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STAFF PAPER

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Project	**Amendments to IFRS 17**		
Paper topic	Applicability of the risk mitigation option—non-derivative financial instruments at fair value through profit or loss		
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Purpose of the paper

1. This paper discusses staff analysis and recommendations about the feedback in response to the Exposure Draft *Amendments to IFRS 17* that suggested the International Accounting Standards Board (Board) extend the applicability of the risk mitigation option to circumstances in which an entity uses non-derivative financial instruments measured at fair value through profit or loss to mitigate financial risk arising from insurance contracts with direct participation features. This paper follows the tentative decision of the 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 amend IFRS 17 *Insurance Contracts* to extend the risk mitigation option for insurance contracts with direct participation features in paragraph B115 of IFRS 17. The extension would permit an entity to apply the option when the entity mitigates the effect of financial risk on the fulfilment cash flows set out in paragraph B113(b) of IFRS 17 using non-derivative financial instruments measured at fair value through profit or loss. An entity would apply the option if, and only if, the conditions in paragraph B116 of IFRS 17 are met.

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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.

Background

4. The risk mitigation option in IFRS 17 permits an entity to 'switch off' the variable fee approach to the extent that financial risk is mitigated. Applying the option, an entity recognises 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 would otherwise adjust the contractual service margin of those contracts.

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.

   (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.

[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.

6. When developing the Exposure Draft, the Board considered a suggestion from stakeholders that the risk mitigation option should also apply when an entity uses financial instruments other than derivatives, for example, bonds, to mitigate financial risk. The Board disagreed with this suggestion because the risk mitigation option was designed to address a specific accounting mismatch between insurance contracts with direct participation features and derivatives.

7. However, the Board proposed extending the risk mitigation option to apply when an entity uses reinsurance contracts held to mitigate financial risk. The Board proposed that extension to address stakeholder concerns about an accounting mismatch when insurance contracts issued are in the scope of the variable fee approach and are covered by a reinsurance contract held (in the scope of the general model). The Board acknowledged that the concern expressed by stakeholders for reinsurance contracts held is similar to the concern previously raised in relation to derivatives. The Board tentatively decided to finalise that amendment at its December 2019 meeting.

Feedback

The Board's rationale for not extending the risk mitigation option to non-derivative financial instruments

8. Consistent with feedback during the development of the Exposure Draft, some respondents suggested the Board amend IFRS 17 to permit an entity to also apply the risk mitigation option when the entity uses financial instruments measured at fair value through profit or loss other than derivatives (for example, bonds) to mitigate financial risk arising from insurance contracts with direct participation features. Those respondents expressed the view that this would further reduce accounting mismatches.

9. Respondents generally expressed the view that the Board has not adequately explained the reasons for precluding an entity from using the risk mitigation option when the entity uses non-derivative financial instruments measured at fair value through profit or loss to mitigate financial risk arising from insurance contracts with direct participation features.

10. A small number of respondents noted that IFRS 9 *Financial Instruments* permits non-derivative financial assets and some non-derivative financial liabilities measured at fair value through profit or loss to be designated as hedging instruments.

The use of non-derivative financial instruments to mitigate financial risks arising on insurance contracts with direct participation features

11. Some respondents explained that:

    (a) entities often use a combination of derivatives and non-derivative financial instruments, for example, fixed income securities, to mitigate financial risk on insurance contracts with direct participation features.

    (b) an entity may mitigate some financial risk using either derivatives or non-derivative financial instruments. Those respondents explained that often using non-derivative financial instruments can be less costly than using derivatives.

    (c) an entity may mitigate some financial risk using non-derivative financial instruments when the availability of derivatives is limited.

12. Those respondents expressed the view that the same accounting mismatch arises when an entity mitigates financial risk on insurance contracts with direct participation features using:

    (a) derivatives; or

    (b) non-derivative financial instruments at fair value through profit or loss.

Staff analysis and recommendations

13. The staff note that the feedback set out in paragraphs 8–12 of this paper is similar to the feedback the Board received on the 2010 Exposure Draft *Hedge Accounting* relating to the designation of non-derivative financial instruments as hedging instruments applying IFRS 9. In the light of that feedback, the Board amended IFRS 9 to permit non-derivative financial assets and some non-derivative financial liabilities measured at fair value through profit or loss to be designated as hedging instruments.

