit or loss,[1] 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[2] 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. The fulfilment cash flows in a group of contracts to which the risk mitigation is applied is determined in a consistent manner in each reporting period.

10. If any of the conditions required for applying the risk mitigation option cease to exist, an entity prospectively ceases applying the risk mitigation option. Therefore, an entity stops applying the risk mitigation option from the date on which the economic offset does not exist anymore.[3]

11. Paragraph BC393 of the Basis for Conclusions on IFRS 17 explains that the documentation requirement for the risk mitigation option 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

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[1] Or OCI if the entity has made this election.

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

[3] Consistent with the hedge accounting requirements under IFRS 9, the risk mitigation option could be elected when the relationship meets the criteria and needs to be discontinued when they are not met. This could be for example when the derivative expires or is sold, terminated or exercised or economic offset ceases to exist. The staff has been made aware that it may not be clear that an entity ceases applying the risk mitigation option *only* when the conditions required for applying the risk mitigation option cease to exist. The staff plans to consider whether a clarification to the requirements is needed to reflect this.

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 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.

Summary of the Board's discussion from its February 2019 meeting

12. The Board considered stakeholders' concerns that the risk mitigation option can only be used prospectively from the date of initial application of IFRS 17 even though risk mitigation activities may have been in place before that date. Given that the contractual service margin on transition will be allocated to profit or loss in future periods, those stakeholders are concerned that 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 on transition includes the changes in financial risks that would have been excluded had the risk mitigation option been applied retrospectively.

13. The Board also observed stakeholders' concern that applying the risk mitigation option from the date of initial application of IFRS 17, rather than the transition date, could result in an accounting mismatch for the comparative reporting periods, and reduced comparability over time, because for these periods:

    (a) changes in the fair value of the derivatives will be recognised in profit or loss; and

    (b) changes in the fulfilment cash flows for which a risk mitigation activity has taken place, will adjust the contractual service margin.

14. The Board acknowledged that a retrospective application that did not use hindsight would provide useful information to users of financial statements about risk mitigation activities that took place in previous periods. However, the Board observed that it is hard to see how the option could be applied retrospectively without the use of hindsight, and without risking 'cherry picking' opportunities. The Board observed that any approach taken to address stakeholders' concerns that allows retrospective application may have this problem, albeit to different degrees.

15. Therefore, the Board tentatively decided to retain the prohibition in IFRS 17 of retrospective application of the risk mitigation option. The Board asked the staff to explore alternative proposals that would address stakeholders' concerns about the results of not applying the option retrospectively.

Staff analysis, recommendation and questions for Board members

16. The staff considered two possible ways, other than retrospective application of the risk mitigation option, to address stakeholders' concerns:

    (a) permitting entities to apply a prospective application of the risk mitigation option from the IFRS 17 *transition date;*[4] and

    (b) permitting entities that have used derivatives or reinsurance contracts held to mitigate financial risk arising from insurance contracts with direct participating features before the transition date to apply the fair value approach to transition, even if they are able to apply IFRS 17 retrospectively.

Prospective application of the risk mitigation option from transition date

17. The staff have considered whether an approach that is based on a prospective application of the risk mitigation option from the IFRS 17 transition date could address stakeholders' concerns. A prospective approach will permit entities to apply the risk mitigation option provided that an entity designates its risk mitigation

[4] Paragraph C2 of IFRS 17 defines the IFRS 17 transition date as the beginning of the annual reporting period immediately preceding the date of initial application. Paragraph C25 of IFRS 17 states that if an entity presents adjusted comparatives for earlier period the transition date is the beginning of the earliest adjusted comparative period.

relationships to apply the risk mitigation option no later than the IFRS 17 transition date, in addition to the criteria in paragraph B116 of IFRS 17 being met at that date.[5] Given the approach is prospective, it could be applied without the use of hindsight or risking 'cherry picking'.

