Insurance Working Group

Staff Paper

Agenda reference	**7**
Date	**November, 2010**

Project	**Insurance Contracts: Phase II**
Topic	**Participating investment contracts**

Objective

1. The purpose of this session is to discuss the appropriate treatment of financial instruments with discretionary participation features (ie participating investment contracts). Such contracts meet the definition of financial instruments, not those of insurance contracts, but are often issued by insurers.

2. We would like to ask working group members:

   (a) whether a participating investment contract should be treated as a financial instrument or an insurance contract; and

   (b) if participating investment contracts are treated as insurance contracts, how to define and account for them.

Which standard?

3. The IASB exposure draft proposes that participating investment contracts should be accounted for in the same way as insurance contracts, ie in accordance with the draft IFRS on insurance contracts. The FASB discussion paper proposes instead that participating investment contracts should be accounted for as financial instruments.

4. The arguments for accounting for participating investment contracts in the same way as insurance contracts are:

   (a) Participating investment contracts and participating insurance contracts are often linked to the same underlying pool of assets. Using the same approach for both types of contracts would provide more relevant information for users and simplify the accounting.

This paper has been prepared by the technical staff of the IASB for the purposes of discussion at a public meeting of the IASB working group identified in the header of this paper.

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The meeting at which this paper is discussed is a public meeting but it is not a decision-making meeting of the Board. Official pronouncements of the IASB are published only after the Board has completed its full due process, including appropriate public consultation and formal voting procedures.

(b) Both types of contracts often share features that more closely resemble insurance contracts (for example, long maturities, recurring premiums, and high acquisition costs) than financial instruments. The objective of the insurance contracts model is to provide useful information about contracts containing those features.

(c) Participating investment contracts contain complex, interdependent options and guarantees that would be bifurcated under current and proposed requirements for financial liabilities. However, applying different accounting methods to the separate components may not provide a faithful representation of the entire contract, resulting in less understandable information.

5. Arguments for treating participating investment contracts as financial instruments are:

(a) Participating investment contracts do not meet the definition of an insurance contract, because they do not transfer significant insurance risk to the insurer. Consequently, they should be treated as financial instruments.

(b) Applying the insurance model to contracts that do not meet the definition of an insurance contract would cause additional complexities—for example, the need to isolate those contracts from other investment contracts and develop a separate contract boundary principle.

(c) In some jurisdictions, investment contracts with discretionary participation features form a substantial part of an insurer's business. Including a substantial volume of non-insurance contracts within the scope of the proposed insurance guidance might cause the model to take on the character of an industry-specific model.

(d) Similar contracts issued by non-insurer financial institutions are accounted for under current guidance on financial instruments. Accounting for similar contracts using different accounting models would reduce comparability and add complexity.

Question—Scope
Q1. Should participating investment contracts be accounted for under the financial instruments requirements or under the proposed insurance requirements? Why?

Exposure draft proposals

6. Without prejudging the IWG recommendations on the question above or the boards' redeliberations, the rest of the paper assumes that participating investment contracts are included within the scope of the draft IFRS on insurance contracts. If they are not, entities would need to apply the existing requirements for financial instruments. However, the boards would need to consider whether to provide further guidance on how to apply those requirements to the participating features.

7. We would like to ask working group members about:

   (a) the proposed definition of a discretionary participation feature;

   (b) the unbundling of these contracts; and

   (c) the modifications proposed to the accounting for these contracts as insurance contracts.

Definition

8. The exposure draft proposes to define discretionary participation features (and the related term 'guaranteed benefits') as follows:

Discretionary participation feature	A contractual right to receive, as a supplement to **guaranteed benefits**, additional benefits: (a) that are likely to be a significant portion of the total contractual benefits; (b) whose amount or timing is contractually at the discretion of the issuer; and (c) that are contractually based on: (i) the performance of a specified pool of insurance contracts or a specified type of insurance contract; (ii) realised and/or unrealised investment returns on a specified pool of assets held by the issuer; or (iii) the profit or loss of the company, fund or other entity that issues the contract, provided that there also exist insurance contracts that provide similar contractual rights to participate in the performance of the same insurance contracts, the same pool of assets or the profit or loss of the same company, fund or other entity.
Guaranteed benefits	Payments or other benefits to which a particular **policyholder** or investor has an unconditional right that is not subject to the contractual discretion of the issuer.

