STAFF PAPER

27 February - 2 March 2012

REG IASB Meeting

Project	**Insurance contracts**		
Paper topic	Financial instruments with discretionary participation features – applicable standard		
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Overview

1 This paper analyses, from an IFRS perspective, the arguments for and against including financial instruments with discretionary participation features (but insignificant or no insurance risk) within the scope of the insurance contracts standard.

2 The staff recommend that the IASB should include them.

The IASB is the independent standard-setting body of the IFRS Foundation, a not-for-profit corporation promoting the adoption of IFRSs. For more information visit www.ifrs.org

Structure of paper

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Background – differences between the requirements

3 If financial instruments with discretionary participation features (but insignificant or no insurance risk) were not included within the scope of the insurance contracts standard, they would be within the scope of the financial instruments standards:

(a) IAS 32 *Financial Instruments: Presentation*

(b) IAS 39 *Financial Instruments: Recognition and Measurement*, and

(c) IFRS 9 *Financial Instruments*

4 The requirements of these standards are different in several respects from those being developed for insurance contracts. Notably:

(a) issuers would recognise liabilities only for 'contractual obligations' (instead of for all expected cash outflows). Future distributions over which the issuer has constrained discretion might or might not be 'contractual obligations' depending on their exact terms and the regulatory environment in which the issuer operates.

(b) issuers would measure the liabilities at amortised cost or fair value (instead of at the present value of the fulfillment cash flows plus residual margin). In measuring the liabilities at fair value:

(i) the issuer would recognise them at no less than the amount payable on demand (ie no account would be taken of expected policyholder behaviour regarding the exercise of demand features); and

(ii) the issuer would also take into account non-performance risk.

(c) fewer acquisition costs might be deductible in measuring the liability. Only those costs that are directly attributable at the individual contract level (rather than at the portfolio level) would be deductible, and they would be deductible only if the liability is measured at amortised cost.

Staff analysis

Arguments against including in insurance contracts standard

5 As reported in paper 14A, most respondents to the exposure draft supported its proposal to include financial instruments with discretionary participation features within the scope of the insurance contracts standard. However, there were some opponents. This section considers opponents' concerns in more detail.

The instruments are not insurance contracts

6 Most respondents opposing the exposure draft proposals said simply that financial instruments with discretionary participation features are not insurance contracts. So, on principle, they should not be treated as if they *were* insurance contracts. They are financial instruments, so should be treated as such.

7 However, the Board would not be including financial instruments with discretionary participation features within the insurance contracts standard because it wants to portray them as if they were insurance contracts. It would be including them because of all the available models for financial instruments, the model developed for insurance contracts is the most appropriate one for instruments with discretionary participation features.

8 Insurance contracts are themselves financial instruments. The Board has decided that, like some other financial instruments (such as leases), insurance contracts have special features that justify a separate accounting standard. The model that has been developed for insurance contracts is designed to address the features that are often present in insurance contracts, including discretionary participation features. It is logical to use that model for all financial instruments for which it is more suitable than the general financial instruments standards.

Loss of comparability with other financial instruments

9 Some fear that including some financial instruments within the insurance contracts standard will reduce comparability. They note that the instruments would not be accounted for in the same way as other (possibly similar) financial instruments. For example, unlike other financial liabilities, they could be measured at an amount less than that payable on demand, because their measurement would take into account expected policyholder behaviour.

10 Clearly, the measurement of financial instruments within the scope of the insurance contracts standard will be different from the measurement of those within the scope of the other financial instruments standards. And the differences will mean that measurements will not be entirely comparable. However, the only way to ensure complete comparability would be to have a single set of requirements for all financial instruments, *including insurance contracts*. An inevitable consequence of introducing a separate standard for insurance contracts is that, whatever the scope of that standard, the amounts reported for contracts within its scope will not be fully comparable with the amounts reported contracts that are outside. The Board needs to position the scope boundary so that comparability is achieved where it is most needed, ie between the most similar items whose values are most likely to be compared.

11 It can be argued that comparability is more important between participating insurance contracts and other financial instruments with discretionary participation features than between financial instruments with such features and those without. Many insurers issue both participating insurance contracts and other financial instruments with discretionary participation features. As many respondents emphasised, the contracts are very similar. They share key features that distinguish them from other investment contracts. For example, they tend to be subject to the same regulatory constraints and build on the principle of mutualisation of risk. Respondents argued that accounting for these contracts in the same way provides users of financial statements with more comparable and readily understandable information.

