Project **Insurance contracts**

Topic **Bifurcation of embedded derivatives**

What is this paper about?

1. Many insurance contracts contain embedded options, guarantees or other types of embedded derivatives. This paper addresses whether the boards should carry forward current requirements for separating derivatives embedded in insurance contracts from the host insurance contract to the forthcoming IFRS/FASB exposure draft. Those requirements are in IAS 39 *Financial Instruments: Recognition and Measurement*/IFRS 9 *Financial Instruments* and IFRS 4 *Insurance Contracts* and Topic 815 *Derivatives and Hedging* in the *FASB Accounting Standards Codification*®.

2. Agenda paper 12F discusses the overall considerations for unbundling. We intend to address in future papers the unbundling of investment components, and goods and services. We also intend to discuss in a future paper the separation of embedded derivatives that are in the form of riders, ie benefits that are additional, or limitations, to payments of the sum assured. (Some unexercised riders may meet the definition of a derivative under IAS 39/IFRS 9 and Topic 815.)

3. This paper does not consider derivatives embedded in investment contracts with discretionary participation features. We will ask the boards to consider at a future date whether investment contracts with discretionary participation features (DPF) will be included in the scope of the future IFRS on insurance contracts. If those contracts are within the scope of that IFRS, all aspects of the measurement model

would apply to those contracts. In relation to unbundling of investment contracts with DPF, we have identified no reason to treat them differently from insurance contracts.

4. We will consider at the end of the planned series of papers on unbundling whether the decisions on unbundling made separately are operational as a whole and whether principles can be developed. In addition, we will consider whether further unbundling should be permitted or prohibited.

Staff recommendation

5. We recommend that the existing separation requirements in IFRS 4 and IAS 39/IFRS 9 and Topic 815 for derivatives embedded in insurance contracts should be carried forward to the forthcoming IFRS (discussed in paragraphs 24-29).

Background

Derivatives

6. Both IFRS and US GAAP generally require entities to measure derivatives at fair value. This achieves the following benefits:

   (a) Consistency of financial variables (for example, discount rates, equity market prices) with observable market data.

   (b) Capturing both the intrinsic value of options and their time value.

   (c) Changes in the carrying amount of the derivatives are recognised in profit or loss.

   (d) Both IFRS and US GAAP require the separation and measurement at fair value through profit or loss of embedded derivatives that are not closely related to the host contract. Paragraph 4.3.1 of IFRS 9 states that 'An embedded derivative is a component of a hybrid contract that also

includes a non-derivative host—with the effect that some of the cash flows of the combined instrument vary in a way similar to a stand-alone derivative.

7. US GAAP's definition of a derivative differs in one significant respect from IFRS. US GAAP requires net settlement. (See Appendix A for a comparison of the definitions between IFRS and US GAAP.) These definitional differences, as well as other specific GAAP, have resulted in some items being treated differently in practice.

IFRS considerations

8. IAS 39/IFRS 9:

   (a) requires the separation of specified equity-index, commodity index, foreign currency derivatives, and specified minimum interest guarantees from a host insurance contract because the risks are dissimilar (See Appendix B).

   (b) permits (but does not require) separation of:

      (i) an embedded derivative that meets the definition of an insurance contract; and

      (ii) an embedded derivative that is closely related to the host insurance contract.

9. IAS 39 and IFRS 9 provide examples of embedded derivatives that are closely related and not closely related to the host contract. In that guidance, three examples are particularly important for this project:

   (a) embedded derivatives that are so interdependent with the host insurance contract that they cannot be measured independently (Paragraph B4.3.8(f) of IFRS 9).

   (b) Interest rate floors and caps that were out of the money at inception. Minimum interest rate guarantees (ie interest rate floors) are an important

feature of some long-term life insurance contracts (Paragraph B4.3.8 (b) of IFRS 9).

(c) Surrender options that are a common feature of some long-term life insurance contracts (Paragraph B4.3.5(e) of IFRS 9).

IFRS 4

10. IFRS 4 grandfathers until the completion of this project an insurer's existing accounting policies on insurance contracts with limited improvements. In developing IFRS 4, the IASB decided that derivatives embedded in an insurance contract that were not 'closely related' should be unbundled and measured under IAS 39. The IASB decided to do so because they believed **all** derivatives should be measured at fair value even if those derivatives are embedded in an insurance contract. Unbundling for embedded derivatives that are closely related is permitted, but not required.

11. However, paragraph 8 of IFRS 4 mean that an insurer is not required to separate specified surrender options in an insurance contract:

> As an exception to the requirements in IFRS 9, an insurer need not separate, and measure at fair value, a policyholder's option to surrender an insurance contract for a fixed amount (or for an amount based on a fixed amount and an interest rate), even if the exercise price differs from the carrying amount of the host insurance liability. However, the requirements in IFRS 9 do apply to a put option or cash surrender option embedded in an insurance contract if the surrender value varies in response to the change in a financial variable (such as an equity or commodity price or index), or a non-financial variable that is not specific to a party to the contract. Furthermore, those requirements also apply if the holder's ability to exercise a put option or cash surrender option is triggered by a change in such a variable (for example, a put option that can be exercised if a stock market index reaches a specified level).

