

This paper has been prepared by the EFRAG Secretariat for discussion at a public meeting of EFRAG TEG. The paper forms part of an early stage of the development of a potential EFRAG position. Consequently, the paper does not represent the official views of EFRAG or any individual member of the EFRAG Board or EFRAG TEG. The paper is made available to enable the public to follow the discussions in the meeting. Tentative decisions are made in public and reported in the EFRAG Update. EFRAG positions, as approved by the EFRAG Board, are published as comment letters, discussion or position papers, or in any other form considered appropriate in the circumstances.

Summary of discussion held at IAWG November 2019 on hedge accounting Issues Paper

Objective

- 1 The objective of this session is to provide an overview of the discussion held at EFRAG IAWG in November 2019 on hedge accounting.

Introduction

- 2 The basis for the work of the EFRAG Secretariat is formed by EFRAG's final comment letter on the IFRS 17 Amendments as approved by the EFRAG Board. I.e. topics that have been addressed during the due process of the final comment letter and which were not included in the letter as concerns are not re-opened.
- 3 Hedge accounting was not assessed so far. For the issue relating to equities as long-term investments the EFRAG Secretariat relies on work done in this separate project.

Overview of the discussion

General introduction

- 4 Currently, due to shadow accounting economic mismatches are not necessarily visible. Derivatives are mainly used with a solvency purpose and many insurers do not apply hedge accounting in accordance with IFRS 9 today. As such the insurance industry is not familiar with the IFRS 9 hedge accounting and many have to start their experience as from now.
- 5 The lack of a dynamic risk management solution currently does not mean there no tools available to insurers. These are the OCI-election, the risk mitigation option, the fair value option in IFRS 9. Given the existence of these tools now and the possibility to combine them, the chances of unrepresentative income volatility is considered to be low.
- 6 There are several possibilities available with regard to hedge accounting (some which are discussed in more detail below).
 - (a) Portfolio (macro) fair value hedge accounting;
 - (b) Cash flow hedge accounting;
 - (c) Fair value hedge accounting; and
 - (d) Net-investment hedge accounting.
- 7 Applying hedge accounting requires fulfilment of some conditions:
 - (a) Determination and measurement of hedge effectiveness;

- (b) Identification of an eligible hedged item: there is an emerging consensus that insurance liabilities are a financial liability (and thus an eligible hedged item);
- (c) There is a need for risk management strategy and policy;
- (d) There is a need to develop hedge documentation;
- (e) Hedge accounting is done prospectively;
- (f) Identification of an eligible hedging instrument (mostly derivatives but not exclusively).

Cash flow hedge accounting

- 8 Cash flow hedge accounting is already applied by some insurers today. A challenge in applying this model is that future cash flows need to be highly probable.

Fair value hedge accounting

- 9 Under this model the fair value of the hedged item is being hedged. Subsets of this model are the portfolio fair value hedge and hedging the risk components.
- 10 As insurance liabilities are measured at fulfilment value, not fair value, the designation of insurance liabilities for hedging purposes is not deemed appropriate in order to achieve an effective offset with derivatives at fair value. In applying hedge accounting the debits or credits are not clear: it is uncertain how to process the updates of changes to cash flows to the fulfilment value.

Portfolio fair value hedge and carve-out

- 11 The risk strategies employed by insurers are dynamic in nature, hence the need for applying macro hedges. These strategies also relate to the hedging of groups of contracts not just individual financial instruments. It is noted that the fair value portfolio hedge model in IAS 39 can be used even when applying IFRS 9 for hedge accounting purposes. Some auditors are of the view that this model is the most likely one to be used by insurers.
- 12 For macro hedging the preparer need to schedule the expected cash flows in time buckets (monthly, quarterly, or large time buckets further in the future) as well as the derivatives used to hedge and see how the movements in fair value offset each other per bucket by tracking these. When dynamically updating the hedge, the time buckets need to be updated and the tracking of movements in each bucket is to be followed. Some insurers may say that this is not how they manage their business, but the same is true for banks and they use this method to apply the portfolio fair value hedge accounting for their interest rate risk management.
- 13 The model is not as generous as risk mitigation under IFRS 17 and requires tracking of the underlying positions and could result in some ineffectiveness if the hedges are not perfectly matched. The ineffectiveness would depend on how often one adapts the hedge as this avoids hedges become ineffective and no longer qualifying for hedge accounting (as IAS 39 still require hedges to be between 80% and 125% effective).
- 14 Applying the carve-out could be an alternative as it is operational easier but also the carve out requires a lot of work. The use of proxy hedges seems to be inevitable, just as it is for banks.

