

Mr. Jean-Paul Gauzès
President of the EFRAG Board
EFRAG
Square de Meeûs 35
B-1000 Brussels
Belgium

Sent by email

Brussels, 23 April 2020

Subject: EFRAG request - Preliminary consideration on interaction between IFRS 9 Hedge Accounting and IFRS 17 Insurance Contracts: Hedge accounting of insurance liabilities and their risk components

Dear Mr. Gauzès,

We are pleased to respond to EFRAG's request concerning the interaction between IFRS 9 Hedge Accounting and IFRS 17 Insurance Contracts: Hedge accounting of insurance liabilities and their risk components.

Background

EFRAG is investigating certain concerns of the insurance industry related to the application of hedge accounting to insurance liabilities. After a few discussions with EFRAG TEG and EFRAG IAWG and an outreach to experts of the BIG 4, Accountancy Europe is now seeking advice from the IWP.

For a better understating of the topic and of the proposed views, please note that this paper has been prepared on the basis of a document prepared by the ACE IFRS9 TF, hereby included as appendix.

General requirements of Hedge Accounting under IFRS

1. Hedge accounting is an accounting model described in IAS 39 and IFRS 9 that is aimed at depicting in accounting records the effect of risk management strategies, if certain conditions are met. In broad terms, hedging purposes are viewed as means to protect an entity from variability of the cash-flows or the fair-value of a hedged item caused by adverse evolution of a variable (i.e. interest rate, commodity price, foreign exchange rate).
2. In basic terms, the application of hedge accounting under IFRS requires:
 - a. the identification of a hedged item/hedged risk (usually a financial instrument/interest rate risk or a non-monetary item such as a price of a commodity) (eligibility) and

- b. the identification of a hedging instrument (usually a derivative contract) (designation)
 - c. the measurement of the degree of the matching between the cash flows or the fair value of a. and b. above in a reliable manner (hedge relationship effectiveness)
 - d. the availability (at any time) of suitable and appropriate documentation of the entire hedge relationship (i.e. hedging strategy documentation, risk management techniques, financial models adopted to measure the effectiveness and so forth)
3. Qualifying for hedge accounting under IAS 39 requires the hedge to cover all risks for any hedged non-financial assets or liabilities or to cover only a portion of the risk of a financial instrument, provided such portion can be separately identifiable and reliably measurable. When the insurance contract takes the form of cash-outflows paid by the insurer, such contract meets the definition of a financial instrument and the insurer might hedge only a portion of the risk of such contract, provided such portion can be separately identifiable and reliably measurable. IFRS 9 allows hedge accounting to be applied for hedges of a specific contractual or non-contractual risk component (i.e. a specific financial risk related to a non-financial instrument), if and only if the risk can be clearly identified, is measurable reliably and can be traced to a common market structure (marketability). In other words, the key aspect of the application of the principle is the identification of a Separately Identifiable and Reliably Measurable component (SIRM), whereas the concept of marketability seems to converge towards the identification of an observable market input.
 4. The IASB created a scope exception from the IFRS 9 hedging accounting requirements that allows entities to use the specific fair value hedge accounting for portfolio hedges of interest rate risk, as defined in IAS 39. In addition, it is worth noting, that under IFRS as adopted by EU an IAS 39 carve out exists that allows the application of hedge accounting for portfolio hedges of interest rate risks with some reliefs.