12. In 2004, the IASB published *Guidance on Implementing IFRS 4* to accompany IFRS 4. Appendix C to this paper contains the section of that guidance dealing with embedded derivatives, and this may give board members an insight into the types of derivative that might be embedded in insurance contracts. The IASB ED did not state whether the IASB intended to issue similar guidance to accompany

the new IFRS. The staff believe that in general US GAAP would be consistent with the conclusions reached in this implementation guidance.

Proposals in the IASB ED

13. The IASB exposure draft *Insurance Contracts* (ED) largely carries forward from IFRS 4 and IAS 39 (and IFRS 9*)* the requirements to separate specified embedded derivatives from a host insurance contract. The IASB ED proposed two changes to the current guidance on the bifurcation of embedded derivatives:

    (a) it proposed to prohibit unbundling of embedded derivatives that are not 'closely related'. Under IFRS 4 insurers are permitted to unbundle these embedded derivatives.

    (b) it proposed to remove the exception in IFRS 4 paragraph 8 that an insurer need not separate specified surrender options in an insurance contract (described in paragraph 11).

14. Paragraph BC225 describes the IASB's reason for the removal of the exception in paragraph 8 of IFRS 4 as follows:

> Paragraph 8 of IFRS 4 specifies that, as an exception to IAS 39, an insurer need not bifurcate a policyholder's option to surrender an insurance contract for a fixed amount, even if the exercise price differs from the carrying amount of the host insurance contract. Paragraph 9 of IFRS 4 provides the same exception for financial instruments that contain a discretionary participation feature. Because paragraph AG33(h) of IAS 39 already provides bifurcation guidance consistent with the proposed overall approach to unbundling, the draft IFRS does not carry forward this exception as a separate item. Instead, an insurer would apply the requirements in IAS 39 to determine whether it needs to bifurcate a surrender option.

US GAAP considerations

15. The FASB proposed Accounting Standards Update, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities* would have eliminated bifurcation of embedded derivatives

and required the entire hybrid instrument to be measured at fair value through income if the embedded derivative was not clearly and closely related to the host. However, feedback on this proposal was not supportive because in part, from the asset side, host instruments that would have qualified for measurement at fair value through other comprehensive income (or amortized cost) would be required to be measured at fair value through net income. In addition there were concerns about the liability side and including adjustments for own credit. The FASB will be redeliberating in the near future and may decide to require bifurcation.

Proposals in the FASB DP

16. The FASB DP referenced the existing embedded derivative bifurcation guidance in Topic 815. In addition to the specific DIG issues on point (See Appendix D), the guidance requires that:

> An **embedded derivative** shall be separated from the host contract and accounted for as a **derivative instrument** pursuant to Subtopic 815-10 if and only if all of the following criteria are met:
>
> - The economic characteristics and risks of the embedded derivative are not clearly and closely related to the economic characteristics and risks of the host contract.
> - The **hybrid instrument** is not remeasured at **fair value** under otherwise applicable generally accepted accounting principles (GAAP) with changes in fair value reported in earnings as they occur.
> - A separate instrument with the same terms as the embedded derivative would, pursuant to Section 815-10-15, be a derivative instrument subject to the requirements of this Subtopic. (The initial net investment for the hybrid instrument shall not be considered to be the initial net investment for the embedded derivative.)

Overview of comments on the ED/DP

17. Not many responses specifically commented on the requirement to separate embedded derivatives.

18. Some supported the proposal to carry forward the requirements of IFRS 4 and IAS 39/IFRS 9 and Topic 815 for separating those embedded derivatives.

19. However, some recommended that all embedded derivatives in an insurance contract should be accounted for under the proposed model (ie not bifurcated). One large accounting firm (CL 172) argues as follows:

> 'Overall, we see very little benefit in requiring the efforts necessary to assess whether there is a close relationship of embedded derivatives with the host insurance contract and the resulting bifurcation compared to leaving the embedded derivative as an integral component of the insurance contract to be accounted for under the ED as there is a sufficiently clear requirement to use market prices to ensure the embedded derivatives cash flows are substantially aligned with their stand alone market value.'

20. One response expressed a preference that the boards should expand the population of embedded derivatives to be separated from insurance contracts to include those meeting the definition of an insurance contract. The aim would be to minimise accounting mismatches arising when there are hedged derivative instruments measured at fair value. Some of the hedged derivative instruments are discounted at the risk-free rate. This issue was raised by one of the presenters at the unbundling education session, at the boards' 16 February 2011 meeting.

21. One response requested that the boards work on converging the current differences in the existing requirements for separating embedded derivatives from an insurance contract.

22. Some respondents recommended that the IASB should carry forward:

    (a) the current implementation guidance in IFRS 4 on the separation of embedded derivatives; and

    (b) the current exception in paragraph 8 of IFRS 4 that an insurer need not separate and measure specified policyholders' surrender options, because such guidance has been useful in the past and provides clarity on the issue.

Staff analysis

23. We have provided a staff analysis from two points of view:

    (a) **View A**: embedded derivatives that are currently separated should continue to be separated from insurance contracts.

    (b) **View B**: no embedded derivatives should be separated from insurance contracts.