Additional complexity

12 Some have also expressed a fear that applying the insurance contracts standard to financial instruments with discretionary participation features could cause additional complexities. For example, insurers would need to isolate these contracts from other financial instruments for accounting purposes.

13 However, respondents have said that the vast majority of financial instruments with discretionary participation features are issued by insurers and managed alongside participating insurance contracts. Insurers would have more difficulty isolating financial instruments with discretionary participation features from participating insurance contracts than they would have isolating them from other financial instruments (which they need to do anyway to apply the participation mechanism). In other words, excluding financial instruments with discretionary participation features from the scope of the insurance contracts standard would cause greater practical complexities than including them.

Structuring opportunitites

14 As detailed in paragraph 19 of paper 14A, one Board member who voted against the exposure draft expressed a concern that including financial instruments with discretionary participation features within the scope of the insurance contracts standard would permit structuring opportunities to avoid the requirements of the financial instruments standards. In his view, it would invite deposit-taking institutions or any other entity to add a discretionary participation feature to a financial liability.

15 However, respondents to the exposure draft did not highlight any particular risks. Although two respondents (a US insurer and an accounting firm) said that they agreed with the views of the dissenting Board member, they did not identify any specific problems that might arise in practice.

16 It is also of note that:

(a) an issuer could not add a discretionary participation feature to a contract without substantially changing the terms of the contract. To meet the definition of a discretionary participation feature, the contract would have to offer the holder 'additional benefits that are likely to be *a significant portion of the total* contractual benefits' and 'whose amount or timing is contractually at the discretion of the issuer'.

(b) these hypothetical structuring opportunities exist at present. Financial instruments with discretionary participation features are within the scope of IFRS 4 at present. The requirements of IFRS 4 are less prescriptive than those proposed for the new insurance contracts standard so might present greater structuring opportunities. However, the staff are not aware of any problems in practice.

Arguments for including in the insurance contracts standard

17 As reported in paper 14A, most respondents to the exposure draft supported the proposal to include financial instruments with discretionary participation features within the scope of the financial instruments standards. Two of the reasons they gave—comparability and practicability—are discussed in the previous section. The other two main reasons were that:

(a) the financial instruments standards could be difficult to apply to discretionary participation features; and

(b) the model developed for insurance contracts gives more meaningful information to users of financial statements.

18 These two arguments are explored further below.

Financial instruments standards could be difficult to apply

19 When discussing the difficulties of applying the financial instruments standards to discretionary participation features, many respondents focused on the difficulties of classifying the features.

20 Paragraph 15 of IAS 32 requires the issuer of a financial instrument to classify the instrument *or its component parts* as a financial liability, a financial asset or an equity instrument according to the substance of the contractual arrangement and the definitions of a financial liability, a financial asset and an equity instrument. IAS 32 defines a financial liability as a 'contractual obligation' and describes an entity as having an obligation that meets the definition of a financial liability when it does not have an unconditional right to avoid delivering cash or another financial asset to settle a contractual obligation[1]. It defines an equity instrument as 'any contract that evidences a residual interest in the assets of the entity after deducting all of its liabilities'.

21 The issuer of a financial instrument with discretionary participation feature has at least some contractual obligations (the guaranteed benefits). However, the additional benefits could be a separate 'component part' that, due to the combination of discretion and constraint, might be more difficult to classify. The issuer would need to distinguish its contractual obligations from any additional benefits that it expects to pay (for example, as a result of economic compulsion). The issuer would need to take into account regulatory and legal constraints and any special features (such as vesting

[1] Refer to IAS 32. 19

features) that can also influence payments. Identifying the extent of the contractual obligations could be difficult because the dividing line between a constructive obligation and economic compulsion can be difficult to determine, and the types of constraint that apply to discretionary participation features may fall in the grey area in the middle. The extent of an issuer's obligations is rarely tested: insurers tend to pay more than the minimum amounts that they think they could get away with paying, so they do not have historical evidence to support judgements about how much the minimum amount might be.

22 In practice, insurers might need to make many separate assessments, because the constraints vary from one jurisdiction to another, and from one type of contract to another. Each needs to be judged on a case-by-case basis. Judgements are also likely to change over time as judicial, regulatory and societal views evolve and as economic circumstances change. Therefore, the assessments could be unduly burdensome.

