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STAFF PAPER

15–19 October 2012

REG IASB Meeting

Project	**Insurance contracts**		
Paper topic	Adaptations for the measurement of financial instruments with discretionary participation features		
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What is this paper about?

1. This paper examines the adaptations that are needed to the measurement model for participating insurance contracts for financial instruments with discretionary participation features.

2. Discretionary participation features are present in many insurance contracts, including contracts that combine investment with life insurance. Some insurers also issue financial instruments that contain discretionary participation features. These contracts do not transfer significant insurance risk and therefore do not meet the definition of an insurance contract. Appendix A provides further background information on the nature of these contracts.

3. At its February 2012 meeting, the IASB confirmed the Exposure Draft *Insurance Contracts* (ED) proposal that financial instruments with discretionary participation features should be within the scope of the forthcoming Standard. However, the IASB restricted the proposal to only those contracts that have been issued by an insurer. One of the considerations in arriving at that decision was that financial instruments with discretionary participation features, while not transferring significant insurance risk, are more akin to insurance contracts with discretionary participation features than to other financial instruments. Appendix B provides other reasons behind the IASB's decision to include financial instruments with discretionary participation features within the scope of the ED.

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4. The proposed measurement model for participating insurance contracts could largely be applied without additional guidance to the measurement of financial instruments with discretionary participation features. (Appendix C provides a summary of the requirements that would apply to both participating insurance contracts and financial instruments with discretionary participation features.) However, in a few instances the proposed requirements would need to be adapted for financial instruments with discretionary participation features, because the requirements refer specifically to insurance risk.

Staff recommendation

5. We recommend that the contract boundary for a financial instrument with a discretionary participation feature should be defined as follows:

> The contract boundary for a financial instrument with a discretionary participation feature is the point at which the contract no longer confers substantive rights on the contract holder. This occurs when the contract holder no longer has a contractual right to receive benefits arising from the discretionary participating feature in that contract, or the premiums charged confer upon the contract holder substantially the same benefits as those that are available, on the same terms, to those that are not yet contract holders.

6. We recommend that the recognition requirement for a financial instrument with a discretionary participation feature should be as follows:

> An entity shall recognise a financial instrument with a discretionary participation feature asset or liability when, and only when, the entity becomes a party to the contractual provisions of the instrument.

7. We do not recommend any other adaptations. In particular, we recommend that the IASB does not make any adaptations to the proposals for the allocation of the residual margin.

Structure of the paper

8. The structure of the paper is as follows:

   (a) An overview of the ED proposals for the measurement of financial instruments with discretionary participation features (paragraphs 9–10); including the specific adaptations proposed in the ED as follows:

      (i) contract boundary (paragraphs 11–20); and

      (ii) allocation of the residual margin (paragraphs 21–25).

   Those sections also discuss feedback received and a staff analysis.

   (b) A discussion of whether further adaptations are needed in the light of the feedback received and decisions made since publication of the ED (paragraphs 26–36).

Overview of the ED proposals

9. The ED proposed that the requirements that apply to insurance contracts should also apply to financial instruments with discretionary participation features, except when those requirements:

   (a) are specifically for insurance risk; or

   (b) have no material effect on the measurement of the contract.

10. The ED also proposed to adapt the following requirements for financial instruments with discretionary participation features:

   (a) contract boundary (paragraphs 11–20); and

   (b) allocation of the residual margin (paragraphs 21–25).

Contract boundary

ED proposals and feedback received

11. The ED proposed that the contract boundary of an insurance contract is the point at which an insurer either:

   (a) is no longer required to provide coverage; or

(b) has the right or the practical ability to reassess the risk of the particular policyholder and, as a result, can set a price that fully reflects that risk.

12. Because the contract boundary refers to insurance risk, that requirement had to be adapted for financial instruments with discretionary participation features. Consequently, the ED proposed the following contract boundary for financial instruments with discretionary participation features:

> Paragraph 27 defines the boundary of an insurance contract. Instead, the boundary of a financial instrument with a discretionary participation feature is the point at which the contract holder no longer has a contractual right to receive benefits arising from the discretionary participating feature in that contract.

13. In general, most respondents supported the proposed contract boundary for financial instruments with discretionary participation features, because they think that it is consistent with the contract boundary principle for insurance contracts. Some were concerned that the contract boundary would include consideration of future premiums paid by current contract holders even if the premiums conferred substantially the same rights as those available to new contract holders. For example, current contract holders may wish to increase their benefits by paying in additional premiums. However, the same additional benefits are also available to new contract holders.