Features of an insurance liability

5. Before assessing whether or not an Insurance liability is a hedgeable item, it is important to bear in mind the most common features of the insurance contracts and of the determination of the insurance liability.
6. Under IFRS, the measurement of insurance contracts is not in scope of IAS39/IFRS9 and the IASB provides a clear definition of insurance risks and the reasons why it is dissimilar from financial risk.
7. An important feature of insurance liabilities, irrespective of the accounting or MCEV or SII models applied, is that they are extremely illiquid and do not have a liquid “market” with observable prices. Therefore, a market consistent valuation of an insurance liability is generally determined through complex actuarial models, based on the following inputs:
 - i. Cash flows (deterministic or expected);
 - ii. Discount rate (current market rate or lock-in);
 - iii. Economic scenarios (risk neutral or real world)
 - iv. Operating assumptions (entity specific)
 - v. Economic assumptions (market observable or entity specific)
 - vi. A risk margin (implicit or explicit)
8. Arguably, insurance liabilities retain some features that are similar to financial liabilities (cash-flows, discounting, economic assumptions), however others are “insurance specific” such as certain operating assumptions (mass-lapse, mortality, morbidity, longevity, frequency, severity).
9. Insurance specific assumptions affecting the cash-flows are not sensitive to interest or market prices: this can add complexity to the identification of a hedging instrument that can work effectively. In fact, the vast majority of insurers, overcome the issue by using other risk-mitigation techniques such as reinsurance, purchase or sale of index-linked securities such

as cat-bonds and other contracts which bundled risks together and mitigate possible negative outcomes.

10. That said, the fact that Insurance liabilities are illiquid and do not have observable market prices can create additional complexity in considering them eligible according to the marketability criteria. However, it should be noted that in the banking industry the portfolio hedge of interest rate risk is applied to mortgage loans and deposits which are generally speaking illiquid.
11. Moreover, it is worth noticing that however reliable an actuarial valuation might be, it can hardly be considered a market observable input, and therefore this might weaken the applicability of the market structure concept to insurance liabilities.
12. Even in the context of transactions and M&A related to insurance portfolios or insurance companies the actuarial valuation used by the negotiating parties can significantly differ from the fair value determined in accordance with IFRS 13.
13. Finally, even if insurance contract liabilities could be argued to be theoretically admissible for hedge accounting, the population to which this could apply, once IFRS 17 is introduced might be limited. In fact:
 - a. Premium Allocation Approach (PAA) contracts appear to be excluded because the portfolios have short-term duration and limited or no exposure to financial risks. In addition, in the vast majority of the non-life insurance business, the payments do not depend on interest rate movements;
 - b. contracts apply the more comfortable risk mitigation accounting techniques contained within IFRS 17;
 - c. as such the matter seems to be relevant to general model contracts only for which however a practical expedient exists which is the designation of assets at Fair Value.
14. Based on the most recent statistics provided by EIOPA (2018), overall yearly premiums for non-life contracts accounts for some 626b EUR; life and health premiums accounts for 927b EUR (of which 39% are Unit-Linked, 32% With Profits, 7% Health and 11% remaining life products (protection)). Of the 32% With Profits business that accounts for 292b EUR, 75% are represented by Germany, France and Italy which most likely apply Variable Fee Approach (VFA). So, assuming that the vast majority of non-life business will be accounted for under PAA, the relevance of the matter might relate only to a minor portion of the life European Business, amounting to some 10-12%.

Applying hedge accounting to insurance liabilities

15. Insurers might need to apply hedging strategies to their life business sensible to volatility of interest rates. Since the duration of insurance liabilities is generally much longer than the duration of the backing assets, the insurer incurs a re-investment risk due to the economic mismatch between assets and liabilities or duration gap. Insofar as the insurer may provide guaranteed returns to the policyholders, the issue is amplified.
16. Insurers that currently adopt hedge accounting, presumably do this in the context of derivatives strategies that mitigate changes in cash-flows or fair values of financial assets backing life insurance liabilities caused by changes in interest rates.
17. In order to explore the possibility of applying hedge accounting to insurance liabilities in the context of IFRS 17, it is worth considering the experience provided by the banking industry in portfolio strategy of interest rate risks related to mortgage loans and deposits.
18. Although, in general the option to apply IAS 39 portfolio hedge is viable - even if with some operational burden related to the necessity to continuously reassess the hedge effectiveness - it seems more practicable to apply the EU IAS 39 carve-out that allows for portfolio fair value hedge using the “bottom-layer” approach.