23 Further difficulties could arise because it is not clear how some of the requirements of the financial instruments standards would apply. For example, it is unclear whether the insurer's 'contractual obligations' include cash flows that existing contracts require to be paid to potential future policyholders. (The Boards have tentatively decided that the insurance contracts standard should require entities to include all payments that result from an existing contract, whether paid to current or future policyholders.)

24 Consequently, if the Board were to require issuers to apply the financial instruments standards to discretionary participation features, it might need to consider amending those standards. The amendments could result in requirements that are different from both the requirements for other financial instruments and the requirements for insurance contracts. The differences could reduce comparability and increase complexity without necessarily providing any significant advantages. Also, developing new requirements or guidance would take time. They might not be finalised within the proposed timetable for the insurance contracts standard. In which case, the boards would need to consider delaying the insurance contracts standard or

temporarily including financial instruments with discretionary participation features within its scope. The latter approach might result in two changes in practice for insurers—the first when they implement the insurance contracts standard and the second when they implement the amended requirements for financial instruments with discretionary participation features

25 Appendix A to this paper contains a more detailed staff analysis of the steps that issuers would need to follow to apply *existing* financial instruments standards to discretionary participation features, and the difficulties that could arise. The appendix also evaluates two ways in which IAS 32 could be amended to overcome *some* of the difficulties. However, the Board would not have to consider these amendments if it includes financial instruments with discretionary participation features within the scope of the insurance contracts standard.

More meaningful information

26 Supporters of the proposal to include financial instruments with discretionary participation features within the scope of the insurance contracts standard also argued that the requirements of that standard would lead to more useful information for investors: the most relevant measure of a contract with participating features is one that includes all cash flows that are expected to be paid to policyholders (and hence will not be available to other investors).

Convergence considerations

27 For reasons summarised in paragraph 22 of paper 14A, and analysed in paragraphs 5-16 of this paper, the FASB discussion paper proposed to limit the scope of the insurance contracts standard to insurance contracts only. Other financial instruments with discretionary participation features would then be within the scope of the financial instruments standards. The FASB has not yet re-deliberated this proposal. It is possible that, when it does so, it will reaffim the proposal.

28 However, the FASB and IASB might logically reach different conclusions on this matter because they have different factors to consider. Financial instruments with discretionary participation features (but without insurance) are uncommon in the US. Hence the benefits of including such instruments within the scope of the insurance contracts standard could be less in a US GAAP context than in an IFRS context.

29 Furthermore, because US GAAP financial instruments standards are different from IFRS financial instruments standards, the boards would not achieve convergence by simply including financial instruments with discretionary participation features within the scope of their respective financial instruments standards.

Staff conclusions and recommendations

30 The staff conclude that, from an IFRS perspective, the arguments for applying the insurance contracts model to all financial instruments with discretionary participation features outweigh the arguments for applying it to insurance contracts only.

31 Consequently, the staff recommend that the IASB should include financial instruments with discretionary participation features within the scope of the insurance contracts standard.

Question for the Board
Do you agree that the IASB should include financial instruments with discretionary participation features within the scope of the insurance contracts standard?

APPENDIX A

Applying financial instruments IFRSs to discretionary participation features

A1. This appendix:

(a) contains a more detailed staff analysis of the steps that issuers would need to follow to apply *existing* financial instruments IFRSs to discretionary participation features (DPF), and the difficulties that could arise (A2-A13), and

(b) evaluates two ways in which the standards could be amended to overcome some of the difficulties (A14-24). (The Board would not have to consider these amendments if it includes financial instruments with discretionary participation features within the scope of the insurance contracts standard.)

Steps needed to apply financial instruments standards

Debt versus equity

A2. In our view, the first issue to be addressed is whether the DPF as a whole or in part meets the definition of a financial liability. DPFs are not necessarily legally or contractually binding and some payments can be driven by economic compulsion.

A3. Economic compulsion is currently not sufficient to meet the definition of a financial liability in accordance with the IFRS literature[2].

[2] The issue of economic compulsion was discussed by the IFRIC during 2006. The IFRIC decided not to take the item onto its agenda. A summary of the rejection notice is in Appendix B.

A4. Therefore, from the issuer's perspective, a financial instrument with a DPF might be a compound instrument for which debt and equity components need to be identified and measured at inception.