Risk components

- 15 For hedge accounting purposes, risk components need to be separately identifiable and reliably measurable in order to qualify for hedge accounting. This raises a conceptual hurdle as there is no secondary market structure where these can be observed (for some auditors this does not require the existence of a liquid market in insurance liabilities, which is only one way how to demonstrate the market

structure). It is noted that the identification of interest rate risk in an actuarial valuation is not sufficient for hedge accounting purposes.

- 16 Some auditors noted that insurance liabilities may not be dissimilar to fixed rate debt instruments. In particular the requirement that the instrument is issued in an environment with a market in which a large variety of similar debt instruments are compared by their spreads to a benchmark rate could be seen as the year one entry, the amount what is charged to the customer. This is considered a market transaction which can be considered for hedge accounting purposes. This is true even it is considered an entry price (which have been accepted for unlisted bonds by some auditors previously). Other auditors note that the price is not determined by interest rate risk only but could also be impacted by product demand of clients.
- 17 The second condition is that interest rate swaps are frequently used to manage interest rate risk on the basis of that benchmark rate. Also, the price of the fixed-rate debt instruments varies directly in response to changes in the benchmark rate as they happen. Whether these conditions can be fulfilled for risk components in insurance liabilities is an ongoing discussion.
- 18 However, audit firms did not have unanimous views on whether financial risk components in insurance liabilities can qualify for hedge accounting purposes; it also depends on the contractual features of the insurance liabilities, as not all of them are the same. Some auditors have not seen situations where the financial risk was separately identifiable.
- 19 In case risk components are being hedged, it is not clear whether the fair value adjustment of the hedged item needs to be adjusted through CSM or through the risk adjustment as insurance liabilities are not carried at either fair value or amortised cost but rather fulfilment value there may be some overlap.
- 20 For insurance risk components (such as mortality risk), hedge accounting is in principle possible but complex. Some longevity swaps are part of the insurance contracts and thus fall under IFRS 17. In addition, it was noted mortality risk is estimated to be fairly stable so not necessary to apply hedge accounting to.
- 21 Applying reinsurance could be an option but also here specific challenges arise. Reinsurance is expected to be taken based on the economics not on the result one expects in profit or loss. Some insurers noted that they have not considered yet all the complexities that arise in this field.
- 22 Weather derivatives were considered a better example (but insurers are mostly not applying hedge accounting to these). Here the challenges arise that changes on the underlying go to P&L financial result while the non-financial assumptions of the liability move to CSM where this relates to future service.

Lapse risk

- 23 The existence of lapses is seen by some auditors as a similar challenge as prepayments in bank loans however more complex in its application, as there are more components than only a benchmark rate and the credit risk spread.
- 24 For prepayments in a fixed rate mortgage, a change in market interest rates affects not only the measurement of the mortgage but also the prepayment option. So either the full fair value of the loan is included or the portfolio fair value approach is used where one can estimate the value of the prepayment option. In order to isolate lapses from interest rate risk it is thought that some lapses are independent from interest rate risk, others are not. All lapses (irrespective whether they depend on interest rates or not) affect the cash flows, causing a hurdle on how to adapt the hedge for something that is no longer there. While it may be challenging to separate the two, some banks consider all their prepayments (whichever the nature) in the

portfolio fair value approach. Thanks to the dynamic nature of the hedge and the frequent changes this can be dealt with.

