IFRS 17: Reinsurance and the risk mitigation option

[This article is one in a series of articles (which can be found here and here) published on behalf of the IFRS 17 CSM Working Party. Members are Antoon Pelsser, Asim Ghosh, Clarence Er, James Thorpe, Joanna Stansfield, Kruti Malde, Natalia Mirin (Deputy Chair), Richard Dyble, Rob Walton, Timothy Berry, Weihe Qin and Wijdan Yousuf (Chair).]

1. Overview

This article looks at how the risk mitigation option can be applied to reinsurance contracts held. In particular, it focuses on how to establish whether a reinsurance contract held meets the risk mitigation option criteria and how in practice the P&L mismatch can be minimised by applying this option.

2. Background

Under the General Measurement Model ('GMM'), the impact of changes in financial risk does not adjust the CSM but flows through to P&L directly. However, under VFA, the impact of changes in financial risk adjusts the CSM.

When underlying contracts are measured under the VFA, and the entity uses derivatives or reinsurance contracts[1] to mitigate the financial risks arising from these contracts, the impact of changes in financial risk on the underlying contracts adjusts through CSM whereas the impact on derivatives or reinsurance contracts goes through P&L. This results in an accounting mismatch. The source of the mismatch for derivatives is that these are measured under IFRS 9 and must recognize changes in fair value through P&L ("FVPL"). The source of the mismatch for reinsurance contracts held is that IFRS 17 requires all reinsurance contracts held to be measured using the GMM even if the underlying contract is measured under the VFA.

To minimize the impact of such mismatches, IFRS 17 allows an exception known as the risk mitigation option: If financial risk is hedged through derivatives or reinsurance contracts, paragraph B115 of the Standard allows an entity to recognise the impacts of changes in financial risk on an underlying VFA contract through the P&L (instead of adjusting the CSM) to match, to some extent, the P&L impact from derivatives and reinsurance contracts. The amount and timing of the financial impacts that can be brought through the P&L for the underlying contracts should be consistent with the financial impacts recognised in the P&L for the derivatives and reinsurance contracts.

3. Challenges

Whilst the principle is clear that the risk mitigation option should reduce the accounting mismatch under VFA, the key challenge is around defining what reinsurance can be used to apply the risk mitigation option. In addition to addressing this challenge, this section also sets out practical considerations to ensure consistency in applying the risk mitigation option.

B116 requires an entity to have a previously documented risk management objective and strategy and, in particular,

a) *the entity mitigates the financial risk arising from the insurance contracts using a derivative or a reinsurance contract held.*

This means that an entity must have a written document clearly stating how derivatives and reinsurance are used to mitigate financial risk before the risk mitigation option can be applied.

[1] The June 2019 Exposure Draft (ED) extends the risk mitigation option to reinsurance. This document is based on IFRS 17 requirements as per this ED.

b) *an economic offset exists between the insurance contracts and the derivative or reinsurance contract held, i.e. 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 shall not consider accounting measurement differences in assessing the economic offset.*

To demonstrate the economic offset, the document should set out both conceptually and numerically the financial risk that will be mitigated and the size of mitigation by the proposed derivatives or reinsurance. The demonstration on the offset between underlying insurance contracts and reinsurance contacts is particularly important because reinsurance may cover more than a single type of financial risk. In addition, a single reinsurance contract may cover multiple business lines, including multiple CSM units of account and even some non-insurance business, which consequently requires an approach to disaggregate and allocate the offsets appropriately.

The entity should also set out the procedure to ensure the impact of changes in financial risk is measured consistently for underlying contracts and reinsurance contracts in the 'analysis of change' process. The following areas need further consideration depending on an entity's own methodology:

- How to measure the right amount of impact to be recognised in P&L? The delta from a change in financial risk for an underlying contract and the corresponding derivatives or reinsurance may be different. Also, this delta may change due to market movements e.g. derivatives or reinsurance may have been providing a 50% hedge for the impact on underlying contact based on the economic conditions at inception but this percentage could be different at later reporting periods. Quantifying this ratio accurately, which normally needs stochastic modelling, within a tight reporting timeline is likely to be a challenge.

- How to treat new derivatives or reinsurance which were not in the original risk mitigation document? Entities will need to assess whether new derivatives or reinsurance contracts would have the same treatment as that applied to those already existing.

(c) credit risk does not dominate the economic offset.

B116(c) means that a hedge designed to mitigate credit risk as the **primary** purpose, e.g. credit default swaps, is not in scope of the risk mitigation option and therefore does not qualify for the relief available.

4. Conclusion

Whilst the basic principle of the risk mitigation option is relatively straightforward, ensuring consistency in applying this is challenging. Extending the risk mitigation option to reinsurance in the revised exposure draft is welcomed as it will reduce (but not eliminate) the accounting mismatch when reinsurance is used to mitigate financial risks of a VFA contract. Given that reinsurance can be structured in a bespoke way, entities should start examining the treatment of their programmes early to identify and resolve practical and technical issues.

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