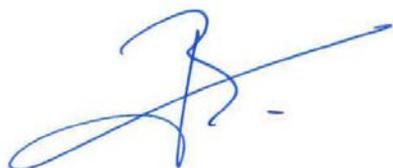
19. In the banking industry, the application of the IAS 39 carve-out is based on the “bottom-layer” approach: a portfolio of assets or liabilities is split into time buckets whose cash-flows also consider probability of prepayment. There will be buckets whose cash-flows are more volatile than others to changes of interest rates. Stress-tests can also be applied to determine those cash-flows stemming from the portfolio that are more stable and can reliably be measured (the bottom-layer) to which eventually apply the hedging strategy.
20. This process, which is based on the robustness of the financial techniques used to predict the cash-flows, appear to be applicable *mutatis mutandis* to life insurance cash-flows. In fact, it could be argued that the concept of prepayment in a mortgage loan shares some common feature with a lapse risk typical in the insurance industry: it is sensitive to interest rate since it exposes the insurer to an economic mismatch, it is an option in the hands of the customer, can be determined by reason not entirely linked to financial decisions and market conditions (i.e. behavioral and/or commercial decision to change of insurance provider, personal medical conditions, tax advantages).
21. With currently available financial and actuarial models, whose degree of sophistication may vary, based on cash-flow projections used for instance for Solvency 2 and in the foreseen IFRS 17, it seems possible to reliably build duration buckets and related cash-flows. Naturally in any predictive exercise, it is important to test the forecasting capability of the insurer against the reality via reliability of data, robustness of models and back-testing techniques.
22. That said, even if in theoretical terms similarities exists, the main point to address by insurers in applying hedge accounting to life insurance cash-flows is to clearly identify a SIRM. In particular, how insurance liabilities can pass the test of the “market structure”.
23. The banking industry has applied the EU carve out to some demand deposits that carry a fixed interest rate (including when it is nil) and for which no active market exists. Nevertheless, because of the presence of the fixed rate component, such deposits have been designated as a hedged item for their interest rate risk component only. The derivation of a market consistent curve cannot be achieved with a ready-made standardized solution but needs to be applied case by case by analyzing for instance the feature of the insurance portfolio that varies products by products, the risks associated, the pricing techniques used to gauge the appropriate level of premium related to time value of options and guarantees.
24. Clear documentation is paramount. To achieve the desired level of robustness the back-up documentation needs to address several complexities typical of the insurance industry that might make it in practice difficult to overcome. In particular, the overall strength of the governance of the process (methodology, process, systems, models, data and expert judgement) should be duly considered.
25. The auditor should exercise its professional skepticism in order to conclude on the reasonability of the elements of expert judgement that will inevitably underpin the actuarial valuation and assumptions adopted by the insurer to demonstrate the effectiveness of the hedging strategy. The audit evidence gathered should adequately address the needs of the auditor to substantiate the analysis of the complexities of the subject matter, for instance, in terms of:
 - a. reliability and availability of historical data underpinning the assumptions related to lapses and cash flows;
 - b. appropriateness, accuracy and completeness of data quality;
 - c. integrity of the IT environment surrounding actuarial engines and risk management systems, including their implementation;
 - d. competency, skill and availability of personnel assigned to the tasks;
 - e. robustness of the overall governance model;
 - f. consistency between derivative use plans, objective of the hedging strategy, adopted instruments and overall configuration of the management actions included in the actuarial models.

Conclusion

26. In summary, even with the application of hedging strategies applied by the banking industry and specific practical expedients thereto, there is no guarantee that hedge accounting will always be available because it depends on the features of the insurance contracts and not all the risk types can be hedged. However, if all of the relevant conditions that according to IFRS 9 are the prerequisite for hedge accounting are met, provided that the insurer makes the necessary investments in systems and tools, the auditability of hedge accounting in the IFRS 9 / IFRS 17 foreseeable environment of the insurance industry does not seem to be impaired.

Please do not hesitate to contact Ben Renier (Ben@accountancyeurope.eu) in case of any additional questions or remarks.