- 25 Some auditors noted an additional challenge in separating the lapse risk and modelling it, i.e. the fact that one cannot “look” at the price charged to the customer (the price charged to the customer depends on offer/demand and not on the interest rate risk).
- 26 It was also noted that next to prepayments there is also surrender risk which could be intertwined.

Financial guarantees

- 27 Some insurers hedge their guarantees which can be unbundled under IFRS 4, but this is no longer permitted under IFRS 17 (guarantees are not distinct). Hence under IFRS 17 the guarantee would be included in the measurement of the liability when being hedged. Hedging of these guarantees forms a subset of hedging of risk components and those requirements are relevant also here.
- 28 For VFA contracts insurers will use the risk mitigation option and will not use hedge accounting for these contracts. Also, the derivatives are in some cases part of the underlying items; hence the fair value changes of these derivatives get smoothed through CSM.

Assets held under the held to collect business model in IFRS 9

- 29 Some insurers hold assets that back their liabilities under the held to collect business model in IFRS 9. This depends on the ALM of the entity, the granularity of its application, and how the mandates for ALM have been set. There is no general conclusion that IFRS 17 will force insurers to fair value all their assets.

Interim conclusion

- 30 Currently only very few insurers apply hedge accounting, as a result there is no market practice on the application of hedge accounting today. Practice will have to emerge and auditors will have to form a consensus on what is possible considering the conceptual and practical hurdles as well as the operational complexity. Notwithstanding the challenges to overcome in applying hedge accounting, the situation is expected to improve compared to today as currently as hedging now is not visible in the financial accounts.
- 31 Candidate for a relevant role is the portfolio-hedge fair value hedge of interest rate risk components, i.e. the approach adopted today by the banks. The carved-out version of IAS 39 would help further on the operational side.
- 32 It is noted that EFRAG’s final comment letter to the IFRS 17 Amendments does not include the application of the risk mitigation option to insurance contracts accounted for under the general model. EFRAG position on this topic is to consider that such a solution should form part of a broader project and should not delay the introduction of IFRS 17. Although the situation is not ideal, some insurers noted the need to set priorities and hedge accounting was not identified as such. While IFRS 17 is not perfect there is a need to progress with what is on the table today.

Questions for EFRAG TEG

- 33 Does EFRAG TEG have questions on the overview provided?

Appendix 1: Summary of answers received to the hedge accounting questionnaire

Current economic hedging strategies

- 1 The main risk management strategies currently used by respondents include interest rate, foreign exchange, inflation and solvency risks.
- 2 For interest rate risk the main exposures include guarantees and options embedded in insurance liabilities, investments as well as issued debt; these exposures are managed by a variety of instruments.
- 3 Investments, insurance liabilities, issued debt and foreign operations are the main contributors to foreign exchange risk, which is mainly managed by foreign exchange forwards and cross currency swaps.
- 4 Inflation risk exposures arise in a variety of instruments and the management tool of choice is inflation swaps along with a variety of other instruments.
- 5 Other risks covered include credit, equity and insurance risks as well as 'all-in-one hedges' i.e. strategies to minimise total changes in cash flows.

Accounting for current economic hedging strategies

- 6 Currently six of the 11 respondents apply IAS 39 hedge accounting to some of the strategies mentioned above. One of these respondents has been continuing to apply IAS 39 hedge accounting requirements under IFRS 9 as allowed. Furthermore, one respondent indicated that it applies the carve-out in respect of hedge accounting to its insurance activities. None of the respondents use the overlay approach.
- 7 Three respondents indicated that they apply both fair value and cash flow hedging to interest rate exposures in investments. A further three apply both cash flow hedging to foreign exchange exposures in issued debt and investments and net investment hedging to hedge foreign operations. One respondent applies fair value hedging to equity risk and cash flows hedging to inflation risk.
- 8 Respondents do not apply hedge accounting to the remainder of their economic strategies described above and indicated that in many cases the derivative is recognised at fair value through profit or loss, whilst the exposure is treated in accordance with the relevant standard. One respondent described applying shadow accounting as allowed by IFRS 4 whilst another described strategies that allow for natural offsetting of amounts in profit or loss.

