STAFF PAPER

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IASB® meeting

Project	**Amendments to IFRS 17 *Insurance Contracts***
Paper topic	Reinsurance contracts held—underlying insurance contracts with direct participation features

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Purpose

1. This paper discusses the accounting for reinsurance contracts held when the underlying insurance contracts are insurance contracts with direct participation features.

Staff recommendation

2. The staff recommend the International Accounting Standards Board (Board) amend IFRS 17 to expand the scope of the risk mitigation exception for insurance contracts with direct participation features in paragraph B115 of IFRS 17 *Insurance Contracts* so that it applies when an entity uses a derivative or a reinsurance contract held to mitigate financial risk, to the extent that the entity meets the conditions in paragraph B116 of IFRS 17.

Structure of the paper

3. This paper provides:

   (a) an overview of the requirements in IFRS 17 (paragraphs 4–6 of this paper);

   (b) a summary of the Board's rationale for setting those requirements, including an overview of the Board's previous discussions (paragraphs 7–11 of this paper);

   (c) an overview of the concerns and implementation challenges expressed since IFRS 17 was issued (paragraphs 12–16 of this paper); and

   (d) the staff analysis, recommendations and a question for Board members (paragraphs 17–28 of this paper).

IFRS 17 requirements

4. The variable fee approach applies to insurance contracts that meet the definition of insurance contracts with direct participation features. Insurance contracts with direct participation features are insurance contracts that are substantially investment-related service contracts under which an entity promises an investment return based on underlying items. IFRS 17 requires the contractual service margin for variable fee approach contracts to be updated for more changes than those affecting the contractual service margin of other contracts. For variable fee approach contracts, the contractual service margin is also adjusted for the effect of changes in:

   (a) the entity's share of the underlying items; and

   (b) financial risks other than those arising from the underlying items, for example the effect of financial guarantees.

5. The variable fee approach includes a choice when an entity mitigates the financial risks of variable fee approach contracts using derivatives. The entity may choose to recognise changes in financial risk in such insurance contracts, such as those created by minimum payments guaranteed to the policyholder, in profit or loss, instead of adjusting the contractual service margin as normally required by the variable fee

approach. In other words, an entity can 'switch-off' the variable fee approach to the extent that the derivative mitigates the risks.

6. Reinsurance contracts issued and reinsurance contracts held cannot be insurance contracts with direct participation features for the purpose of applying IFRS 17.

Board's rationale

Risk mitigation exception in the variable fee approach

7. When the Board introduced the variable fee approach, it noted that the variable fee approach would create accounting mismatches when an entity purchases derivatives to mitigate risks that are included in the measurement of the contractual service margin.[1] The Board concluded that to avoid such accounting mismatches, an entity should be allowed to choose not to adjust the contractual service margin for the changes in the fulfilment cash flows and the entity's share of the fair value return on the underlying items that the derivatives are intended to mitigate.

Ineligibility of reinsurance contracts for the variable fee approach

Reinsurance contracts held

8. For reinsurance contracts an entity holds, the entity and the reinsurer do not share in the returns on underlying items, and so the criteria for the scope of the variable fee approach are not met. This is the case regardless of whether the underlying insurance contracts issued are insurance contracts with direct participation features.

9. During the development of IFRS 17, some stakeholders stated that the treatment of the contractual service margin for reinsurance contracts held should be the same as the treatment of the contractual service margin for the underlying insurance contracts issued. They argued that this would avoid mismatches that result when the pattern of recognition of the contractual service margin for reinsurance contracts differs from the pattern of recognition of the contractual service margin for the underlying insurance contracts. This would mean that the variable fee approach would apply to reinsurance contracts held that provide coverage for insurance contracts within the scope of the

[1] This is discussed in Agenda Paper 2C of the December 2018 Board meeting

variable fee approach, and that the general model would apply to reinsurance contracts held that provide coverage for insurance contracts within the scope of the general model.

10. The Board considered this feedback and decided it would not modify the scope of the variable fee approach to include reinsurance contracts held when the underlying insurance contracts issued are insurance contracts with direct participation features. The Board concluded that such an approach would be inconsistent with its view that a reinsurance contract held should be accounted for separately from the underlying insurance contracts issued.

Reinsurance contracts issued

11. The Board also considered stakeholder feedback that some reinsurance contracts *issued* might meet the criteria for the scope of the variable fee approach. The Board decided that, although some types of reinsurance contracts issued might meet the criteria for the scope of the variable fee approach, reinsurance contracts issued are not eligible for the variable fee approach. This is because the Board developed the variable fee approach for contracts for which, in the Board's view, the returns to the entity from a pool of underlying items should be viewed as part of the compensation that the entity charges the policyholder for the services provided by the insurance contract. That view does not apply to reinsurance contracts issued.

Concerns and implementation challenges expressed since IFRS 17 was issued

Reinsurance contracts held

12. Consistent with feedback during the development of IFRS 17, some stakeholders are concerned that measuring a reinsurance contract held applying the general model when the underlying insurance contracts are measured applying the variable fee approach may give rise to mismatches they regard as accounting mismatches. In their view, the resulting accounting fails to reflect the economics of the arrangement mitigating the entity's risk exposure.

13. Some stakeholders note that the economic effect of some reinsurance arrangements is to transfer both non-financial and financial risk from the entity to the reinsurer. For

example, some reinsurance contracts are structured to share the entity's share of the returns on underlying items between the entity and the reinsurer. However, generally the underlying items are managed by the insurer and are not transferred to the reinsurer.

