STAFF PAPER

27 February – 2 March 2012

REG IASB Meeting

Project	**Insurance contracts**		
Paper topic	Financial instruments with discretionary participation features – background information		

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Purpose of paper

1 This paper provides background information to support the staff analysis in paper14B. **It does not include any questions for the Board.**

2 This paper explains:

(a) the definition of a 'discretionary participation feature' in IFRS 4 *Insurance Contracts* (paragraph 3);

(b) the nature of financial instruments with discretionary participation features (paragraphs 5-11);

(c) existing accounting requirements in IFRSs (paragraph 12-15) and US GAAP (paragraph 16):

(d) the proposals in the IASB exposure draft (paragraphs 17-20);

(e) the proposals in the FASB discussion paper (paragraphs 21-22):

(f) feedback from respondents (paragraphs 23-27).

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Definition of a discretionary participation feature

3 The IASB created the term 'discretionary participation feature' in IFRS 4 to describe a feature of many insurance contracts that gives rise to particular accounting difficulties. IFRS 4 defines a discretionary participation feature as:

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,

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.

Nature of financial instruments with discretionary participation features

5 Discretionary participation features are present in many insurance contracts, including contracts that combine investment and life insurance. Some insurers also issue investment contracts that contain discretionary participation features *without* the addition of significant life insurance. These contracts sometimes have the legal form of an insurance contract and sometimes transfer a small amount of insurance risk. However, they do not transfer significant insurance risk so do not meet the definition of an insurance contract.

6 The contracts are issued predominantly by life insurers as general investment / savings vehicles to enable contract holders to participate in the performance of designated assets held by the insurer. In some cases, assets for both participating insurance and participating investment contracts are held in the same fund and both types of contracts share in the profits of the fund. In other cases, assets for participating investment contracts are held separately.

7 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 participating 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.

8 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.

9 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 (e.g. 85 per cent) must be allocated to policyholders each year (or within a specified period, say eight years). The issuer may allocate a higher portion to policyholders, 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 policyholders

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

10 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 (e.g. 90%) must go to policyholders.

11 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.

Existing accounting requirements

IFRS requirements

12 Difficulties in determining an appropriate accounting treatment for discretionary participation features led the IASB to defer its detailed consideration of these features until the second phase of the insurance contracts project. The factor that gives rise to the difficulties is *constrained discretion*, i.e. the combination of discretion and constraints on that discretion. The main issue is whether the additional benefits should be classified as liabilities or a more unusual form of equity.

13 As an interim measure, IFRS 4 includes within its scope all financial instruments with discretionary participation features (as defined in paragraph 3 of this paper), regardless of whether the instruments also transfer insurance risk. By including all of these contracts within the scope of IFRS 4—and thus excluding them from the scope of the financial instruments standards—the IASB avoided imposing for a limited period accounting requirements that might be unsuitable for these contracts and enabled insurers to continue using existing practices.

14 IFRS 4 contains only limited requirements for financial instruments with discretionary participation features, prohibiting some practices. Specifically:

(a) IFRS 4 requires entities to apply few of the requirements of the financial instruments standards to financial instruments with discretionary participation features. It requires entities to apply only the disclosure requirements of IFRS 7 *Financial Instruments: Disclosures* and the requirements for embedded derivatives in IFRS 9 *Financial Instruments*.

(b) IFRS 4 permits the entity to account for the guaranteed element and discretionary participation feature separately or together:

(i) if recognised together, the whole amount must be classified as a liability and subject to a liability adequacy test. The issuer need not determine the amount that would result from applying IFRS 9 to the guaranteed element.

(ii) if recognised separately, the guaranteed element must be classified as a liability. The discretionary participation feature may be classified as a liability or a separate component of equity. IFRS 4 does not specify how the issuer determines whether the discretionary participation feature is a liability or equity, but prohibits any form of intermediate ('mezzanine') classification. If the issuer classifies part or all of the discretionary participation feature as a component of equity, the liability recognised for the whole contract must not be less than the liability that would be recognised applying IFRS 9 to the guaranteed element.

(c) IFRS 4 allows the entity to account for all premiums received as revenue without separating any portion that relates to an equity component.