Future economic hedging strategies

- 9 Most respondents noted their hedging strategies would not change or expected to continue many of these strategies. Some respondents expected the number of hedges to increase, for example in the case of VFA contracts.
- 10 A respondent noted that hedging strategies would be different in response to the increased P&L and equity (OCI) volatility that is expected from the implementation of IFRS 17.

Application of IFRS 9 (including continued use of IAS 39 hedge accounting)

Introduction

- 11 Respondents were divided whether they would apply IFRS 9 or IAS 39 for hedge accounting purposes. Consequently, respondents applied both IFRS 9 and IAS 39 to their respective hedging strategies.
- 12 Few respondents identified strategies for which they concluded it was not possible to apply IFRS 9 hedge accounting. Examples of such strategies were duration matching, hedging of options and guarantees (it was not specified whether these

related to interest rate risk only or also covered other risks), credit risk hedging, hedging insurance risks such as mortality or surrender risk.

- 13 Reasons why hedge accounting was not possible were various:
- (a) high operational effort;
 - (b) inability to identify certain components in the invested assets;
 - (c) impossibility to separate an option from the host contract;
 - (d) the use of macro hedging techniques including the use of open portfolios and the dynamic nature of the economic hedges.

How risks are identified

- 14 One respondent provided detailed information about the level of aggregation of the risk, how the volume of risk was determined and the identification of the contract boundary. Depending on the strategy used they relied on cohorts, product line or by legal entity to aggregate the volume of risks. Also depending on the strategy, the identification boundary was contractual only or renewals were added and in some cases renewals and future sales were added.
- 15 Others provided generic information whereby hedged risk components were mostly identified at group or entity level.
- 16 Of the respondents that answered the question, a majority hedged a net amount of risk, a minority hedged a gross amount of risk. One respondent differentiated their hedging on a net or gross basis depending on the underlying risk component.

Dealing with risk components

- 17 Respondents were equally divided whether it was possible to identify separately and measure reliably risk components in accordance with IAS 39 (for those that currently apply IAS 39)/IFRS 9 (for those that think about applying IFRS 9). Reasons named for not being able to separately identify and measure reliably risk components were:
- (a) Insurance risk components are highly intertwined with financial market variables;
 - (b) Technical risks cannot be identified in the underlying investments;
 - (c) It is challenging to find a suitable market structure as it needs to be determined beyond an observable market (no further clarification was provided);
 - (d) The pricing of some insurance contracts includes a fee covering the occurrence of particular risks, while the pricing of other insurance contracts do not include such a fee. When considering all these contracts together it is unclear how the risk component can be identified.
 - (e) Hedging is done on an open portfolio basis and done dynamically.
- 18 The insurer may have relatively robust assumptions for policyholder behaviours in “central” economic scenarios and understand the impact of financial risks changing, with no knock-on impact on policyholder behaviours but what’s difficult to understand is the correlation between changes in financial variables and policyholder behaviours. i.e. if equity markets fell substantially:
- (a) Policyholders with maturity guarantees may be more likely to hold on to their contracts as guarantees are now more valuable to them – increasing the cost to the insurer.
 - (b) Or if the equity market fall was due to wider economic dislocation, because of reduced financial circumstances they may be more likely to lapse / make paid-up their contract – reducing the cost to the insurer.