14. Some stakeholders have suggested two amendments to IFRS 17 that they think would address their concerns. Those two amendments are:

    (a) permit an entity to choose to account for reinsurance contracts it holds applying the variable fee approach when the underlying insurance contracts are insurance contracts with direct participation features; or

    (b) expand the risk mitigation exception in the variable fee approach that applies when an entity uses derivatives to mitigate financial risk so that the exception also applies when an entity uses reinsurance contracts held to mitigate financial risks.

Reinsurance contracts issued

15. Some stakeholders note that in some internal reinsurance arrangements between subsidiaries of a group, the reinsuring subsidiary might hold or manage the underlying items on behalf of the insuring subsidiary. Those stakeholders think that those internal reinsurance contracts might meet the criteria for the scope of the variable fee approach if IFRS 17 did not explicitly exclude them from the variable fee approach.

16. Some stakeholders that have suggested the amendment in paragraph 14(a) of this paper have also suggested a related amendment for reinsurance contracts *issued*. Those stakeholders have suggested that IFRS 17 is amended to permit an entity to choose to account for reinsurance contracts it issues applying the variable fee approach, if the contract meets the criteria for the scope of the variable fee approach.

Staff analysis and recommendation

Reinsurance contracts held

17. The staff observe that some reinsurance contracts held do not mitigate the financial risks of variable fee approach insurance contracts. However, stakeholders have noted that some reinsurance contracts held may do so. For those reinsurance contracts, there may be an accounting mismatch similar to the accounting mismatch created when an entity uses derivatives to mitigate financial risks of underlying variable fee approach contracts. Therefore, the staff think an amendment to IFRS 17 that would resolve that accounting mismatch could be justified.

18. The staff think that either of the two amendments suggested by stakeholders in paragraph 14 of this paper would resolve that accounting mismatch.

19. The staff observe that the variable fee approach was developed to give a faithful representation of insurance contracts that are substantially investment-related service contracts. The Board views these contracts as creating an obligation for the entity to pay policyholders an amount equal in value to specified underlying items, minus a variable fee for service. Reinsurance contracts that the entity *holds*, by definition, cannot be considered to be such contracts from the perspective of the entity.

20. The staff think that to apply the variable fee approach to contracts for which it was not developed, as suggested by stakeholders in paragraph 14(a) of this paper, would not be suitable. The staff therefore do not recommend that the Board amend IFRS 17 to permit an entity to account for reinsurance contracts it holds applying the variable fee approach when the underlying insurance contracts are insurance contracts with direct participation features.

21. The staff observe that the risk mitigation exception in paragraph B115 of IFRS 17 was introduced to resolve an accounting mismatch introduced by the variable fee approach. The accounting mismatch discussed in this paper is similar to that accounting mismatch. Therefore, the staff think that amending IFRS 17 to expand the scope of the risk mitigation exception for insurance contracts with direct participation features in paragraph B115 of IFRS 17 so that it applies when an entity uses a

derivative *or a reinsurance contracts held* to mitigate financial risk would be appropriate.

22. The staff observe that the risk mitigation exception is a choice and therefore expanding the scope of the exception may reduce comparability. However, the staff think that the benefit of avoiding accounting mismatches that the Board considered when it added the existing exception for derivatives applies equally here.

23. The staff think the amendment discussed in paragraph 21 of this paper would meet the criteria set by the Board at its October 2018 meeting because it would not:

    (a) result in a significant loss of useful information compared to that which would be provided applying IFRS 17. Although this amendment would change the accounting for the underlying insurance contracts, it is an expansion of an exception that already exists in IFRS 17.

    (b) unduly disrupt implementation. The staff observe that this expanded exception would only apply when reinsurance contracts held meet the existing conditions for the risk mitigation exception in paragraph B116 of IFRS 17, and that the expanded exception is permitted but not required.

24. The staff therefore recommend the Board amend IFRS 17 to expand the scope of the risk mitigation exception for insurance contracts with direct participation features in paragraph B115 of IFRS 17 so that it applies when an entity use a derivative *or a reinsurance contract held* to mitigate financial risk, to the extent that the entity meets the conditions in paragraph B116 of IFRS 17.

Reinsurance contracts issued

25. The staff note that some stakeholders also expressed views that IFRS 17 should be amended to permit an entity to choose to account for reinsurance contracts it issues applying the variable fee approach, if the contract meets the criteria for the scope of the variable fee approach.

26. The staff observe that some stakeholders think that some internal reinsurance contracts issued might meet the criteria for the variable fee approach if IFRS 17 did not explicitly exclude them from the variable fee approach. Those stakeholders noted that in some internal reinsurance arrangements between subsidiaries of a group, the

reinsuring subsidiary might hold or manage the underlying items on behalf of the insuring subsidiary. The staff observe that, at a consolidated group of entities level, there is no reinsurance.

27. As explained in paragraph 11 of this paper, the Board developed the variable fee approach for contracts for which, in the Board's view, the returns to the entity from a pool of underlying items should be viewed as part of the compensation that the entity charges the policyholder for the services provided by the insurance contract. That view does not apply to reinsurance contracts issued. The staff think that to apply the variable fee approach to contracts for which it was not developed, as suggested by stakeholders in paragraph 16 of this paper, would not be suitable.

28. The staff therefore do not recommend the Board amend IFRS 17 to permit an entity to choose to account for reinsurance contracts it issues applying the variable fee approach.

Question for Board members
Do you agree the Board amend IFRS 17 to expand the scope of the risk mitigation exception for insurance contracts with direct participation features in paragraph B115 of IFRS 17 so that it applies when an entity use a derivative *or a reinsurance contract held* to mitigate financial risk, to the extent that the entity meets the conditions in paragraph B116 of IFRS 17?