14. In addition, some misinterpreted the ED’s contract boundary proposals as requiring the inclusion of premiums from future contract holders in the measurement of the contract liability.

15. Some of those respondents recommended that the contract boundary should include only future premiums that result in conferring the same guaranteed benefits stated at the inception of the contract that are not available to new contract holders. They believe that this adaptation is more consistent with the contract boundary principle for insurance contracts and with the revenue recognition proposals. The revenue recognition proposals require consideration of options for additional goods or services when allocating the transaction price only when those options provide a material right to the customer. An option to

purchase additional goods or services at a stand-alone selling price would not constitute a material right.

Staff analysis

16. During the post-ED redeliberations, the boards tentatively decided to redefine the contract boundary as the point at which the contract no longer confers substantive rights on the policyholder. The following draft wording implements the boards' tentative contract boundary decision:

> The boundary of an insurance contract is the point at which the contract no longer confers substantive rights on the policyholder. This occurs when either:
>
> (a) the insurer is no longer required to provide coverage; or the insurer has the right or the practical ability to reassess the risk of the particular policyholder and, as a result, can set a price that fully reflects that risk. In assessing whether it can set a price that fully reflects the risk, an insurer shall ignore restrictions that have no commercial substance (ie no discernible effect on the economics of the contract); or
>
> (b) both of the following criteria are satisfied:
>
> (i) the insurer has the right or the practical ability to reassess the risk of the portfolio that contains the contract and, as a result, can set a price that fully reflects that risk of that portfolio; and
>
> (ii) the pricing of the premiums for coverage up to that date does not take into account risks relating to future periods.

17. The risks referred to in the above paragraph are insurance risks. The contract boundary guidance needs to be adapted for contracts that do not contain insurance risks. Consequently, the staff propose the following adaptation for a financial instrument with a discretionary participation feature (highlighted in italics below):

> The contract boundary for a financial instrument with a discretionary participation feature is the point at which the contract no longer confers substantive rights on the contract holder. This occurs when the contract holder no longer has a contractual right to receive benefits arising from the discretionary participating feature in that contract *or the premiums charged confer upon the contract holder substantially the same benefits as those that are available, on the same terms, to those that are not yet contract holders.*

18. The staff think that the period over which the holder of a financial instrument with a discretionary participation feature has a contractual right to receive benefits arising from that feature is akin to the coverage period for an insurance contract. In both cases, the issuer is obliged to provide the benefits promised in the contract.

19. The proposed additional criterion in paragraph 17, highlighted in italics, clarifies that the contract boundary does not include premiums that may be paid by current contract holders when those premiums provide substantially the same benefits as those available to those that are not yet contract holders. Consequently, future premiums would be inside the contract boundary only if those future premiums confer substantive benefits on current contract holders. This addresses the concern discussed in paragraph 12, raised by some respondents when they interpreted the ED proposals as requiring the issuer to consider additional premiums paid by current contract holders even if those premiums confer the same benefits on the same terms as those available to those who are not yet contact holders.

20. As discussed in paragraph 13, a few respondents had concerns that the proposed contract boundary for financial instruments with discretionary participation features would include premiums paid by future contract holders. It was never the IASB's intention to include premiums paid by future contract holders. The staff believe that these concerns would be addressed by another clarification made by the boards. In December 2011, the boards tentatively decided to clarify that the obligations arising from future contracts (and, therefore, also those premiums) should not be considered as part of the contract boundary of current contracts with

participation features. Consequently, the staff think that no further clarification is needed.

Allocating the residual margin

ED proposals and feedback

21. The ED proposed the following for the allocation of the residual margin:

> 50 An insurer shall recognise the residual margin determined at initial recognition as income in profit or loss over the coverage period in a systematic way that best reflects the exposure from providing insurance coverage, as follows:
>
> (a) on the basis of the passage of time; but
>
> (b) on the basis of the expected timing of incurred claims and benefits, if that pattern differs significantly from the passage of time.