9. The proposed definition carries over the existing definition of a discretionary participation feature in IFRS 4 *Insurance Contracts*, but with one modification. The amendment stipulates that the contracts must share in the performance of the same pool of assets as do participating insurance contracts. The IASB is not aware of any reason to make any other changes.

10. The proposed definition must be sufficiently robust so that it captures the intended instruments and does not include financial instruments with similar features issued by non-insurers.

Question—Definition
Q2. Do you agree with the proposed definition of a discretionary participation feature, including the proposed new condition that the investment contracts must participate with insurance contracts in the same pool of assets, company, fund or other entity? Why or why not? If not, what do you recommend and why?

Unbundling

11. Paper 6 discusses whether (and if so, how) the following non-insurance components should be unbundled from insurance contracts:

    (a) non-insurance services or goods;

    (b) an investment component meeting the definition of a financial instrument; and

    (c) an embedded derivative.

12. For consistency, it could be argued that the same unbundling requirements that apply to insurance contracts should also apply to participating investment contracts.

13. However, there are a number of reasons why unbundling an investment component from a participating investment contract should not be required:

    (a) Unbundling raises the question as to what the residual is (ie what the non-investment component is) and whether that residual should be accounted for under the draft IFRS on insurance contracts.

    (b) Unbundling is inconsistent with the decision to include those contracts within the scope of the draft IFRS. It would result in the investment component being accounted for as a financial instrument and only the participating feature being accounted for as an insurance contract.

(c) It would add complexity because participating investment contracts often contain a number of embedded derivatives.

14. If an investment component is unbundled, it would be measured using the financial instruments standards. For example, assuming the insurer is already applying IFRS 9, it would use IFRS to determine whether it measures the investment component at fair value or at amortised cost.

Questions—Unbundling
Q3. Do you think that a participating investment contract should be unbundled? Why or why not? If so, what are the components? Q4. If participating investment contracts are to be unbundled, should that unbundling be required or merely permitted? Why?

15. If the IWG would like to discuss unbundling of participating investment contracts further, it may help to consider the example provided in the Appendix.

Modifications proposed

16. The IASB proposes that entities should apply the draft IFRS to participating investment contracts in the same way as for insurance contracts except for the following modifications proposed in paragraphs 64-65 of the exposure draft:

(a) 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.

(b) The residual margin for an 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:

(i) on the basis of the passage of time; but

(ii) on the basis of the fair value of assets under management, if that pattern differs significantly from the passage of time.

Questions—Modifications
Q5. Do you agree with the proposed modifications? If not, what would you propose and why? Are any other modifications needed for these contracts?

Appendix: Example of a participating investment contract

A1. Consider a contract with the following features:

(c) the policyholder pays a single premium of CU100, which is credited at inception to an account in the name of the policyholder.

(d) each year, interest is credited to the policyholder account at the rate of at least 3%, applied to the policyholder account at the end of the year. The insurer uses its judgement to determine the crediting rate, in the light of actual investment performance, underwriting results and expenses. (Please assume that an otherwise similar deposit providing only a fixed return would pay an annual return of 5%).

(e) If the policyholder surrenders the contract in the first ten years, the surrender value is the account value, less a deduction that declines to zero after 5 years.

(f) If the contract is still in force after ten years, the policyholder receives the account balance. If the policyholder dies before the term of the contract expires, the surrender value is paid out.

Questions—Unbundling

1. Do you think that this contract should be unbundled and, if so, which components would you unbundle? Why or why not?

2. If unbundling is required, how would you (1) split the premium and (2) treat the acquisition costs?

3. If unbundling is required, how would you determine the account balance at inception:

    (a) The stated amount of CU100, subsequently bearing interest at the actual crediting rate of 3%?

    (b) CU83 (CU100 compounded at 3% for ten years, discounted at 5%)?

    (c) another method?

4. Do you think that the same unbundling requirements should apply to both participating investment contracts and participating insurance contracts? Why or why not?

5. In your view, would the proposals in the exposure draft result in unbundling this contract? Why or why not?