Using the possibilities offered by IAS 39 and IFRS 9

- 19 The large majority of the respondents answering the questions did not intend to apply (this answer was unrelated to the first-time application of IFRS 17):
- (a) the portfolio fair value hedge accounting under IAS 39 (this respondent is not the same as the one using the carve out);
 - (b) hedging layers of a group under IFRS 9;
 - (c) rebalancing of a hedge relationship under IFRS 9;
 - (d) hedging aggregated exposures under IFRS 9;
 - (e) hedging net positions under IFRS 9; or
 - (f) designating a credit exposure as measured at FVPL under IFRS 9.
- 20 Very few respondents provided technical answers explaining the challenges in applying these requirements. Those that did provided the following reasons:
- (a) The requirements of IAS 39/IFRS 9 limit designation of hedged items in a number of strategies such as duration matching, hedging of options and guarantees (it was not specified whether this referred to interest rate risk alone or whether other risks were included) and credit risk hedging.
 - (b) The possibilities are not in line with current risk management and/or the underlying economics;
 - (c) The challenges in identifying and measuring risk components (see paragraph 17 above);
 - (d) The operational complexity of applying hedge accounting and hence the preference to apply risk mitigation under IFRS 17. Respondents did not provide information on whether they saw these solutions as conceptually equal.

Current monitoring of strategies

- 21 Almost all respondents indicated that the aim of each of the hedging strategies that according to their conclusions do not qualify for hedge accounting under IFRS 9 is to mitigate solely risks inherent in the balance sheet (although some strategies indicated optimisation of the performance). Only one respondent noted that their aim is also to optimise returns.
- 22 When asked how effectiveness is being measured for hedging strategies where hedge accounting is not applied, respondents indicated the following:

Summary of discussion held at IAWG November 2019 on hedge accounting - Issues Paper

- (a) Effectiveness is measured by the respective decision body and do not need to follow the rules for hedge effectiveness as laid down in IAS 39 or IFRS 9. However, they need to describe that the intended economic goal of the strategy is achieved.
 - (b) Performance and adequacy of the hedge are tested on a monthly basis through the delta profiles per time-bucket and the thresholds for these tests used are defined within the regulatory framework.
 - (c) Through asset-liability management where the objective is to define the optimal asset allocation so that all liabilities can be met with the highest degree of confidence while maximizing the expected investment return.
 - (d) Monitor solvency position and explain movements due to interest, inflation and foreign currency or measuring success by the ability to maintain a solvency ratio in accordance with our risk limits.
 - (e) Success is being measured based on the fact of obtaining an economic coverage that allows to secure the obligations with the insured.
- 23 When asked what role does IFRS book value of equity or equity referred for solvency purposes play in hedging strategies, some respondents considered the Solvency II ratio as the main element within the hedging strategy with the aim that solvency equity remains at a constant value. One respondent noted that they do not see a possible impact of hedge accounting on IFRS book value of equity nor on capital required by Solvency. However other respondents made the following remarks:
- (a) One respondent explains that one of their hedging strategy aims at maintaining a US Statutory Risk Based Capital (RBC) ratio above a risk limit threshold.
 - (b) A respondent noted that they consider impacts of IFRS 9 and IFRS 17 on their IFRS book value of equity and equity required for solvency purposes in determining their hedge targets.
 - (c) Another respondent is making use of hedges are to reduce the IFRS profit or loss volatility and solvency capital requirements.
- 24 Most respondents indicated that thresholds or limits are being set for the quantity of risk the entity is willing to accept.

