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Hedge accounting in the context of IFRS 17 – lessons learnt Issues Paper

Objective

- 1 This paper summarises the outcome of a joint technical discussion held in February/March 2020 between the EFRAG Secretariat and the experts of the audit firms on the application of hedge accounting to insurance liabilities, based on the discussion of selected fact patterns provided by some European insurers.

General messages

- 2 The discussion has considered the application of IFRS 9 and IFRS 17 together, including hedge accounting, to some hedging strategies currently in use. All the submitted strategies addressed financial risk; none of them addressed the management of insurance/non-financial risk.
- 3 In general, hedge accounting is not precluded, provided that all the relevant conditions in IFRS 9 are met for the specific facts and circumstances of each particular case. There will be instances where some hurdles need to be overcome, before it could be stated that hedge accounting should be possible. In some cases, application practices may need to be defined that have not been explored so far. This may require breaking down the strategies in their different parts and further preparatory work from the preparers, to be agreed with auditors. The following paragraphs document some of the lessons that can be taken from the discussions between preparers and auditors on the topic.
- 4 Hedge accounting in IFRS 9 and IAS 39 requires that the strategy meets a number of criteria (including eligibility, designation, hedge effectiveness, measurement and documentation). All of the relevant conditions are a prerequisite for hedge accounting.
- 5 The key area of assessment relates to the designation of insurance liabilities as hedged item with respect to interest rate risk. For such a hedge to qualify for hedge accounting the insurer needs to demonstrate that the hedged interest rate risk component is separately identifiable and reliably measurable component (“SIRM”). This is important as hedging a component rather than the full insurance liability would improve the reported effectiveness of the hedging strategy, including whether one can prove economic off-set as required.
- 6 The following different accounting approaches were considered:
 - (a) Hedge accounting for risk component(s) – a subset of (b) and (c) below;
 - (b) Hedge accounting for assets;
 - (c) Hedge accounting for liabilities (specifically portfolio fair value hedging); and

- (d) In some cases, measurement of certain portfolios of assets at fair value and/or for liabilities presenting insurance finance income and expense in profit or loss.

Duration mismatches

- 7 The key risk that insurers economically manage is the duration mismatch between assets and liabilities. The generally longer maturity of the liabilities compared to the assets results in reinvestment risk from the asset side.
- 8 Under IFRS, insurers could designate either a cash flow hedge of the reinvestment risk of assets and/or a fair value hedge of insurance liabilities, provided the necessary conditions for hedge accounting are met. The choice will be determined by the various factors including resulting volatility in profit or loss and operational burden. Some entities already apply the strategy around reinvestment risk of assets in practice. It should be noted that the hedging designation would need to be sufficiently consistent with the insurer's risk management objective, and therefore may be a proxy hedge¹.
- 9 This is similar to banks who may choose to designate an interest rate swap as a cash flow hedge of floating rate assets or a fair value hedge of fixed rate liabilities to account for risk management strategies that deal with similar interest rate risks (reinvestment and duration).
- 10 As the durations involved in the insurance model are generally longer than under the banking model, an insurer will have greater exposure due to variability as a result of both insurance and financial risk. Furthermore, there may generally be more variability in timing of payments of cash flows on insurance liabilities due to both insurance risk (timing of claims) and non-insurance risk (such as the exercising of extension and cancellation options (lapses)). This further contributes to the volatility due to duration and the related sensitivity to interest rate risk.

IFRS 9 vs IAS 39

- 11 For hedge accounting, one has a choice between the requirements of IFRS 9 or IAS 39 for the hedge accounting. However, under IFRS 9, one can also apply the portfolio fair value hedge of interest rate risk under IAS 39, including the European carve-out.
- 12 Several techniques are available in IFRS 9 and IAS 39.
- 13 IFRS 9 has the following advantages over IAS 39:
 - (a) When hedging with options, the cost of hedging model can be applied to account for the time value of the option (this spreads the initial premium paid for an option in profit or loss. Under IAS 39 this required to be measured at FVPL)², and

¹ Proxy hedging¹ is a colloquial reference to the use of designations of hedging relationships that do not exactly represent an entity's actual risk management. Examples include:

- (a) using a designation of a gross amount of an exposure (gross designation) when risks are actually managed on a net position,
- (b) designating variable-rate debt instruments in cash flow hedges while managing the interest rate risk of prepayable fixed-rate debt instruments or deposits (such as core deposits), and
- (c) designating fixed-rate debt instruments in fair value hedges while managing the interest rate risk of variable-rate debt instruments.

² This may be of particular importance to insurers.

(b) it does not require 80%-125% effectiveness as qualifying criterion for hedge accounting.³

- 14 However, both standards require measuring and recognising ineffectiveness in profit or loss (subject to the lower of test for a cash flow hedge). For example, the extent to which hedge accounting offers an offset in P&L between the hedged item and the hedging instrument depends on various factors such as counterparty credit risk, different payment dates or foreign exchange basis risk, lapses, extensions, variability of hedged amounts and/or timing of inflows and outflows without extension or lapse all of which will cause ineffectiveness.