22. Because the allocation of the residual margin for insurance contracts referred to the expected provision of insurance coverage, the ED proposed the following for financial instruments with discretionary participation features:

> 65 Paragraph 50 describes the basis for the release of the residual margin. Instead, the residual margin for a financial instrument with a discretionary participation feature shall be recognised as income in profit or loss over the life of the contract in a systematic way that best reflects the asset management services, as follows:
>
> (a) on the basis of the passage of time; but
>
> (b) on the basis of the fair value of assets under management, if that pattern differs significantly from the passage of time.

23. Many agree that the provision of asset management services is an appropriate driver for the allocation of the residual margin. However, some believe that the fair value of the assets under management, or the passage of time, does not reflect the provision of the asset management services in all cases.

Staff analysis

24. Since publication of the ED, the IASB tentatively decided that the residual margin should be recognised in profit or loss in a way that best reflects the pattern of services provided. Because the allocation of the margin for insurance contracts no longer refers to insurance risk, that requirement could also be applied to financial instruments with discretionary participation features. Consequently, the staff think that the reason the ED included specific guidance for the allocation of the margin for financial instruments with discretionary participation features is no longer valid. However, the staff think that, in practice, the margin for financial instruments with discretionary participation features will be allocated on the basis of the provision of asset management services.

25. In addition, applying the principle of recognising the margin in a way that best reflects the pattern of services will also address the concerns that the ED proposals did not reflect the pattern of the asset management services provided by some financial instruments with discretionary participation features (as discussed in paragraph 23).

Are further adaptations needed?

26. Respondents to the ED asked for further clarification of the application of the unbundling proposals (as discussed in paragraphs 27–32). We also considered whether further adaptations to the boards' tentative decisions for insurance contracts are needed for financial instruments with discretionary participation features (as discussed in paragraphs 33–36).

Unbundling

27. Many thought that the unbundling proposals in the ED were unclear. Some were concerned that the ED proposals required the unbundling of an investment component (eg accumulated allocated surplus to contract holders) from the discretionary participation features. Such unbundling would be costly because of the need to apply IFRS 9 to the investment component and the forthcoming *Insurance Contracts* Standard to the discretionary participation feature. In

addition, they thought that the information produced would not be useful because the investment component and the discretionary participation features are interdependent.

28. During the post-ED redeliberations, the boards have tentatively agreed that any distinct investment components would be unbundled from an insurance contract. The staff think that this requirement should also apply to financial instruments with discretionary participation features. The staff think that this would result in unbundling only in rare cases and not in the arbitrary circumstances raised by respondents in paragraph 27. In general, the investment components of a financial instrument with a discretionary participation feature (eg the accumulated allocated benefits, the guaranteed benefits) are highly interrelated and, hence, will not be unbundled.

29. In the rare cases that the investment component is distinct from the other components, that component shall be accounted for as a financial instrument. The staff think that this is appropriate. The IASB's rationale for including these contracts within the scope of the forthcoming Standard is that these products are more akin to participating insurance contracts. Any distinct investment components will be unbundled from participating insurance contracts (which is likely to be infrequent). Hence, to be consistent, unbundling distinct investment components should also be required for financial instruments with discretionary participation features. In addition, this will minimise structuring opportunities, if any exist. Consequently, we do not recommend any adaptations for the unbundling of distinct investment components for financial instruments with discretionary participation features.

30. The other tentative decisions on unbundling would also apply to financial instruments with discretionary participation features, as follows:

    (a) Embedded derivatives that are not closely related to the financial instrument with discretionary participation features would be unbundled in accordance with the current requirements of IFRS 9.

    (b) Any distinct goods or services would be unbundled from a financial instrument with discretionary participation features. Most, if not all, financial instruments with discretionary participation features provide

some form of asset management services. This requirement would result in the unbundling of asset management services only in rare circumstances, if any. In most cases, the risks and cash flows from the asset management services are highly interrelated with the guaranteed benefits. Other goods or services are not commonly bundled with financial instruments with discretionary participation features.

31. On a related issue, the boards have decided to exclude investment components from volume information presented in the statement of comprehensive income. Consequently, volume information reported would exclude deposits paid and returned to the contract holder. Volume information reported, if any, would likely be for fees for services provided.

32. We therefore think that unbundling and excluding investment components from volume information requirements for insurance contracts can be applied without adaptation to financial instruments with discretionary participation features.