A5. The issuer would need to separate the instrument into two components: a debt component (representing the present value of expected future cash flows that the issuer does not have an unconditional right to avoid settling) and an equity component (representing other expected future cash flows).

A6. Separating the instrument into a debt component and an equity component requires the issuer to identify the extent of its legal/contractual obligations, which can be difficult to achieve in practice. Payments under the DPF may be influenced by economic compulsion (eg market pressures) but there may also be regulatory and legal constraints or special features (such as vesting features) that can also influence payments. Accordingly, a careful analysis of the constraints would need to be performed on a case-by-case basis, as this type of contract falls into the 'grey area' when applying the definitions in IAS 32. Consequently, deciding which features are purely discretionary is not only a conceptual judgement but also a matter of facts and circumstances performed on a product-by-product basis.

A7. IAS 32 states that an instrument is an equity instrument if, and only if, "the instrument includes no contractual obligation to deliver cash or another financial asset to another entity; or to exchange financial assets and financial liabilities under conditions that are potentially unfavourable to the issuer."[3]

A8. Consequently, to the extent that there is no contractual obligation to deliver cash or another financial asset then, in accordance with the requirements in IAS 32, the DPF will meet the definition of an equity instrument.

[3] Refer to paragraph 16 of IAS 32.

Applying IAS 32 to an equity component

A9. Further references to the DPF in this appendix relate to any portion of the DPF that is classified as an equity instrument in accordance with IAS 32 following the analysis of the constraints.

A10. The equity component of the compound financial instrument should be recognised in equity at the inception date on the basis of the residual method[4] and it is not subject to subsequent measurement[5]. At inception the value of this equity component is likely to be zero or a relatively small amount[6], because the issuer has just engaged in the investment activities underlying the management policy of the financial instrument with the DPF. In accordance with IAS 32 irrespective of the performance of the investment activities this equity component will not be remeasured.

A11. The income from the assets backing the financial instrument with the DPF would be recognised when it arises whereas the related 'expense' with the DPF would only be recognised when the distribution under the DPF is declared.

A12. In practice, this would require entities to do a reclassification out of retained earnings once the distributions under the DPF are announced or triggers are achieved. This accounting is no different from distributing dividends to a special class of shareholders, for example, those owning preference shares whereby a liability is created and an adjustment to retained earnings is shown once the amounts are declared.

Differences between current practice and the requirements of IAS 32

A13. The requirements of IAS 32 are inconsistent with the way the economics of the DPF are typically managed and accounted for in practice. Applying IFRS 4, issuers often

[4] Refer to paragraph 31 of IAS 32.
[5] Refer to paragraphs 30 and 31of IAS 32
[6] The equity element will be the fair value of the guaranteed amounts less the fair value of the premiums received.

recognise the value to be paid as discretionary participation at each reporting date. This reflects the expected value of the payout from the insurer's perspective, taking into account its expectations, past experience and commercial considerations related to the underlying instrument and the competitive environment.

Possible amendments to IAS 32 to overcome problems

A14. The current practice of updating the expected value of the DPF undertaken for management purposes would contradict the current accounting requirements for equity instruments. To change the accounting to be consistent with the management's perspective, the Board would need to amend IAS 32. This section considers possible amendments. However, we note that the Board would not have to consider these amendments if it includes financial instruments with discretionary participation features within the scope of the insurance contracts standard.

Possible amendments

A15. The Board could develop a set of requirements within IAS 32 specifically for the equity components of financial instruments with discretionary participation features. This would be an exception that would create a model specifically designed for instruments containing DPFs that would be inconsistent with both the insurance contracts model and with the requirements in the financial instruments standards for other financial instruments that may also pay out based purely on economic compulsion.

A16. Alternatively, an exception could be added to IAS 32. The exception could deem financial instruments with discretionary participation features to be entirely debt instruments, ie treating the DPF as a financial liability (together with the guaranteed elements which will enable changes in the estimates of payments to be included in the measurement of the financial liability). That would require an exception to the

requirements of the financial instruments standards because the combined amount of the liability might contain a component that does not meet the definition of a financial liability.

Remaining difficulties

A17. This section considers the consequences if, because of its complexity, the debt versus equity classification guidance was amended, creating an exception requiring the entire financial instrument with a DPF to be included within the scope of the IFRS 9 / IAS 39 and accounted for as a financial liability.