Possible residual mismatches

- 25 Respondents noted the following will give rise to accounting mismatches with the application of IFRS 9 and IFRS 17 for which they conclude that hedge accounting cannot be applied to further mitigate the mismatches:
- (a) Using fair value through other comprehensive income (FVOCI) and amortised costs (AC) on the asset side following the IFRS 9 requirements, while measuring FVOCI for the insurance liabilities¹ would reduce volatility but would also result in an accounting mismatch.
 - (b) The inability to use the risk mitigation option outside the variable fee approach.
 - (c) For hedging strategies that include non-derivative instruments, the effect of the change in the insurance liability adjusts the CSM, while the corresponding movement in the hedging instrument is recorded in the income statement or other comprehensive income (OCI).
 - (d) Accounting mismatches are generally possible depending on the SPPI result of bonds in the portfolio.
- 26 Respondents acknowledged the fact that the fair value option of IFRS 9 could take away part of the accounting mismatches and noted that short-term volatility will be evident. One respondent also noted that the application of the fair value option reduces differences between solvency and IFRS balance sheets and accordingly profit or loss impacts. Another respondent raised a concern that the fair value option cannot be utilised if there is a time gap between the date of initial recognition of the hedged item and the trade date of the hedging instrument.
- 27 The accounting mismatch which arises due to changes e.g. spread changes on the asset side not reflected in the liability side when assets are measured at FVOCI or amortised costs and the use of FVOCI for liabilities measured were also raised as a concern (similar to the comment made in paragraph 25(a) above). One respondent noted that IFRS 17 reduces volatility for products accounted for under the VFA model but increase it for products accounted for under the general model. The inability to apply the risk mitigation option in circumstances where non-derivatives are being used as a hedging instrument was also echoed as a cause for an accounting mismatch.
- 28 When asked how performance of hedging strategies would be best reflected in the financial statements, respondents remarked the following:
- (a) The introduction of some form of risk mitigation for insurance contract that are measured according to the general model.
 - (b) There should be profit or loss offset between the hedging instrument and the hedged portion of the risk in the IFRS 17 insurance contract liability.
 - (c) When applying the OCI option under the general measurement model, to include the effects of financial risks in profit or loss when such risks are risk-mitigated by both derivatives and non-derivatives.
 - (d) The risk mitigation option in IFRS 17 should be extended further to financial instruments other than derivatives and reinsurance contracts.
 - (e) Mismatches are recognised in profit or loss and explained by management as appropriate.

¹ The disaggregation in OCI of the financial income and expense deriving from the adjustment to current value parameters of the insurance liabilities. No specification was made to the general model or the variable fee approach.

- (f) One respondent noted it would be best to establish a transitional procedure that eliminates the impact on results of current hedging strategies that do not have an accounting reflection and seeking a greater interrelation between IFRS 9 and IFRS 17 accounting standards.

Economic mismatches²

- 29 With the exception of one respondent, none of the respondents identified the existence of economic mismatches in their balance sheet. One respondent indicated the existence of accounting mismatches instead.

IFRS 9 and risk mitigation under IFRS 17

- 30 There were mixed views regarding whether there were hedged items under IFRS 17 where entities wanted to apply risk mitigation because they cannot apply the IFRS 9 hedge accounting requirements.
- 31 The reasons mentioned by respondents who wanted to apply risk mitigation (because they cannot apply IFRS 9 hedge accounting) were:
- (a) the need to appropriately offset results in P&L;
 - (b) ability to mitigate financial risk in insurance contracts using derivatives as IAS 39 cannot be applied
- 32 The reason mentioned by respondents who did not want to apply risk mitigation (because they cannot apply IFRS 9 hedge accounting) were that the risk mitigation option should be available to all contracts and not only VFA

Retrospective application

- 33 Reasons why retrospective application of the IFRS 17 risk mitigation requirements were preferred by the respondents included the following:
- (a) The transition CSM would be affected and would distort future results. The economics of existing hedging arrangements cannot be accurately reflected; and
 - (b) If there is no retrospective application, the accounting mismatch introduced by IFRS 17 would not be eliminated.
- 34 Only two respondents indicated that they currently address the risk mitigation mismatch by (i) unbundling the embedded derivatives from options and guarantees and measuring them at FVPL; and (ii) IFRS 4 has various risk mitigation methods e.g. hedge accounting, FVPL and shadow accounting.
- 35 Four respondents provided suggestions to apply the risk mitigation option retrospectively to the extent that an entity has reasonable and supportable historical information and documentation (some mentioned as per IFRS 17.B116) to prevent hindsight.

² The question asked was the following: Applying IFRS 17 and IFRS 9 together, are there economic mismatches that you are able to hedge account for under IAS 39/IFRS 4, but not under IFRS 9? Please explain.