Sincerely,



Olivier Boutellis-Taft
Chief Executive

ABOUT ACCOUNTANCY EUROPE

Accountancy Europe unites 51 professional organisations from 35 countries that represent close to **1 million** professional accountants, auditors and advisors. They make numbers work for people. Accountancy Europe translates their daily experience to inform the public policy debate in Europe and beyond.

Accountancy Europe is in the EU Transparency Register (No 4713568401-18).

Appendix: Hedging fair value of insurance contracts portfolios

1. **Objective:** The objective of this memo is to discuss how hedge accounting could be applied to an identifiable and separately measurable portion of interest rate exposure of an insurance liability. This paper can only provide some high level perspective and as any hedge accounting relationship, a detailed hedging documentation will have to be provided that can only be fact specific. In summary, the guidance contained in IAS 39 AG 114-132 as endorsed by EU (i.e. “IAS 39 EU carve out”)¹ should be considered by the insurance industry to meet their financial risk targets and reduce P&L volatility that will arise from their interest rate derivatives when they will first apply IFRS 17 for the some insurance contracts listed at §2 below.
2. **Scope of contracts:** This paper will focus on a simplified life insurance contract where the policyholder receives a single payment at maturity only if he is alive, assuming that the contract does not qualify for the variable fee approach (VFA). The insurer receives from the policy holder an upfront premium for issuing such contract. Such approach could also be extended to other insurance businesses, when these insurance contracts include annuities payments or other long term guarantees, where an interest rate risk exists. It is also important to note that some life insurance contracts might include, in addition to financial guarantees, a discretionary participation benefit feature which is not contractual because the participation feature results from a constructive obligation (examples of such jurisdictions include Belgium, Japan) ... and are therefore not eligible to the VFA approach.
3. **Hedging derivatives used:** in order to hedge such contracts, the entity will enter into an interest rate swap receiving fixed rate capitalized over the term of the insurance contract and paying floating risk free benchmark rate.²
4. **Scope of standard for the insurance contract and why hedge accounting is need:**
If the insurer doesn't elect to apply the option for accounting the changes of the IFRS 17 insurance liability contracts discount rate into OCI, and classifies and measures the financial assets and the derivative as at fair value through P&L, it will still be exposed to significant P&L volatility³. However, such volatility is not generated by the variability of interest rate risk component of the insurance liability. The insurer may want to hedge only a portion of the interest rate exposure and hedge accounting generally accommodates hedging only a portion of the interest rate exposure. Note that under a different hedging strategy the derivative may well be designated as a cash-flow hedge of the interest rate exposure on the asset under both IAS 39 and IFRS 9 hedge accounting frameworks. Although such designation is already used in the insurance industry, it can lead to some complexities as the asset portfolio can turn quite frequently leading to some complex tracking accounting issues⁴. Hence some are exploring

¹This paper is on purpose only focused on the application of the ‘EU carve out’ version whose application is easier than the IAS 39 Standard as issued by the IASB. This does not mean that IAS 39 as issued by the IASB would not be applicable but it has its own specific challenges that would deserve a separate paper.

² In general, the insurer will invest into fixed rate asset. But because the insurance contract is very long term, it is difficult to find a well-diversified portfolio of fixed rate assets that match the term of the insurance contract. The insurer generally invests therefore into a well-diversified portfolio of fixed rate asset that have a much shorter maturity than the insurance contract one and then it closes the duration gap using forward starting swaps.

³This is because although the interest rate risk exposure of the insurance liability will be offset by the changes in fair value of the derivative, the fair value of the financial asset, which bears a floating rate in our simple example, will be sensitive to changes in the credit spread. And the current COVID 19 crisis illustrates that such exposure can lead to significant volatility, even for governmental bond type of exposures. This economic mismatch has been well presented by EFRAG in its preparatory work for the IFRS 17 DEA.

⁴In fact, in practice, the insurer invests the premium in fixed rate assets. But the spectrum of fixed rate assets is limited in terms of maturity and tend to be quite short except for government bonds types.

designating the derivative as hedging only a portion of the insurance contracts interest rate risk.