Other decisions post-ED

Participating contracts

33. Because financial instruments with discretionary participation features have very similar features to insurance contracts with discretionary participation features, we think that the proposed measurement model for participating insurance contracts could be applied without additional adaptations to the measurement of financial instruments with discretionary participation features. (Appendix C provides a summary of the requirements that would apply to participating insurance contracts and, therefore, to financial instruments with discretionary participation features.) Consequently, we do not recommend any further adaptations.

Recognition

34. In reviewing the other decisions made in the post-ED redeliberations, the staff have identified another adaptation needed for financial instruments with discretionary participation features.

35. The boards have tentatively decided that an entity shall recognise an insurance contract at the beginning of the coverage period (ie when it starts providing coverage for insured

events). Because the coverage period refers to insured events, the staff are recommending the following adaptation for the recognition of a financial instrument with a discretionary participation feature:

> An entity shall recognise a financial instrument with a discretionary participation feature asset or liability when, and only when, the entity becomes a party to the contractual provisions of the instrument.

36. The draft wording above is adapted from paragraph 3.1.1 of IFRS 9:

> An entity shall recognise a financial asset or a financial liability in its statement of financial position when, and only when, the entity becomes party to the contractual provisions of the instrument.

Question to the IASB: adaptations for financial instruments with discretionary participation features

1) Do you agree to adapt the contact boundary criteria for a financial instrument with a discretionary participation feature to the following?

The contract boundary for a financial instrument with a discretionary participation feature is the point at which the contract no longer confers substantive rights on the contract holder. This occurs when the contract holder no longer has a contractual right to receive benefits arising from the discretionary participating feature in that contract, or the premiums charged confer upon the contract holder substantially the same benefits as those that are available, on the same terms, to those that are not yet contract holders.

2) Do you agree to adapt the recognition criteria for a financial instrument with a discretionary participation feature to the following?

An entity shall recognise a financial instrument with a discretionary participation feature asset or liability when, and only when, the entity becomes a party to the contractual provisions of the instrument.

Appendix A: Background—nature of financial instruments with discretionary participation features

A1. Paragraphs A2–A6 provide background on the nature of financial instruments with discretionary participation features and are reproduced from Agenda paper 14A (as discussed at the IASB's February 2012 meeting).

A2. In practice, financial instruments with discretionary participation features vary widely in terms of structure and complexity due to legal or regulatory requirements. However, they share the following key characteristics with participation insurance contracts:

(a) the amounts paid to contract holders are contractually linked to the performance of a pool of underlying assets held by the issuer (such as equities, bonds or property) and comprise both guaranteed benefits and additional benefits.

(b) the issuer has some discretion over the amount and/or timing of additional benefits to contract holders, although that discretion may be subject to contractual, regulatory or competitive constraints.

(c) although the issuer has contractual discretion over the distribution of additional benefits, it is common practice that current or future contract holders will ultimately receive part of the accumulated surplus of the underlying portfolio.

A3. Financial instruments with discretionary participation features enable contract holders to share in the performance of a pool of assets in a manner that smoothes the investment return over time so that contract holders are not exposed to volatility as directly as they are in unit-linked (variable) contracts. No precise formula dictates how the smoothing mechanism operates and the issuer generally has some discretion over it. The extent of that discretion, and the constraints on the discretion, vary geographically and from case to case.

A4. In one common type, the distributable surplus is based on net income that includes realised (but not unrealised) gains on assets. At least a specified portion of the distributable surplus (eg 85 per cent) must be allocated to contract holders each year (or within a specified period, say eight years). The issuer may allocate a higher portion to contract holders, and in some environments often

does, for example for competitive reasons. In this case, the insurer may have constrained discretion over:

(a) timing of asset realisations;

(b) the portion allocated to contract holders; and/or

(c) how, and perhaps when, aggregate allocations to contract holders are shared between individual contract holders.

A5. In another type, the issuer has discretion over the amount of any distribution out of distributable surplus, but if it does make a distribution, at least a specified portion (eg 90%) must go to contract holders.

A6. If the actual return on investment is worse than expected, the additional amount distributed to contract holders would be reduced, or not made at all. If the actual investment returns are below the guaranteed benefits, the shortfall results in a loss to the insurer.