18. The staff observe that a prospective application of the risk mitigation option from the transition date would eliminate accounting mismatches in the comparative periods presented and will achieve comparability over time because for these periods:

    (a) the change in the fair value of the derivative would be recognised in profit or loss applying IFRS 9, and the effect of changes in financial assumptions on the measurement of a reinsurance contract held would be recognised in profit or loss; [6] and

    (b) the change in the insurance contract, the risk of which was mitigated by the derivative or a reinsurance contract held, would not adjust the contractual service margin applying IFRS 17, but be recognised in profit or loss.[7]

19. The staff think that considering the timeline to transition to IFRS 17, entities could apply the risk mitigation option prospectively from the transition date (1.1.2021 based on the proposed effective date of 1.1.2022) if they choose to do so. Entities that are planning their transition to IFRS 17 have sufficient time to collect the necessary information at the transition date.

20. The staff considered whether prospective application of the risk mitigation option could be permitted from a date earlier than the transition date, for example any date after IFRS 17 was issued. This would require entities to designate (or have designated) its IFRS 17 risk mitigation relationships at the earlier date. The staff also observed that the main benefit of prospective application from the transition date is that it makes the amounts presented in the financial statements in which IFRS 17 is first applied consistent across the current and comparative periods. Prospective application does not address concerns about a mismatch arising from not reflecting

[5] This wording is similar to that used in IFRS 1 *Fist-time Adoption of International Financial Reporting Standards* which allows a prospective approach to new hedge accounting relationships from the transition date.
[6] Assuming an entity does not elect to disaggregate the insurance finance income or expense between profit or loss and OCI.
[7] Assuming an entity does not elect to disaggregate the insurance finance income or expense between profit or loss and OCI.

risk mitigation activities before that date. Accordingly, the staff thinks that prospective application from a date earlier than the transition date:

(a) will not be possible for dates significantly earlier than the transition date; and

(b) will not provide significant incremental benefit beyond prospective application at the transition date.

21. Given the risk mitigation option can be applied whenever the criteria are met, if an entity prefers, it can still start to apply the risk mitigation option prospectively from the date of initial application rather than from the transition date. Therefore, this approach will not disrupt implementation processes already underway.

22. Consequentially, the staff recommend the Board should amend the requirements of IFRS 17 to permit entities to apply the risk mitigation option prospectively from the transition date.

Question 1 for Board members
Do you agree that the Board should amend the requirements of IFRS 17 to permit an entity to apply the risk mitigation option prospectively from the IFRS 17 transition date provided that an entity designates its risk mitigation relationships to apply the risk mitigation option no later than the IFRS 17 transition date?

Permitting entities that are affected by the prohibition of applying the risk mitigation option retrospectively to apply the fair value approach to transition

23. For groups of contracts for which it is impracticable for an entity to apply a full retrospective approach, an entity is permitted to apply the fair value approach to transition. Applying the fair value approach to transition, the contractual service margin[8] is determined as the difference between the fair value of a group of insurance contracts at that date and the fulfilment cash flows measured at that date.

24. When applying the fair value approach to transition, the distortion related to risk mitigating activities from previous periods noted in paragraph 12 of this paper does not exist because:

    (a) the derivative[9] on transition will be measured at its fair value and therefore equity on the transition date reflects previous changes in its fair value; and

    (b) the group of insurance contracts will be measured using current estimates of financial assumptions. Therefore equity on the transition date reflects previous changes in the fulfilment cash flows due to changes in financial assumptions, and the contractual service margin on transition does not reflect those changes.

25. This can be illustrated with the following example:

    (a) on 1.1.2020 (a year before the proposed transition date to IFRS 17), an entity issues an insurance contract that provides a financial guarantee that promises a minimum return of 2% on an investment regardless of the actual performance of that investment. As part of its risk management activities the entity purchases on the same day a derivative to mitigate the financial risk that the return on the investments the entity holds will be lower than the amounts promised to be paid. The derivative is a swap contract for which the entity pays market rates and receives 2% for the next five years on a specified notional amount.

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[8] Or loss component of the liability for remaining coverage.