Separating embedded derivatives currently required to be separated

24. Staff supporting **View A** believe that the ED's/DP's proposals to bifurcate embedded derivatives produces more understandable information than not bifurcating them, for the following reasons:

    (a) *Embedded derivatives should be measured at fair value:* Most, if not all, users agree that derivatives should be measured at fair value with all changes, including those arising from the change in the entity's own credit risk, in profit and loss.[1] The proposed measurement model for insurance contracts is not fair value.

    (b) *Separation adds transparency*. The values, and changes in values, of those embedded derivatives will be included with the insurance liability and in our view this is less transparent. There is signaling information when the carrying values, and changes in those carrying values, are attributed to derivatives. At a minimum, information on the risks borne by the company (ie risks arising from specified derivatives versus insurance contracts).

[1] This is consistent with the feedback received from the IASB's outreach on the effects of changes in the fair value of financial liabilities due to the changes in the entity's own credit. The widespread view was that all derivatives (including bifurcated embedded derivatives) should be measured at fair value with changes in profit and loss. This is in comparison to the feedback received that it is inappropriate to recognise changes in the entity's own credit risk in profit or loss for financial liabilities designated at fair value through profit and loss.

(c) *Reduced arbitrage opportunities:* Accounting arbitrage opportunities arise when there are differences between the financial instruments and insurance contracts requirements. Continuing to require the small subset of derivatives that are currently required to be separated from an insurance contract would reduce accounting arbitrage opportunities (eg for equity-indexed and commodity-indexed features).

25. Furthermore, staff supporting **View A** believe that most insurers preparing financial statements under IFRS and US GAAP are accustomed to separating embedded derivatives from insurance contracts under the current requirements—hence, there is little additional cost in continuing to follow current practice.

26. Staff supporting **View A** think that, on balance, the arguments for separating embedded derivatives, currently separated in IAS 39/IFRS 9 (and IFRS 4) and Topic 815, outweigh the arguments against doing so, but only marginally so. Those staff place more weight on the argument that separating embedded derivatives will provide more transparency and useful information because changes in the fair value of such derivatives will be recognised in profit and loss and attributed as arising from derivatives. Furthermore, the staff note that **View A** was the approach proposed in the exposure draft.

Not bifurcating any embedded derivatives

27. In **View B**, the Boards would exempt issuers of insurance contracts from the requirement to separate embedded derivatives from a host insurance contract.

28. Staff supporting **View B** believe that the costs of separating any embedded derivatives from the insurance contracts outweigh the benefits. They argue that:

(a) unbundling introduces excessive complexity with little additional benefit. This is because:

(i) unbundling is inconsistent with the proposed models that treat an insurance contract as a bundle of rights and

obligations that generate a package of mostly interdependent cash inflows and outflows;

(ii) the current guidance in IAS 39/IFRS 9 and Topic 815 is a series of examples and only those examples are separated in practice. It separates only specified derivatives in an arbitrary manner and has been criticised as rules-based;

(b) there is no significant difference between measuring those derivatives at fair value and measuring them under the proposed model except that the proposed model does not include consideration of the insurer's own credit risk. Consequently, applying the proposed measurement model to the entire contract is analogous to not requiring separation of the embedded derivatives of a financial liability that has been measured using the fair value option; and

(c) proposed disclosure requirements (including a sensitivity analysis for market risk) provide additional information on the risks arising from those embedded derivatives (information is also provided by reporting the changes in the insurance liability in profit and loss).

29. Staff supporting **View B** believe that the benefits of separating embedded derivatives from insurance contracts are limited, and perhaps non-existent, and that the costs—particularly the complexity—outweigh those limited benefits. The proposed insurance contracts model is a current value model with market-consistent assumptions, with changes reported in profit and loss. Measuring the embedded derivatives at fair value would not be significantly different from the proposed model.

Alternatives rejected

Separating embedded derivatives not currently required to be separated

30. As discussed in paragraph 20, one respondent suggested expanding the population of embedded derivatives to be separated from insurance contracts to include

further embedded derivatives including some meet the definition of an insurance contract. We intend to discuss at a later stage whether further unbundling of non-insurance components only should be permitted or prohibited. Staff thinks it would be inconsistent to measure some insurance contracts (those that might be regarded as embedded derivatives) at fair value and to measure all other insurance contracts using the model being developed in this project. Furthermore, identifying that sub-population of insurance contracts might be difficult.

Converging the embedded derivatives guidance between US GAAP and IFRS

31. As discussed in paragraph 21, one respondent requested that the boards converge on their respective embedded derivative guidance for insurance contracts. We believe that this would be well beyond the scope of this project.

IASB Question 1–Bifurcation of embedded derivatives
Does the IASB confirm that the existing separation requirements in IFRS 4 and IAS 39/IFRS 9 for derivatives embedded in insurance contracts should be carried forward to forthcoming IFRS (as set out in Appendix B)?

FASB Question 1–Bifurcation of embedded derivatives
Does the FASB confirm that the current requirements in Topic 815 on the separation of embedded derivatives should be carried over to the forthcoming ED?