Considerations relating to useful approaches

Hedging of components: separately identifiable and reliably measurable

- 15 As mentioned above, a key challenging area relates to hedges of an interest rate risk component in insurance liabilities. For such a hedge to qualify for hedge accounting, preparers will have to provide evidence to demonstrate the interest rate risk component they intend to hedge meets the SIRM conditions. The time value component derived from the use of discounting does not satisfy the SIRM conditions in the standards.
- 16 IFRS 9 states that an explicit risk component in a contract (i.e. contractually specified, such as a specified rate or formula) can be a hedged item in a qualifying hedging relationship.
- 17 Where such a risk component is not explicitly contractually specified but is implicit in the fair value or cash flows of an item, it needs to be separately identifiable and reliably measurable in order to qualify as a hedged item. This requires an assessment of the market structure to which the risks relate and in which the hedging activity takes place. Such an evaluation needs to take into account the relevant facts and circumstances which may differ by risk and by market.
- 18 While there has been significant experience of application under IAS 39 and the IASB has indicated that the additional guidance in IFRS 9 on this topic should not result in a different outcome for financial instruments under IAS39, the application of this in the context of insurance liabilities is new. Preparers and auditors will have to consider how the practice that exists for hedging strategies in the banking sector (in particular the macro fair value hedge under the IAS 39 carve-out) can be tested and applied to the insurance sector.
- 19 For example, where appropriate evidence can be provided of an economic link between the pricing of insurance liabilities and any underlying interest rate benchmark⁴ that would be helpful, given the lack of a secondary market for insurance liabilities in which to demonstrate the effect interest rates has on its fair value (see also the paragraph below about similarities with the hedging activities of banks).

Measurement of assets at FVPL and presenting finance changes of liabilities in profit or loss

- 20 Measuring both assets and liabilities with changes related to financial risk in profit in loss (i.e. not using the OCI option in IFRS 17 or FVOCI in IFRS 9) can be a useful alternative for some insurance portfolios with limited residual or unhedged duration mismatches. Insurers could consider that this may result in a similar outcome to the

³ It still requires an economic off-set amongst other requirements.

⁴ A possible approach would be to assess whether an economic link may be established via either transfers of pre-existing books of insurance contracts in the secondary market or pricing between insurers and customers in the primary market.

application of hedge accounting (due to ineffectiveness) but with a significantly lower operational burden. Depending on the facts and circumstances, additional sources of volatility may limit the final offset of the different components.

Hedge accounting for assets

- 21 In some circumstances, the hedging of the interest rate risk or the reinvestment risk of the related assets may be used as a proxy for hedging the insurance liabilities for financial risk. Furthermore, assets do not contain insurance risks and are not directly affected by the complexity relating to lapses and surrenders and demonstrating that interest rate is SIRM is often easier for financial assets than for insurance liabilities. However, this would not resolve resulting volatility remaining in OCI, where changes in financial risk are recognised in OCI for the unhedged insurance liability. Furthermore, it may add constraints on the asset allocation process, for example the highly probable criterion may require a commitment to purchase specified instruments with specified maturities at predetermined future dates.
- 22 Relevant instruments may include forward starting interest rate swaps to hedge the reinvestment risk of existing bonds and interest rate swaps to hedge existing variable rate bonds.

Hedge accounting for insurance liabilities

- 23 IAS 39 offers the portfolio fair value hedge of interest rate risk (and its carved-out version in the EU) which can be used for open and closed portfolios of insurance liabilities. For this type of hedge, the designated hedged item is expressed as an 'amount of currency' (e.g. an amount of euros, sterling, US dollars etc.) rather than as individual assets or liabilities.
- 24 The carved-out version of the portfolio fair value hedge of interest rate risk allows the introduction of a bottom layer (from a variable amount rather than a bottom layer from a defined nominal amount as per IFRS 9) for the purposes of measuring ineffectiveness. Lapses and surrenders⁵ are modelled and stressed. This is done in order to identify a stream of cash flows that, on portfolio level, is unaffected (i.e. affected with a very low statistical probability) by those timing impacts. This provides the ground for identifying an eligible hedged item. Once the unhedged top layer is exhausted, further maturities, lapses and surrenders affect the bottom layer resulting in ineffectiveness and profit or loss volatility. Therefore, it may be prudent to reduce the bottom layer at inception of the hedge to alleviate this risk.

Implementation activities needed

- 25 Insurers should be clear about appropriate strategies and related requirements, for example, the highly probable criterion is only relevant for hedges of forecast transactions (i.e. reinvestment of existing assets), but it is not needed in cases where there are insurance contractual relationships in place. Also, as an alternative to hedge accounting, the following options should not be dismissed in order to help address volatility:
 - (a) fair value measurement with changes in profit or loss of related assets and presentation of insurance finance income or expense in profit or loss for certain portfolios of insurance liabilities; or
 - (b) the classification as FVOCI for debt instruments meeting the SPPI criteria, as long as the held-to-collect-and-sale business model criteria are met.