[9] In January 2019, the Board tentatively decided to amend IFRS 17 to expand the scope of the risk mitigation option so that the option applies when an entity uses a derivative or a reinsurance contract held to mitigate financial risk. Because reinsurance contracts held are not eligible to apply the variable fee approach, the changes related to financial risks are recognised in profit or loss (or in OCI – if an entity makes this election), similar to derivatives.

(b) during 2020, the market interest rates decrease and as a result the fair value of the derivative increases (asset position) and the fulfilment cash flows of the insurance contract increases.

(c) at 1.1.2021, the proposed transition date to IFRS 17, the entity applies a fully retrospective approach to measure its insurance contract without retrospectively applying the risk mitigation option. Therefore, its equity on transition reflects:

 (i) the changes in the fair value of the derivative during 2020; but

 (ii) the changes in the fulfilment cash flows of the insurance contract caused by the risk mitigated by the swap contract only to the extent the adjusted contractual service margin is recognised in profit or loss.

(d) if the entity could have applied the risk mitigation option retrospectively, the change in the fulfilment cash flows caused by the risk mitigated by the swap contract, would have also been recognised in equity on transition.

(e) If the entity were eligible to apply the fair value approach to transition, the contractual service margin on transition would have been determined considering the amount the entity would pay at the transition date to exit the insurance contract, which values the financial guarantee based on market interest rates on the transition date. Therefore, the contractual service margin on the transition date would not reflect any previous changes in the financial risk of the contract but only the financial risk at the transition date. The increase in the fulfilment cash flows related to the reduction in market interest rates in year 2020 would effectively be absorbed in equity.

26. The fair value transition approach therefore could address stakeholders concerns in a way that does not involve the use of hindsight or risk ‘cherry picking’. However, IFRS 17 restricts its use to circumstances in which it is impracticable to apply a fully retrospective approach.

27. The staff observe that the Board could address some stakeholders concerns by permitting an entity to use the fair value transition approach in circumstances where it is affected by the prohibition from applying the risk mitigation option retrospectively.

The staff considered how to identify when an entity should be able to use that option, for example:

(a) should it be able to use it only if it had documentation as specified in paragraph B116 of IFRS 17 for past periods; or

(b) should it be able to use it only when it intends to use the risk mitigation option applying IFRS 17 in periods after transition?

28. The staff observes that entities are coming from different practices and different levels of documentation, and it would not be appropriate to deny the option to those without the documentation IFRS 17 prescribes for future periods.

29. The staff think that permitting entities to apply the fair value transition approach in circumstances where an entity can apply a full retrospective approach should be limited to ensure the benefits of information provided by an approach that better reflects the entity's financial risk mitigation activities outweigh the loss of retrospective information about the contracts. The staff also think that, in the absence of full historical documentation about the entity's risk-management objective and strategy, the option to apply the fair value transition approach should be limited in a way that avoids cherry picking opportunities related to identifying for which groups of contracts an entity has applied a risk-mitigation activity before the transition date.

30. The staff therefore recommend permitting entities to apply the fair value transition approach to a group of insurance contracts with direct participating features, even if they are able to apply IFRS 17 retrospectively to that group, if:

(a) they choose to apply the risk mitigation option to the group prospectively from the transition date; and

(b) have used derivatives or reinsurance contracts held to mitigate financial risk arising from the group before the transition date.

31. The staff observe that introducing additional optionality may decrease comparability between entities on transition. However the staff think this is an acceptable compromise given the information provided applying the fair value transition approach provides useful information to the users of financial statements.

32. Hence, the staff recommend that the Board should amend IFRS 17 as explained in paragraphs 27–30 of this paper.

Question 2 for Board members
Do you agree that the Board should amend the requirements of IFRS 17 to permit an entity that can apply IFRS 17 retrospectively to a group of insurance contracts with direct participation features to use the fair value transition approach for the group if they: (a) choose to apply the risk mitigation option to the group prospectively from the transition date; and, (b) have used derivatives or reinsurance contracts held to mitigate financial risk arising from the group before the transition date.