Implementation guidance

32. Some request that the implementation guidance currently in IFRS 4 on the separation of embedded derivatives should be carried over into the forthcoming IFRS. That guidance is reproduced in Appendix C. Some believe that removing the guidance is likely to cause confusion and result in inconsistent application.

33. We plan to consider at a later date what, if any, implementation guidance should accompany the forthcoming IFRS / FASB ED. At that stage, we will consider

whether the current implementation guidance on embedded derivatives in IFRS 4 should be amended and carried forward.

Appendix A: Comparing the definition of a derivative under IFRS and US GAAP

A1. This appendix provides a comparison of the definition of a derivative in IFRS and derivative instrument in U.S. GAAP.

A2. IFRS 9 defines a derivative as:

> **derivative** A financial instrument or other contract within the scope of this IFRS (see paragraph 2.1) with all three of the following characteristics.
>
> (a) Its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (sometimes called the 'underlying').
>
> (b) It requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.
>
> (c) It is settled at a future date.

A3. Accounting Standards Codification Topic 815-10-15-83 defines a derivative instrument as:

> A derivative instrument is a financial instrument or other contract with all of the following characteristics:
>
> a. The contract has both of the following terms, which determine the amount of the settlement or settlements, and, in some cases, whether or not a settlement is required:
>
> 1. One or more underlyings
> 2. One or more notional amounts or payment provisions or both.
>
> b. The contract requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.
>
> c. The contract can be settled net by any of the following means:
>
> 1. Its terms implicitly or explicitly require or permit net settlement.
> 2. It can readily be settled net by a means outside the contract.
> 3. It provides for delivery of an asset that puts the recipient in a position not substantially different from net settlement.

Appendix B: Extracts from the current embedded derivative guidance in IFRS 9

A4. The following paragraphs are marked up with consequential amendments that may be needed if the guidance is carried over to the future IFRS. Additional consequential amendments may be needed at a later stage depending on the final decisions made by the boards or to take into account the drafting of the future IFRS.

Surrender options

A5. Some request that the IASB reinstate the exception in IFRS 4 paragraph 8. Some life insurance contracts have a cash surrender option. A cash surrender option is a form of put option. Paragraph B4.3.5(e) of IFRS 9 requires the separation of a call, put or prepayment option when its exercise price is **not** approximately equal to the carrying amount of the host insurance contract. There is an inconsistency between the unit of account of the proposed model, ie the portfolio, because B4.3.5(e) of IFRS 9 requires the assessment of 'closely related' to be at the contract level. Under the proposed model, it will be difficult to determine the carrying value of the host insurance contract, unless the portfolio consists of homogenous insurance contracts.

A6. To resolve both of those issues, we recommend:

(a) that paragraph B.4.3.5(e) of IFRS 9 is amended to apply to a host insurance contract **only** if the holder's ability to exercise a put option or cash surrender option is triggered by a change in such a variable (for example, a put option that can be exercised if a stock market index reaches a specified level); and

(b) that the Board adds the following additional example of a call, put or prepayment option embedded in a host insurance contract that is not closely related to the insurance contract:

A cash surrender option is not closely related to a host insurance contract if the surrender value varies in response to the change in:

(i) a financial variable (such as an equity or commodity price or index), or

(ii) a non-financial variable that is not specific to a party to the contract.

A7. The result of both of the proposals in paragraph A6 is to carry over the current requirements to separate surrender options that respond to specific financial and non-financial risk. This is consistent with paragraph B4.3.5(c) and (d) of IFRS 9 that equity-indexed and commodity-index interest (or principal) derivatives should be separated from insurance contracts.

IFRS 9 *Financial Instruments*	**FASB Reference**
4.3.3 If a hybrid contract contains a host that is not an asset within the scope of this IFRS, an embedded derivative shall be separated from the host and accounted for as a derivative under this IFRS if, and only if: (a) **the economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host (see paragraphs B4.3.5 and B4.3.8);** (b) **a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative; and** (c) **the hybrid contract is not measured at fair value with changes in fair value recognised in profit or loss (ie a derivative that is embedded in a financial liability at fair value through profit or loss is not separated).**	815-15-25-1
B4.3.5 The economic characteristics and risks of an embedded derivative are not closely related to the host contract (paragraph 4.3.3(a)) in the following examples. In these examples, assuming the conditions in paragraph 4.3.3(b) and (c) are met, an entity accounts for the embedded derivative separately from the host contract. .. (c) Equity-indexed interest or principal payments embedded in a host debt instrument or insurance contract—by which the amount of interest or principal is indexed to the value of equity instruments—are not closely related to the host instrument because the risks inherent in the host and the embedded derivative are dissimilar.	815-15-25-49
(d) Commodity-indexed interest or principal payments embedded in a host debt instrument or insurance contract—by which the amount of interest or principal is indexed to the price of a commodity (such as gold)—are not closely related to the host instrument because the risks inherent in the host and the embedded derivative are dissimilar.	815-15-25-48

