



# Hedging, reinsurance, and accounting mismatches under IFRS 17

Hedging and reinsurance are widely used tools that help insurers manage risk. In most cases, these tools are designed to protect the Solvency Capital Requirement (SCR) ratio. However, they are less commonly focused on stabilizing results and equity under IFRS reporting standards.

A central feature of IFRS 17 is the Contractual Service Margin (CSM) – a balance sheet item that represents the unearned profit an insurer will receive over time as it provides services under its insurance contracts. Specific mechanisms surrounding the CSM can create mismatches between assets and liabilities, leading to volatility in either the profit and loss (P&L) statement or in equity (net assets/capital).

This article describes these mechanisms, the measures introduced by the IASB to address them, and how and to what degree insurance companies are applying them in practice.

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## KEY ACCOUNTING MISMATCHES AND CHALLENGES

### 1. VFA Accounting with Hedging – The Risk Mitigation Option

The Variable Fee Approach (VFA) is a measurement model under IFRS 17 applied to direct participating contracts – such as unit-linked or with-profits insurance products – where policyholders share in the returns of underlying assets. Under the VFA, changes in the variable fee (the insurer's share of underlying asset returns) are typically absorbed into the CSM rather than flowing through P&L.

When an insurer uses a hedge – such as a derivative – or reinsurance to manage financial risks associated with VFA contracts, the hedging instrument is typically classified under IFRS 9 as Fair Value Through Profit or Loss (FVTPL). This means its gains and losses flow directly through P&L. However, the corresponding change in the insurance liability – the variable fee adjustment – is recorded in the CSM and does not affect P&L. The result is a one-sided P&L impact: the hedge result is visible in P&L, while the offsetting liability adjustment is captured in the CSM.

To address this, IFRS 17 provides an optional exception known as the Risk Mitigation Option. When selected, changes in the variable fee that would normally be recorded in the CSM are instead recognized in P&L, aligning the accounting treatment of both the hedge and the hedged item, and thereby reducing artificial P&L volatility.

Example: The variable fee decreases by 100 due to a fall in the value of underlying funds, reducing the CSM accordingly. The insurer has hedged this risk using a derivative, which increases in value by 100 and is recognized as a profit in P&L. By applying the Risk Mitigation Option, the decrease in the variable fee is no longer recorded in the CSM but is instead recognized as a loss in P&L – resulting in a net zero effect on the income statement.

### 2. Loss Component and Loss Recovery Component

Under IFRS 17, when an insurance contract or group of contracts becomes onerous, the insurer must immediately recognize a loss component in P&L. The CSM cannot turn negative; instead, a separate loss component is established as part of the fulfilment cash flows of the insurance contract.

On the reinsurance side, the CSM can be either positive or negative, meaning gains and losses are recognized over the lifetime of the reinsurance contracts. As a result, if a group of underlying contracts becomes onerous, the CSM of the corresponding reinsurance contract will likely increase – creating an asymmetry in timing between the direct insurance loss and the reinsurance recovery.

The Loss Recovery Component aims to address this difference in treatment. When the cedant holds reinsurance that covers onerous contracts, IFRS 17 requires the recognition of a loss recovery component on the reinsurance asset.

Example: An insurer holds an 80% quota share reinsurance arrangement. Due to a change in mortality assumptions on the direct insurance contracts, a loss component of 100 is created and recognized as a loss in P&L. Under normal treatment, the reinsurance CSM would increase by 80, reflecting the higher expected claims recovery. However, when the Loss Recovery Component is established, the CSM does not increase; instead, a profit of 80 is recognized in P&L – resulting in a net P&L impact of –20. The Loss Component and Loss Recovery Component are released over time with the pattern of the claims and/or via changes in the portfolio.

### 3. Accounting Mismatches in Reinsurance

Two additional mismatches arise from differences in the measurement models applied to direct insurance contracts and to reinsurance contracts held. For reinsurance contracts, only the Premium Allocation Approach (PAA) or the General Measurement Model (GMM) may be applied.

First mismatch – Contract boundaries: Reinsurance contracts generally have longer contract boundaries than direct insurance contracts. This requires the application of the GMM and the inclusion of new business in the measurement, which can introduce volatility into P&L.

Second mismatch – Measurement model differences for participating contracts:

- Direct insurance contracts written on a participating basis are measured under the VFA.
- Reinsurance contracts held are measured under the GMM, as the VFA is not permitted for reinsurance contracts. Changes in financial risks are presented in insurance finance income and expense.

These two models calculate and amortize the CSM differently. The primary source of mismatch is the treatment of changes in the variable fee due to shifts in financial risk. For direct insurance contracts, this effect is reflected in the CSM, while for reinsurance contracts, it flows through P&L or equity. Even when the economic risk transfer is effective, the two models produce asymmetric results. IFRS 17 currently does not provide a solution to reduce the P&L impact of these mismatches.

### 4. Currency Effects on the CSM

For insurance contracts written in foreign currencies, the CSM is denominated in the currency of the relevant group of insurance contracts. When exchange rates move, the CSM must be translated into the functional currency, and the resulting currency translation difference is recognized in P&L.

Assets backing these contracts may be held in the same foreign currency, but their translation effects may flow through Other Comprehensive Income (OCI) or be treated differently. In many cases, the currency risk related to the CSM is not hedged, creating a currency-related P&L mismatch between the asset and liability sides.



Insurers writing cross-border business or managing multi-currency portfolios must carefully monitor and document currency exposures to avoid unexpected P&L volatility arising from CSM translation effects.

## OBSERVATIONS FROM THE DUTCH MARKET AND BEYOND

Drawing on data collected from the annual reports of more than 80 companies, we can illustrate how the Risk Mitigation Option for VFA and the Loss Recovery Component are being applied and provide an indication of the Foreign Exchange (FX) effect on the CSM. The Dutch companies in our dataset include Achmea, Aegon (Bermuda-based with Dutch roots), a.s.r., Athora, Atradius, Chesnara (with a Dutch subsidiary), and NN Group.

Risk Mitigation Option: Only 14 companies in our dataset adopted the Risk Mitigation Option, with a combined pre-tax impact of €3.3 billion. Most of these companies offer unit-linked contracts with guarantees and are based in Bermuda, Canada, the United Kingdom, and South Korea. In the Netherlands, Achmea and a.s.r. adopted the option, with impacts of €72 and €565 million respectively in 2025.

Loss Recovery Component: 39 companies in our dataset presented the effect of the Loss Recovery Component in their annual reports. On average, approximately 16% of the loss component was offset by the loss recovery component. None of the Dutch companies disclosed the effects of the Loss Recovery Component – likely because larger European insurers tend to carry limited reinsurance, reducing the relevance of this mechanism. In 2025, the loss component increased by €8.3 billion across the sample and was reflected in companies' income statements, yet only €0.3 billion was absorbed by the loss recovery component.

## CONCLUSION

Despite the mechanisms available under IFRS 17 to reduce accounting mismatches, their adoption remains limited in practice. As a result, insurers continue to experience a degree of avoidable volatility in their income statements – volatility that does not necessarily reflect the underlying economic reality of their risk positions. ■