Appendix B: Extract from the Basis for Conclusions on the Exposure Draft *Insurance Contracts*

Financial instruments with discretionary participation features (paragraph 2(b))

BC198 The Board proposes that issuers of financial instruments with discretionary participation features ('participating investment contracts') should apply the draft Standard to those contracts. Although those contracts do not meet the proposed definition of an insurance contract, the IASB noted the following advantages of treating participating investment contracts in the same way as participating insurance contracts, rather than as financial instruments:

(a) Participating investment contracts and participating insurance contracts are sometimes linked to the same underlying pool of assets (and sometimes participating investment contracts even share in the performance of insurance contracts). Using the same approach for both types of contract will produce more relevant information for users and simplifies the accounting for those contracts. For example, some cash flow distributions to participating policyholders are made in aggregate for both participating insurance and investment contracts, making it problematic to apply different accounting models to different parts of that aggregate participation.

(b) Both of these types of contracts often have characteristics, such as long maturities, recurring premiums and high acquisition costs that are more commonly found in insurance contracts than in most other financial instruments. The proposed model for insurance contracts was developed with the specific aim of generating useful information about contracts containing these features.

(c) Participating investment contracts contain a complex package of interdependent options and guarantees (eg minimum guarantees, surrender options, conversion options and paid-up options). Accordingly, some of these features might be separated into components under the IASB's current and proposed requirements for financial liabilities. Splitting these contracts into components with different accounting treatments would not be a faithful

representation of the package as a whole, resulting in information that is not understandable, and would be burdensome and costly.

BC199 The FASB concluded that these arguments are insufficient to justify excluding these contracts from the scope of its financial instruments Standards.

BC200 In contrast, the IASB found the arguments listed in paragraph BC198 persuasive and proposes to apply the draft Standard to those contracts.

Appendix C: Relevant tentative decisions of the boards

A7. In March 2011, the boards tentatively decided:

(a) To clarify that the objective of the discount rate used to measure participating insurance contracts should be consistent with the discount rate used to measure non-participating contracts, ie a current discount rate that reflects the characteristics of the insurance contract liability updated each reporting period. No method is prescribed for determining the discount rate, but the rate should:

(i) be consistent with observable current market prices for instruments with cash flows whose characteristics reflect those of the insurance contract liability, including timing, currency and liquidity but excluding the effect of the insurer's non-performance risk;

(ii) exclude any factors that influence the observed rates but that are not relevant to the insurance contract liability; and

(iii) reflect only the effects of risks and uncertainties that are not reflected elsewhere in the measurement of the insurance contract liability.

(b) To provide guidance that, to the extent that the amount, timing or uncertainty of the cash flows arising from an insurance contract depends wholly or partly on the performance of specific assets, the insurer should adjust those cash flows using a discount rate that reflects that dependency.

(c) At its 11 May 2011 meeting, the IASB tentatively decided that:

(i) The measurement of the fulfilment of cash flows relating to the policyholder's participation should be based on the measurement in the IFRS financial statements of the underlying items in which the policyholder participates.

Such items could be assets and liabilities, the performance of an underlying pool of insurance contracts or the performance of the entity.

(ii) An insurer should reflect, using a current measurement basis, any asymmetric risk-sharing between insurer and policyholder in the contractually linked items arising from a minimum guarantee.

(iii) An insurer should present changes in the insurance contract liability in the statement of comprehensive income consistently with the presentation of changes in the linked items (ie in profit or loss or in other comprehensive income).

(iv) The same measurement approach should apply to both unit-linked and participating contracts.

A8. In December 2011, the boards confirmed that the obligation for the performance-linked participation feature should be measured in a way that reflects how those underlying items are measured in the US GAAP/IFRS financial statements. That could be achieved by two methods, which both lead to the same measurement:

(a) eliminating from the building block approach changes in value that are not reflected in the measurement of the underlying items, or

(b) adjusting the insurer's current liability (that is, the contractual obligation incurred to date) to eliminate accounting mismatches that reflect timing differences (between the current liability and the measurement of the underlying items in the US GAAP/IFRS statement of financial position) that are expected to reverse within the boundary of the insurance contract.

A9. In December 2011, the boards also tentatively:

(a) confirmed that options and guarantees embedded in insurance contracts that are not separately accounted for as derivatives under the financial

instrument requirements should be measured within the overall insurance contract obligation using a current, market-consistent, expected value approach.

(b) agreed that, when an insurer measures an obligation, created by an insurance contract liability, which requires payment depending wholly or partly on the performance of specified assets and liabilities of the insurer, that measurement should include all such payments that result from that contract, whether paid to current or future policyholders.