14. The staff acknowledge that the amendment to IFRS 9 is a relevant comparison. Therefore, the analysis in this paper considers whether the Board should extend the risk mitigation option to apply when an entity uses non-derivative financial instruments to mitigate financial risks arising from insurance contracts with direct participation features and the conditions in paragraph B116 of IFRS 17 are met.

15. As discussed in paragraph 4 of this paper, the risk mitigation option 'switches off' the additional adjustments to the contractual service margin that are made in the variable fee approach. Those additional adjustments are for the effect of:

    (a) changes in the fulfilment cash flows that are changes in the effect of the time value of money and financial risks not arising from underlying items, for example the effect of financial guarantees (paragraph B113(b) of IFRS 17); or

    (b) changes in the amount of the entity's share of fair value of the underlying items (paragraph B112 of IFRS 17).

    The analysis in this paper considers each of (a) and (b) in turn.

Fulfilment cash flows (paragraph B113(b) of IFRS 17)

16. The fulfilment cash flows of an insurance contract with direct participation features will include both cash flows that do and cash flows that do not vary based on the returns on underlying items. Some respondents explained that an entity may mitigate the effect on the fulfilment cash flows of some financial risk not arising from underlying items using non-derivative financial instruments.

17. The staff are persuaded that circumstances may exist in which an entity uses non-derivative financial instruments to mitigate the effect of financial risk on the fulfilment cash flows. If so, and those non-derivative financial instruments are measured at fair value through profit or loss, an accounting mismatch could arise that would be similar to the accounting mismatch that can arise between derivatives and insurance contracts with direct participation features (for which the Board introduced the risk mitigation option).

The amount of the entity's share of the fair value of the underlying items (paragraph B112 of IFRS 17)

18. Paragraph B101 of IFRS 17 requires that for insurance contracts with direct participation features the contractual terms specify that the policyholder participates in a share of a clearly identified pool of underlying items. An entity is not required to hold the underlying items for the contract to meet the conditions for the scope of the variable fee approach.

19. Paragraph BC239 of the Basis for Conclusions on IFRS 17 explains that the Board views insurance contracts with direct participation features as creating an obligation to pay policyholders an amount equal in value to the specified underlying items, minus a variable fee for service. That fee is an amount equal to the entity's share of the fair value of the underlying items minus any expected cash flows that do not vary directly with the underlying items.

20. The staff acknowledge that if an entity does not hold the underlying items, the amount the entity actually earns could differ from the contractual variable fee. For example, the entity could choose to earn a fixed amount, rather than a variable fee, by investing some or all of the premium in fixed rate non-derivative financial instruments instead of investing in the underlying items. In some circumstances, this may achieve for the entity a similar overall return as would be achieved if the entity invested 100% of the premium in the underlying items and purchased a derivative to mitigate the effect of financial risk on the amount of the entity's share of the fair value of the underlying items.

21. However, the staff think that permitting an entity to apply the risk mitigation option in the example described in paragraph 20 of this paper would contradict the principle that the variable fee approach applies regardless of whether the entity holds the underlying items.

Staff recommendation

22. Considering the analysis in paragraphs 13–21 of this paper, the staff recommend the Board amend IFRS 17 to extend the risk mitigation option for insurance contracts with direct participation features in paragraph B115 of IFRS 17. The extension would permit an entity to apply the option when the entity mitigates the effect of financial risk on the fulfilment cash flows set out in paragraph B113(b) of IFRS 17 using non-derivative financial instruments measured at fair value through profit or loss. An entity would apply the option if, and only if, the conditions in paragraph B116 of IFRS 17 are met.

Question for Board members
Do you agree the Board should amend IFRS 17 to extend the risk mitigation option for insurance contracts with direct participation features in paragraph B115 of IFRS 17? The extension would permit an entity to apply the option when the entity mitigates the effect of financial risk on the fulfilment cash flows set out in paragraph B113(b) of IFRS 17 using non-derivative financial instruments measured at fair value through profit or loss. An entity would apply the option if, and only if, the conditions in paragraph B116 of IFRS 17 are met.