IFRS 9 *Financial Instruments*	**FASB Reference**
(e) A call, put, or prepayment option embedded in a host debt contract ~~or the host insurance cost~~ is not closely related to the host contract unless: (i) the option's exercise price is approximately equal on each exercise date to the amortised cost of the host debt instrument ~~or the host insurance cost~~; or (ii) the exercise price of a prepayment option reimburses the lender for an amount up to the approximate present value of lost interest for the remaining term of the host contract. Lost interest is the product of the principal amount prepaid multiplied by the interest rate differential. The interest rate differential is the excess of the effective interest rate of the host contract over the effective interest rate the entity would receive at the prepayment date if it reinvested the principal amount prepaid in a similar contract for the remaining term of the host contract. The assessment of whether the call or put option is closely related to the host debt contract is made before separating the equity element of a convertible debt instrument in accordance with IAS 32. (eA) A call, put, or prepayment option embedded in a host insurance contract is not closely related to the host contract when the exercise of the option is triggered by a change in a financial variable such as an equity or commodity price or index), or a non-financial variable that is not specific to a contract. ..	815-15-25-40
B4.3.8 The economic characteristics and risks of an embedded derivative are closely related to the economic characteristics and risks of the host contract in the following examples. In these examples, an entity does not account for the embedded derivative separately from the host contract. (a) An embedded derivative in which the underlying is an interest rate or interest rate index that can change the amount of interest that would otherwise be paid or received on an interest-bearing host debt contract or insurance contract is closely related to the host contract unless the hybrid contract can be settled in such a way that the holder would not recover substantially all of its recognised investment or the embedded derivative could at least double the holder's initial rate of return on the host contract and could result in a rate of return that is at least twice what the market return would be for a contract with the same terms as the host contract.	815-15-25-26
(b) An embedded floor or cap on the interest rate on a debt contract or insurance contract is closely related to the host contract, provided the cap is at or above the market rate of interest and the floor is at or below the market rate of interest when the contract is issued, and the cap or floor is not leveraged in relation to the host contract. Similarly, provisions included in a contract to purchase or sell an asset (eg a commodity) that establish a cap and a floor on the price to be paid or received for the asset are closely related to the host contract if both the cap and floor were out of the money at inception and are not leveraged.	815-15-25-32 815-15-25-26

IFRS 9 *Financial Instruments*	**FASB Reference**
The revisions indicated in this row are consequential amendments of the boards' decision that an insurance contract that results in cash flows in a foreign currency is treated as an a monetary item for IAS 21 (paragraph 61 of the IASB ED).	
(d) An embedded foreign currency derivative in a host contract that is ~~an insurance contract or~~ not a financial instrument (such as a contract for the purchase or sale of a non-financial item where the price is denominated in a foreign currency) is closely related to the host contract provided it is not leveraged, does not contain an option feature, and requires payments denominated in one of the following currencies: (i) the functional currency of any substantial party to that contract; (ii) the currency in which the price of the related good or service that is acquired or delivered is routinely denominated in commercial transactions around the world (such as the US dollar for crude oil transactions); or (iii) a currency that is commonly used in contracts to purchase or sell non-financial items in the economic environment in which the transaction takes place (eg a relatively stable and liquid currency that is commonly used in local business transactions or external trade). (dA) An embedded foreign currency derivative in a host contract that is an insurance contract is closely related to the insurance contract provided it is not leveraged and does not contain an option feature. …	815-15-15-10
(g) A unit-linking feature embedded in a host financial instrument or host insurance contract is closely related to the host instrument or host contract if the unit-denominated payments are measured at current unit values that reflect the fair values of the assets of the fund. A unit-linking feature is a contractual term that requires payments denominated in units of an internal or external investment fund.	N/A
(h) A derivative embedded in an insurance contract is closely related to the host insurance contract if the embedded derivative and host insurance contract are so interdependent that an entity cannot measure the embedded derivative separately (ie without considering the host contract).	N/A

Appendix C: Extracts from the Implementation Guidance of IFRS 4

A8. The following are the relevant extracts of the IASB's *Guidance on Implementing IFRS 4*. We plan to discuss at a later stage whether to provide such guidance to accompany the new standard/ED.

A9. The following paragraphs are marked up with consequential amendments that may be needed if the guidance is carried over to the future IFRS. Additional consequential amendments may be needed depending on the final decisions made by the boards or to take into account the drafting of the future IFRS. For example, we plan to ask the boards to consider the prohibition on unbundling the non-insurance components that are not specifically required to be separated. The guidance below reflects the current requirements in IFRS 4 that permits bifurcation of embedded derivatives that are closely related to the host insurance contract.

Embedded derivatives

IG3 IFRS 9 requires an entity to separate embedded derivatives that meet specified conditions from the host instrument that contains them, measure the embedded derivatives at fair value and recognise changes in their fair value in profit or loss. However, an insurer should~~need~~ not separate an embedded derivative that itself meets the definition of an insurance contract (paragraph 7 of the IFRS) from an insurance contract. ~~Nevertheless, separation and fair value measurement of such an embedded derivative are not prohibited.~~

IG4 IG Example 2 illustrates the treatment of embedded derivatives contained in insurance contracts and investment contracts. The term 'investment contract' is an informal term used for ease of discussion. It refers to a financial instrument that does not meet the definition of an insurance contract. The example does not illustrate all possible circumstances. Throughout the example, the phrase 'fair value measurement is required' indicates that the issuer of the contract is required:

(a) to measure the embedded derivative at fair value and include changes in its fair value in profit or loss.