5. Scope of hedge accounting standard and eligibility of the insurance contract to be designated as a financial instrument.

- a. The insurance contract as described at §2 will fall within IFRS 17.
- b. Whatever choice the insurer will make when it will first apply IFRS 17 – applying either chapter 6 hedge accounting versus continuing applying IAS 39, it will still be able to elect to apply the guidance applicable to hedging the fair value attributable to the interest rate risk of a portfolio of financial instruments described at IAS 39 AG 114-132.
- c. Note that notwithstanding the requirements of IAS 39, IFRS 9 now would permit hedge accounting of a specific risk component only of a non-financial liability if certain conditions are met. It seems that a consensus is increasing around the fact that some insurance liabilities meet the definition of a financial liability. Although the contracts described at §2 above are insurance contracts within the scope of IFRS 17, they nevertheless present features similar to a financial instrument⁵ and accordingly only a risk component such as the interest rate risk can be designated as hedged item under IAS 39 provided the interest rate risk is separately identifiable and reliably measurable (AG 99F).
 - i. § 6 below will discuss whether interest rate is separately identifiable and reliably measurable. A European insurer may take advantage of using fair value hedge accounting of interest rate risk for a portfolio (as defined by IAS 39) of financial liabilities described at IAS 39 AG 114-132 as endorsed by EU. The main benefit of the ‘EU carve out’ version is to allow the use of the hedge designation methodology called bottom layer as opposed to the percentage approach required by the IASB. This bottom layer approach allows the insurer to isolate a stream of cash-outflows that on a portfolio basis can be considered with a high confidence level unaffected by sources of variability such as mortality risk or prepayment risk that are not hedged. Such designation, aligned with risk management of the insurer, largely facilitates the monitoring of the exposure and the related ineffectiveness. This approach is very similar to hedging demand deposits or prepayable fixed rate mortgages in the banking industry. It will be further developed in §7 below.

6. Interest rate risk is separable and reliably measurable

- a. IAS 39 AG 118(a) specifies that the fair value of the hedged item (the insurance contract) should change in response to changes in interest rate. More generally, here are some points to consider when assessing whether an eligible interest rate component can be separately identifiable from an insurance contract, having in mind that both IAS 39 and IFRS 9⁶ recognise this is an area of significant judgement⁷:

The strategy consists in entering into a forward starting swap that will hedge the cash-flows exposure on the reinvestment of the asset. To avoid making the paper more complex than it needs, we have voluntarily simplified the fact pattern.

⁵ Otherwise they would not need to be scoped out of IFRS 9. Note that the ability to hedge only a portion of the risk of a financial instrument does not require that financial instrument to be within the scope of the financial instrument. The mere fact that the instrument meets such definition makes it therefore eligible.

⁶ Note that the concept of market structure has been introduced by IFRS 9 to allow portions of non-financial instruments to be designated as hedged items. Since we are only using IAS 39 fair value hedge on a portfolio basis, this concept does not need to be discussed in detail. Nevertheless, we do expect the bullet points developed under §6 to be equally relevant for the IFRS 9 market structure concept.

⁷ IAS 39 BC 172J & IFRS 9 BC6.176

- i. Hedging interest rate risk in an insurance contract share several similarities with common hedging practice in the banking sector
 - 1. Both insurance and banking industries are required by their respective regulator to manage interest rate risk embedded in the portfolio of assets and liabilities they manage.
 - 2. 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 necessarily an active market.
 - 3. Although interest rate component may interact with other components such as mortality and lapse risk,
 - a. mortality risk embedded in insurance contracts described at §2 it interacts with interest rate risk in a similar way than credit risk in a mortgage.
 - b. Prepayment risk embedded in an insurance contract is similar to demand feature embedded in demand deposits contracts.
 - ii. We understand EFRAG has discussed in its technical papers how insurance contracts are priced and that interest rate is an element considered by insurers in pricing insurance contracts.
 - iii. The pricing of a reinsurance contract can also provide some evidence that an interest rate component does exist into the economic value of an insurance contract.
 - iv. The fair value of such contracts as determined under a business combination generally consists in discounting the expected cash outflows using a current discount rate which has a component that corresponds to the risk free rate.
- b. IAS 39 AG118(b) requires each hedged item of the portfolio to have qualified as an eligible hedged item. That paragraph has been carved out under the EU version and it is generally accepted that hedging can be done at the portfolio level (as defined by IAS 39.AG 114). At the portfolio level, because of the law of large numbers, the expected cash outflows will be less subject to significant fluctuation as a result of mortality risk if the hedged item is designated using a bottom layer approach. In addition, the deposit floor does not apply under IFRS 17 and if the hedged item is designated using a bottom layer approach, lapse risk should not cause significant sources of ineffectiveness.