⁵ The standards literally refer to prepayment risk rather than these terms. Therefore, the treatment of a termination of a party per the terms of the contract before maturity has to be assumed to be significantly similar to the prepayment risk in order for these sections to apply in the insurance world.

- 26 In the banking sector two different sets of portfolio hedging strategies are observed:
- (a) Compensation of the uncertainty of the hedged cash flow by frequent and dynamic adjustment of the hedging relationship (used in the UK and the Netherlands); or
 - (b) The layer approach relating to the very stable part of hedged cash flows which may be simpler and more stable in terms of hedging strategy and accounting process (often used in France, Italy, Belgium, Spain and Germany).
- 27 The set-up of a dynamic hedge of an interest rate risk component at group or portfolio level requires due consideration as such hedges can be operationally complex, including when IAS 39's fair value macro hedge is used. The reason for this stems from the need to schedule the hedged liability into appropriate time buckets. The higher the number of time buckets, the higher the complexity. With each time bucket that passes, any remaining hedge adjustment related to that time bucket is immediately recognised in profit or loss. Further, if for a particular time bucket, the amount hedged is reduced (e.g. in the EU carve-out, below the hedged bottom layer), this triggers amortisation of the related hedge adjustment over the remaining life of the items in the time bucket in profit or loss. In a portfolio fair value hedge, entities need to track every time bucket in order to know when to recycle. The more time buckets used in the designation, the greater the extent that tracking is required⁶.
- 28 Insurers will have to set up particular systems to designate hedged items as well as the calculations necessary to measure ineffectiveness and to do the necessary amortisation and recycling.
- 29 Insurers may be able to leverage information or data prepared for regulatory purposes to determine fair value changes due to the hedged risk. However, further work may still be required to determine a fair value in accordance with IFRS.
- 30 Furthermore, such information (including other internal information) may be useful to demonstrate whether/how changes in timing of cash flows in each time bucket (including due to lapses and the exercise of contractual options by policyholders) are impacted by interest rate risk for example. Actuarial information may also provide information about lapses/surrenders that may be useful during hedge designation.
- 31 Finally, even with the application of hedge accounting, there is no guarantee that there will be no profit or loss volatility, because either events happen differently than expected or not all the risk types have been hedged. All of the above may also require further judgement and may only be suitable for some but not all cases or instruments.

Use a building block approach: from simple to complex

- 32 Some of the explanations of current hedging strategies provided during the technical discussion that lead to this paper are high level and include several risk types.
- 33 The strategies also need to be documented/explained with a similar level of detail required in the final hedge designation documentation. For example, in some cases the descriptions do not include duration of the legs of the mitigating derivatives. Or there may be a discussion on managing interest rate risk which is then conflated and side-tracked with price risk and the strategies how to minimise that.

⁶ The requirements in IAS 39 literally refers to effective interest rate recognition and so additional considerations in the context of IFRS 17 may be necessary in the implementation of the detailed accounting model.

- 34 In order to apply hedge accounting, it is better to start simply and progress from there. For example, a simpler scenario to consider is where all the cash flows of both the assets and corresponding insurance liabilities are either known or can be predicted with a very high degree of certainty and are subject to little changes for example coming from lapses. Layers of complexity can be built upon that basic scenario.

Similarities with banks' hedging activities

- 35 Similarities can be drawn between insurers' activities and those of banks:
- (a) The standard allows that the interest rate risk in deposits meets SIRM. Banks hedge their deposits for which there is not an active market from which to directly derive a market structure; this is similar to insurance liabilities for which there is not an active market. Possible solutions to be considered for identifying the SIRM include evidencing a mechanism of pricing that encompasses an economic link between the contractual pricing applied to the client and the current level of the underlying interest rate benchmark.
 - (b) Two technical issues arise in a macro fair value hedge under the carve-out in addition to being able to identify interest risk as a SIRM risk component (as already mentioned above):
 - (i) lapses/surrenders are not literally mentioned in the standard that refer to prepayments (whether or not the IAS 39 macro fair value hedge or the carve-out is used⁷); and
 - (ii) the extent to which, by using the bottom layer approach in such a macro fair value hedge under the carve-out, ineffectiveness from prepayments/lapses can be reduced.
 - (c) Alternatively, it is possible to consider a cash flow hedge of forecasted reinvestments of assets (subject to the highly probable criterion). Banks hedge reinvestment risk of assets, so in some cases a preferable strategy may focus on the related assets rather than liabilities. In some cases, this is also true of insurers currently.
 - (d) Some banks also elect to recognise fair value changes in profit in loss rather than OCI.

Question to EFRAG TEG members:

- 36 Do you have any comments on this paper? Please explain.

⁷ Not an issue for banks using either model.