15 In practice, many issuers of financial instruments with discretionary participation features choose to recognise the guaranteed element and discretionary participation features together and classify the whole amount as a liability, as described in paragraph 14(b)(i), i.e. measuring the liability without reference to IFRS 9 but with the application of a liability adequacy test.

USGAAP requirements

16 At present, US GAAP has no specific requirements for financial instruments with discretionary participation features (but no insurance). Such contracts are uncommon in the US. However, if the overseas operations of a US entity issues contracts with discretionary participation features but no insurance, the US entity would account for those contracts applying the financial instruments standards.

IASB and FASB proposals

IASB proposal

17 The IASB exposure draft proposed that the new model being developed for insurance contracts should also apply to other financial instruments with discretionary participation features.

18 To explain this proposal, paragraph BC198 of the basis for conclusions accompanying the exposure draft noted that:

(a) financial instruments with discretionary participation features are sometimes linked to the same underlying pool of assets as participating insurance contracts, and sometimes 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 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 other financial instruments. The

proposed model for insurance contracts was developed to generate useful information about contracts containing those features.

(c) financial instruments with discretionary participation features contain a complex package of interdependent options and guarantees (e.g. minimum guarantees, surrender options, conversion options and paid-up options). Accordingly, applying current and proposed requirements for financial liabilities, some of these features might be separated into components. Splitting these contracts into components with different accounting treatments applying to the separate components 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 for insurers.

19 One IASB member who voted against publication of the exposure draft disagreed with (among other things) the proposal to include financial instruments with discretionary participation features within its scope. He explained in his alternative view that:

AV10 Mr Smith disagrees with the requirement in the exposure draft to treat financial instruments with discretionary participation features as insurance contracts because they do not contain any insurance risk. As stated [in AV8], he also disagrees with recognising discretionary participation features as liabilities because they don't meet the definition of a liability under the *Framework*. He does not understand what is so unique about a financial instrument with a participation feature to require recognition of that instrument as an insurance liability. He believes this requirement permits structuring to avoid recognition of financial instruments under the accounting standards for financial instruments. He believes the intent-based nature of the participation feature and the subjectivity in applying a risk adjustment to estimates of cash flows under this exposure draft will create an accounting arbitrage inviting deposit taking institutions or any entity to add a participation feature to a financial liability to account for that instrument under this proposed standard. Having added a participation feature to the liability, the entity could avoid separating out embedded derivatives, then add a few renewal options, estimate cash flows considering its own tolerance and price for risk at inception and then subsequently change its intent about the extent of participation payments and immediately recognise the change in profit or loss.

20 Some of the requirements of the insurance contracts standard would need to be modified for contracts that do not include insurance. The modifications proposed in the IASB exposure draft are listed in the appendix to this paper.

FASB proposal

21 The FASB discussion paper proposed that the standard being developed for insurance contracts should apply only to those contracts that meet the definition of insurance. Therefore, other financial instruments with discretionary participation features would not be within the scope of the insurance contracts project and instead, the accounting in the financial instruments standards should be applied.

22 The FASB's reasons were explained in paragraph 37 of the FASB discussion paper. The reasons were that:

(a) these financial instruments do not meet the definition of an insurance contract because they do not transfer significant insurance risk to the insurer. Therefore, 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, financial instruments with discretionary participation features form a substantial part of an insurer's business. Including a substantial volume of non-insurance contracts in the scope of the proposed insurance guidance may 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 applying current guidance on financial instruments. Accounting for similar contracts using different accounting models would reduce comparability and add complexity.

Feedback from respondents

23 A substantial majority of respondents commenting on this matter—especially those in Europe and other jurisdictions that apply IFRS 4 at present—supported the IASB's proposal to apply the insurance contracts model to financial instruments with discretionary participation features. Those supporting the IASB's proposal included:

- all insurance regulators in jurisdictions that apply IFRSs at present,
- insurance regulators in the US,
- the American Council of Life Insurers,
- all actuaries,
- most of the large accounting firms (including two of the largest four), and
- the only user group commenting on this matter.