(b) to separate the embedded derivative from the host contract, unless it measures the entire contract at fair value and includes changes in that fair value in profit or loss.

IG Example 2: Embedded derivatives

Type of embedded derivative		***Treatment if embedded in a host insurance contract***	***Treatment if embedded in a host investment contract***
2.1	Death benefit linked to equity prices or equity index, payable only on death or annuitisation and not on surrender or maturity.	The equity-index feature is an insurance contract (unless the life-contingent payments are insignificant), because the policyholder benefits from it only when the insured event occurs. Fair value measurement is not required (but not prohibited).	Not applicable. The entire contract is an insurance contract (unless the life-contingent payments are insignificant).
2.2	Death benefit that is the greater of: (a) unit value of an investment fund (equal to the amount payable on surrender or maturity); and (b) guaranteed minimum.	Excess of guaranteed minimum over unit value is a death benefit (similar to the payout on a dual trigger contract, see IG Example 2.19). This meets the definition of an insurance contract (unless the life-contingent payments are insignificant) and fair value measurement is not required (but not prohibited).	Not applicable. The entire contract is an insurance contract (unless the life-contingent payments are insignificant).
2.3	Option to take a life-contingent annuity at guaranteed rate (combined guarantee of interest rates and mortality charges).	The embedded option is an insurance contract (unless the life-contingent payments are insignificant). Fair value measurement is not required (but not prohibited).	Not applicable. The entire contract is an insurance contract (unless the life-contingent payments are insignificant).
2.4	Embedded guarantee of minimum interest rates in determining surrender or maturity values that is at or out of the money on issue, and not leveraged.	The embedded guarantee is not an insurance contract (unless significant payments are life-contingent[2]. However, it is closely related to the host contract (paragraph B4.3.8(b) of IFRS 9). Fair value measurement is not required (but not prohibited). If significant payments are life-contingent, the contract is an insurance contract and contains a deposit component (the guaranteed minimum). However, an insurer is not required to unbundle the contract if it recognises all obligations arising from the	Fair value measurement is not permitted (paragraph AG33(b) of IAS 39).

[2] Payments are life-contingent if they are contingent on death or contingent on survival.

Type of embedded derivative		***Treatment if embedded in a host insurance contract***	***Treatment if embedded in a host investment contract***
		deposit component (paragraph 10 of the IFRS). If cancelling the deposit component requires the policyholder to cancel the insurance component, the two cancellation options may be interdependent; if the option to cancel the deposit component cannot be measured separately (ie without considering the other option), both options are regarded as part of the insurance component (paragraph B4.3.8(h) of IFRS 9).	
2.5	Embedded guarantee of minimum interest rates in determining surrender or maturity values: in the money on issue, or leveraged.	The embedded guarantee is not an insurance contract (unless the embedded guarantee is life-contingent to a significant extent). Fair value measurement is required (paragraph B4.3.8(b) of IFRS 9).	Fair value measurement is required (paragraph B4.3.8(b) of IFRS 9).
2.6	Embedded guarantee of minimum annuity payments if the annuity payments are contractually linked to investment returns or asset prices:		
	(a) guarantee relates only to payments that are life-contingent.	The embedded guarantee is an insurance contract (unless the life-contingent payments are insignificant). Fair value measurement is not required (but not prohibited).	Not applicable. The entire contract is an insurance contract (unless the life-contingent payments are insignificant).
	(b) guarantee relates only to payments that are not life-contingent.	The embedded derivative is not an insurance contract. Fair value measurement is required (unless the guarantee is regarded as closely related to the host contract because the guarantee is an unleveraged interest floor that is at or out of the money at inception, see paragraph B4.3.8(b) of IFRS 9).	Fair value measurement is required (unless the guarantee is regarded as closely related to the host contract because the guarantee is an unleveraged interest floor that is at or out of the money at inception, see paragraph B4.3.8(b) of IFRS 9).

Type of embedded derivative		***Treatment if embedded in a host insurance contract***	***Treatment if embedded in a host investment contract***
	(c) policyholder can elect to receive life-contingent payments or payments that are not life-contingent, and the guarantee relates to both. When the policyholder makes its election, the issuer cannot adjust the pricing of the life-contingent payments to reflect the risk that the insurer assumes at that time (see paragraph B29 of the IFRS for discussion of contracts with separate accumulation and payout phases).	The embedded option to benefit from a guarantee of life-contingent payments is an insurance contract (unless the life-contingent payments are insignificant). Fair value measurement is not required (but not prohibited). The embedded option to receive payments that are not life-contingent ('the second option') is not an insurance contract. However, because the second option and the life-contingent option are alternatives, their fair values are interdependent. If they are so interdependent that the issuer cannot measure the second option separately (ie without considering the life-contingent option), the second option is closely related to the insurance contract. In that case, fair value measurement is not required (but not prohibited).	Not applicable. The entire contract is an insurance contract (unless the life-contingent payments are insignificant).
2.7	Embedded guarantee of minimum equity returns on surrender or maturity.	The embedded guarantee is not an insurance contract (unless the embedded guarantee is life-contingent to a significant extent) and is not closely related to the host insurance contract. Fair value measurement is required.	Fair value measurement is required.
2.8	Equity-linked return available on surrender or maturity.	The embedded derivative is not an insurance contract (unless the equity-linked return is life-contingent to a significant extent) and is not closely related to the host insurance contract. Fair value measurement is required.	Fair value measurement is required.