7. How fair value attributable to the hedges risk is measured:

- a. The entity would schedule either the expected cash-outflows or notional principal amounts into all the time buckets until the insurance liability is expected to be repaid (AG 114(b)).
- b. The hedged risk would be the IBOR / benchmark risk free rate (AG 114(d)).
- c. It is undeniable that prepayment and mortality risk affect the ultimate cash-outflows and interact therefore with interest rate risk. If the entity wants to only hedge a portion of the interest rate risk irrespectively of mortality risk and prepayment risk, it can do so using the bottom layer approach. Under this approach, the entity determines based on its past experience a stressed scenario of expected cash-outflows and only hedges the interest rate risk associated with such bottom layer. If the contract contains prepayment risk, such stressed scenario will factor some conservative prepayment assumptions based on past experience. Similarly, if the contract contains some mortality risk, the entity determines based on its past experience a stressed scenario

of expected cash-outflows and only hedges the interest rate risk associated with such bottom layer. In these scenarios the cumulative changes in fair value attributable to the hedged risk will be measured by using the minimum between the bottom layer hedged cash-flows and the best estimated revised cash-outflows: as long as the revised expected cash outflows exceed the bottom layer, the changes of fair value attributable to the hedged risk will be based on the bottom layer hedged cash-flows, which the EU carve out allows⁸. The discount rate to discount the bottom layer hedged cash-flows will be based on the benchmark rate.

- d. Effectiveness testing: Effectiveness testing would then consist of measuring the ratio between (i) variation of the present value (“PV”) of hedged cash flows discounted at the designated benchmark rate risk hedged, and (ii) variation of fair value of the hedging derivative; such ratio shall be within the 80-125% range. Any ineffectiveness will be recognized in P&L. If the critical terms of the hedging swap perfectly match those of the hedged cash flows, the hedging relationship should be highly effective. The bottom layer approach will be monitored at least at each reporting date, and any over-hedging position will trigger some ineffectiveness and potentially the discontinuation of the related hedging relationship if the effectiveness testing is out of the (80;125) range.
8. Accounting for the changes in fair value attributable to the hedged risk: The changes of fair value attributable to the hedged risk described at §7 above should be recognized in P&L with an offsetting entry in OCI⁹. As the insurer will enter into new insurance contracts and new derivatives, the insurer will have to adjust the designation made at §7(a) to (c). The insurer will have to track the insurance liabilities by vintage and time buckets in order to ensure the cumulative changes of fair value attributable to the hedged risk that are recognized in OCI are recycled in P&L in the right period when the insurance liabilities are prepaid, or lapse as a result of mortality risk.

⁸ It is important to note that IFRS 17 measurement is based on a discount value of best estimate of cash-outflows. That best estimate of cash-outflows will be the foundation of measuring hedge effectiveness but to the extent of the bottom layer.

⁹ That offsetting entry should be booked against OCI instead of a separate line item as envisaged by §89A. This is because the insurance contract is measured in accordance with IFRS 17 with changes in the discount rate of the insurance liability being recognized into OCI. Accordingly, consistent with how changes of fair value attributable to the hedged risk are accounted for when financial assets are measured at fair value through OCI, such changes should be recognized in P&L with an offsetting entry into OCI (IAS 39§89(b) or IFRS 9§6.5.8(b)).