24 The main reasons cited by supporters of the IASB proposal were that:

(a) financial instruments standards do not provide sufficient guidance for discretionary participation features. For example, it is unclear to practitioners whether some discretionary participation features ought to be regarded as debt or equity and how their fair values should be measured. Respondents think that if these financial instruments were within the scope of IFRS 9, the IASB would need to develop additional guidance in that standard to avoid diversity in practice.

(b) the model proposed for insurance contracts is a more appropriate measurement model for contracts containing discretionary participating features than the model underpinning the financial instruments standards.

(c) it is simpler to include financial instruments with discretionary participation features within the scope of the insurance contracts standard than to amend the financial instruments standards to make their requirements more suitable for those instruments.

(d) financial instruments meeting the proposed criteria for inclusion in the insurance contracts standard are economically similar to participating insurance

contracts. They share key features that distinguish them from other investment contracts. For example, they tend to be subject to the same regulatory constraints as participating insurance contracts, and build on the principle of mutualisation of risk.

(e) the vast majority of investment contracts with discretionary participation features are issued by insurers and managed alongside participating insurance contracts. Including the contracts within the scope of the insurance contracts standard will simplify processes (reducing costs) and provide more readily understandable information to users.

25 There was less support for the IASB proposals from two groups of respondents—US insurers and Chinese respondents. Most US insurers, the two Chinese respondents commenting[1], and a minority of respondents in other categories instead supported the FASB proposals:

(a) most gave little explanation for their views beyond saying that financial instruments with discretionary participation features do not meet the definition of insurance contracts. They are economically different from insurance contracts and on principle should not be within the scope of a standard for insurance contracts.

[1] China Accounting Standards Committee and China Insurance Regulatory Commission

(b) some respondents thought that the facts that the financial instruments are within the scope of IFRS 4 at present, can contain complex options and guarantees and share in the performance of the same pool of assets as participating insurance contracts are not sufficient for accounting for them as if they *were* insurance contracts. Other financial instruments have complex features and entities manage to apply the financial instruments guidance to these instruments.

(c) one US insurer and one accounting firm further noted the concerns expressed in the alternative view in the IASB exposure draft, i.e. the risk that entities could add discretionary features to investment products to avoid the requirements of the financial instruments standards. Neither gave any specific examples.

26 Two of the largest accounting firms suggested a third option. They think that financial instruments with discretionary participation features should be accounted for in the same way as other financial instruments. They acknowledged the accounting issues that could arise applying existing financial instruments standards, but suggested that these issues should be addressed by reviewing and possibly amending those standards. One of the firms suggested that the boards should consider financial instruments with discretionary participation features within their project on 'financial instruments with characteristics of equity'. However, both firms added a view that unless (or until) the boards better address discretionary participation features within the financial instruments standards, instruments with those features should be within the scope of the proposed insurance contracts standard.

27 One body representing the banking sector noted that non-insurers might not have been paying close attention to the development of requirements for insurance contracts and so might not be aware of the consequences for other financial instruments with discretionary participation features. However, this respondent did not raise any specific concerns about the IASB proposals and all other banking respondents commenting on the matter supported the IASB proposals.

Appendix – Extract from the IASB exposure draft

Modifications to requirements for financial instruments with discretionary participation features

62 As specified in paragraph 2(b), this [draft] IFRS applies to financial instruments that contain a discretionary participation feature.

63 Such financial instruments do not transfer significant insurance risk. Therefore, some of the requirements in this [draft] IFRS are modified as described in paragraphs 64 and 65 when applied to those financial instruments.

64 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.

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.

66 Other requirements of this [draft] IFRS apply equally to a financial instrument with a discretionary participation feature, even though those contracts do not transfer significant insurance risk. For example, the cash flows arising from those financial instruments may be subject to uncertainty as a result of risks other than insurance risk (eg lapse risk and expense risk). If those risks are material, the present value of the fulfilment cash flows shall include a risk adjustment to reflect the risk that the ultimate cash flows may exceed those expected. But because financial instruments with discretionary participation features contracts do not transfer significant insurance risk, the application of some of the requirements in this [draft] IFRS may not be relevant or may not have a material effect.