A18. By including the financial instrument with a DPF within the scope of IFRS 9 / IAS 39, the unit of account ceases to be the components of the instrument (debt and equity) but instead the entire instrument would be treated as a financial liability.

A19. IFRS 9 allows financial liabilities to be accounted for either at fair value through profit or loss or at amortised cost. If the liability contains embedded derivatives these should be assessed for potential bifurcation[7] or, alternatively, the entire financial instrument should be accounted for at fair value through profit or loss. These consequences of measuring the instrument at amortised cost and fair value are explored below.

Amortised cost

A20. The fact that a DPF is, under the current IFRS literature, not likely to be classified as a financial liability, raises the question as to whether amortised cost would be an appropriate basis for accounting for instruments containing DPFs.

A21. Amortised cost has been designed to deal with the subsequent measurement of debt instruments that are not classified as at fair value through profit or loss. It is simply a

[7] Refer to paragraphs 4.3.3 to 4.3.7 of IFRS9

method for allocating interest over time. Therefore it works most appropriately with simple debt instruments made of principal and interest payments. Some insurers, manage their financial instruments that include DPFs as one aggregated liability (a'block' made of the guaranteed element and the DPF) on a present-value basis under current practice. The measurement of the 'block' (applying IFRS 4 that allows current GAAP to be applied) is similar, but not identical, to amortised cost. In particular, although the fixed component is measured similarly to amortised cost, the cash flows may be discounted using an updated discount rate and the DPF is generally measured at the present value of the expected payout. Thus we do not believe that current practice is entirely consistent with amortised cost measurement.

A22. Because of the limitations of amortised cost measurement, derivative features are required to be separated from hybrid debt liabilities under IFRS. In addition there are other factors to be considered, such as:

(a) The DPF is an embedded derivative that, based on the criteria for financial liabilities in IAS 39/IFRS9, needs to be assessed for separation. Application of the separation criteria in this context will raise complexity; and there could be difficulties in measuring the fair value of the separated derivative.

(b) Even if the derivative is not required to be separated, the outcome is similar to the one given by the insurance model, with the exception of the updates to the discount rate. If amortised cost is applied, the expected future cash flows of the financial liability will need to be reassessed and discounted using the instrument's original effective interest rate in accordance with paragraph AG8 of IAS 39.

Fair value

A23. The other option available within the financial instruments standards is to account for the whole instrument at fair value through profit or loss.

A24. Measuring the contract at fair value could give rise to difficulties. For example:

(a) The assets might not be measured at fair value. This will create accounting mismatches that will create volatility in profit or loss. (The insurance contract model avoids these

mismatches by requiring insurers to measure the liability on a basis that is consistent with the measurement of the assets). The accounting mismatches could be difficult to explain.

(b) If fair value is achieved as a consequence of applying the fair value option, the effect of the own credit risk needs to be separately recognised in other comprehensive income.

Appendix B – Summary of the IFRIC Rejection Notice – November 2006

At the IFRIC meeting in July, the Chairman reported the Board's discussions on the issue at its meeting in June 2006. As stated in the June 2006 IASB *Update*, The Board discussed whether so-called economic compulsion should affect the classification of a financial instrument (or a component of a financial instrument) under IAS 32 *Financial Instruments: Presentation*. This issue had previously been debated at the IFRIC meetings in March and May 2006. For a financial instrument (or a component of a financial instrument) to be classified as a financial liability under IAS 32, the issuer must have a contractual obligation either:

- to deliver cash or another financial asset to the holder of the instrument, or
- to exchange financial assets or financial liabilities with the holder under conditions that are potentially unfavourable to the issuer.(Different requirements apply to financial instruments that may or will be settled in the issuer's own equity instruments.)

The Board confirmed that such a contractual obligation could be established explicitly or indirectly, but it must be established through the terms and conditions of the instrument. Thus, by itself, economic compulsion would not result in a financial instrument being classified as a liability under IAS 32.

The Board also stressed that IAS 32 requires an assessment of the substance of the contractual arrangement. It does not, however, require or permit factors not within the contractual arrangement to be taken into consideration in classifying a financial instrument.

In view of the Board's discussion, the IFRIC believed that it could not achieve anything substantial by adding the issue onto the agenda. Instead, the IFRIC agreed to draw the Board's attention to comments raised by constituents and to ask the Board whether anything could be done to achieve even greater clarity on this point.