Type of embedded derivative		***Treatment if embedded in a host insurance contract***	***Treatment if embedded in a host investment contract***
2.9	Embedded guarantee of minimum equity returns that is available only if the policyholder elects to take a life-contingent annuity.	The embedded guarantee is an insurance contract (unless the life-contingent payments are insignificant), because the policyholder can benefit from the guarantee only by taking the annuity option (whether annuity rates are set at inception or at the date of annuitisation). Fair value measurement is not required (but not prohibited).	Not applicable. The entire contract is an insurance contract (unless the life-contingent payments are insignificant).
2.10	Embedded guarantee of minimum equity returns available to the policyholder as either (a) a cash payment, (b) a period-certain annuity or (c) a life-contingent annuity, at annuity rates prevailing at the **date of annuitisation**.	If the guaranteed payments are not contingent to a significant extent on survival, the option to take the life-contingent annuity does not transfer insurance risk until the policyholder opts to take the annuity. Therefore, the embedded guarantee is not an insurance contract and is not closely related to the host insurance contract. Fair value measurement is required. If the guaranteed payments are contingent to a significant extent on survival, the guarantee is an insurance contract (similar to a pure endowment). Fair value measurement is not required (but not prohibited).	Fair value measurement is required.
2.11	Embedded guarantee of minimum equity returns available to the policyholder as either (a) a cash payment (b) a period-certain annuity or (c) a life-contingent annuity, at annuity rates set at **inception**.	The whole contract is an insurance contract from inception (unless the life-contingent payments are insignificant). The option to take the life-contingent annuity is an embedded insurance contract, so fair value measurement is not required (but not prohibited). The option to take the cash payment or the period-certain annuity ('the second option') is not an insurance contract (unless the option is contingent to a significant	Not applicable.

Type of embedded derivative		***Treatment if embedded in a host insurance contract***	***Treatment if embedded in a host investment contract***
		extent on survival), so it must be separated. However, because the second option and the life-contingent option are alternatives, their fair values are interdependent. If they are so interdependent that the issuer cannot measure the second option separately (ie without considering the life-contingent option), the second option is closely related to the host insurance contract. In that case, fair value measurement is not required (but not prohibited).	
2.12	Policyholder option to surrender a contract for a cash surrender value specified in a schedule (ie not indexed and not accumulating interest).	Fair value measurement is not required (but not prohibited: paragraph 8 of the IFRS). The surrender value may be viewed as a deposit component, but the IFRS does not require an insurer to unbundle a contract if it recognises all its obligations arising under the deposit component (paragraph 10).	The surrender option is closely related to the host contract if the surrender value is approximately equal to the amortised cost at each exercise date (paragraph B4.3.5(e) of IFRS 9). Otherwise, the surrender option is measured at fair value.
2.13	Policyholder option to surrender a contract for account value based on a principal amount and a fixed or variable interest rate (or based on the fair value of a pool of interest-bearing securities), possibly after deducting a surrender charge.	Same as for a cash surrender value (IG Example 2.12).	Same as for a cash surrender value (IG Example 2.12).
2.14	Policyholder option to surrender a contract for a surrender value based on an equity or commodity price or index.	The option is not closely related to the host contract (unless the option is life-contingent to a significant extent). Fair value measurement is required (paragraphs 8 of the IFRS and B4.3.5(c) and (d) of IFRS 9).	Fair value measurement is required (paragraph B4.3.5(c) and (d) of IFRS 9).
2.15	Policyholder option to	If the insurer measures that	If the insurer regards the account

Type of embedded derivative		***Treatment if embedded in a host insurance contract***	***Treatment if embedded in a host investment contract***
	surrender a contract for account value equal to the fair value of a pool of equity investments, possibly after deducting a surrender charge.	portion of its obligation at account value, no further adjustment is needed for the option (unless the surrender value differs significantly from account value) (see paragraph B4.3.8(g) of IFRS 9). Otherwise, fair value measurement is required.	value as the fair value of that portion of its obligation, no further adjustment is needed for the option (unless the surrender value differs significantly from account value). Otherwise, fair value measurement is required.
2.16	Contractual feature that provides a return contractually linked (with no discretion) to the return on specified assets.	The embedded derivative is not an insurance contract and is not closely related to the contract (paragraph B4.3.5(f) of IFRS 9). Fair value measurement is required.	Fair value measurement is required.
2.17	Persistency bonus paid at maturity in cash (or as a period-certain annuity).	The embedded derivative (option to receive the persistency bonus) is not an insurance contract (unless the persistency bonus is life-contingent to a significant extent). Insurance risk does not include lapse or persistency risk (paragraph B15 of the IFRS). Fair value measurement is required.	An option or automatic provision to extend the remaining term to maturity of a debt instrument is not closely related to the host debt instrument unless there is a concurrent adjustment to the approximate current market rate of interest at the time of the extension (paragraph B4.3.5(b) of IFRS 9). If the option or provision is not closely related to the host instrument, fair value measurement is required.
2.18	Persistency bonus paid at maturity as an enhanced life-contingent annuity.	The embedded derivative is an insurance contract (unless the life-contingent payments are insignificant). Fair value measurement is not required (but not prohibited).	Not applicable. The entire contract is an insurance contract (unless the life-contingent payments are insignificant).
2.19	Dual trigger contract, eg contract requiring a payment that is contingent on a breakdown in power supply that adversely affects the holder (first trigger) and a specified level of electricity prices (second trigger). The contingent payment is made only if both triggering events	The embedded derivative is an insurance contract (unless the first trigger lacks commercial substance). A contract that qualifies as an insurance contract, whether at inception or later, remains an insurance contract until all rights and obligations are extinguished or expire (paragraph B30 of the IFRS). Therefore, although the remaining exposure is similar	Not applicable. The entire contract is an insurance contract (unless the first trigger lacks commercial substance).

Type of embedded derivative		***Treatment if embedded in a host insurance contract***	***Treatment if embedded in a host investment contract***
	occur.	to a financial derivative after the insured event has occurred, the embedded derivative is still an insurance contract and fair value measurement is not required (but not prohibited).	
2.20	Non-guaranteed participating dividend contained in a life insurance contract. The amount is contractually at the discretion of the insurer but is contractually based on the insurer's actual experience on the related block of insurance contracts.	The contract contains a discretionary participation feature, rather than an embedded derivative (paragraph 34 of the IFRS).	Not applicable. The entire contract is an insurance contract (unless the life-contingent payments are insignificant).

Appendix D: Other Products Possibly Bifurcated Under U.S. GAAP

A10. The following chart summarizes situations in which U.S. GAAP may require bifurcation. These matters were discussed by the FASB at a public meeting. The Board did not object to dissemination of its responses, and such responses were published as Derivatives Implementation Guidance ("DIG"). This guidance supplemented SFAS 133- *Derivatives and Hedging* and has since been codified as noted in the chart.

DIG	Codification	Issue Title	Subject Contracts
A13	ASC 815-10-15-104 through 15-106 ASC 815-10-55-19 through 55-21	Definition of a Derivative: Whether Settlement Provisions That Require a Structured Payout Constitute Net Settlement under Paragraph 9(a)	Any contract with a structured payout.
A16	ASC 815-10-05-9 through 05-15 ASC 815-10-55-63 ASC 815-10-55-170	Synthetic Guaranteed Investment Contracts	Traditional guaranteed investment contracts Synthetic guaranteed investment contracts Guaranteed investment contract with a rate reset Fixed-rate maturity synthetic guaranteed investment contract
B7	ASC 944-20-05-18 ASC 944-815-25-1 through 25-4	Variable Annuity Products and Policyholder Ownership of the Assets	Variable annuities
B8	ASC 944-20-05-24 ASC 944-815-25-1 through 25-4	Identification of the Host Contract in a Nontraditional Variable Annuity Contract	Multi-bucket annuities
B9	ASC 815-15-55-120 through 55-127	Clearly and Closely Related Criteria for Market Adjusted Value Prepayment Options	Market-value adjusted annuity contract
B10	ASC 815-15-55-73 through 55-76	Equity-Indexed Life Insurance Contracts	Equity-indexed life contracts
B25	ASC 815-15-55-57 through 55-61	Deferred Variable Annuity Contracts with Payment Alternatives at the end of the Accumulation Period	Guaranteed minimum withdrawal benefits Guaranteed minimum income benefits

DIG	Codification	Issue Title	Subject Contracts
B26	ASC 815-10-15-52 ASC 815-10-15-55 through 15-57 ASC 815-15-55-12 ASC 815-10-55-37 through 55-40 ASC 815-10-55-132 through 55-134	Dual-Trigger Property and Casualty Insurance Contracts	Dual trigger property and casualty insurance contracts (most do not contain embedded derivatives)
B27	ASC 815-10-55-32 through 55-36	Dual-Trigger Financial Guarantee Contracts	Dual trigger financial guarantee contracts
B28	ASC 815-15-15-20 through 15-21 ASC 815-15-55-1 through 55-4	Foreign Currency Elements of Insurance Contracts	Foreign currency elements of insurance contracts
B29	ASC 815-15-55-62 through 55-72	Equity-Indexed Annuity Contracts with Embedded Derivatives	Equity-indexed annuities with embedded derivatives
B30	ASC 815-15-55-227 through 55-238	Application of Statement 97 and Statement 133 to Equity-Indexed Annuity Contracts	Equity-indexed annuities with embedded derivatives
B31	No codification reference	Accounting for Purchases of Life Insurance	Separate account corporate owned life insurance Separate account corporate owned life insurance with a stable value rider
B36	ASC 815-15-25-47 ASC 815-15-55-101 through 55-109	Modified Coinsurance Arrangements and Debt Instruments That Incorporate Credit Risk Exposures That Are Unrelated or Only Partially Related to the Creditworthiness of the Obligor under Those Instruments	Modified coinsurance with funds withheld