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Project	**Insurance contracts**		
Paper topic	Contracts with participating features: Background		
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Purpose of the paper

1. This paper has been provided as background for Agenda Paper 2B and should be read in conjunction with that paper. It describes:

   (a) The participating features that can be included in insurance contracts;

   (b) The proposals in the 2013 Exposure Draft *Insurance Contracts* for contracts with participating features; and

   (c) The response to the proposals in the comment letters.

2. Appendix A describes some characteristics of contracts with participating features, and Appendix B sets out the relevant references to the 2013 ED.

3. This paper does not ask any questions.

Participating features in insurance contracts

What are participating features?

4. Insurance contracts always provide payments to policyholders that depend on the occurrence of an insured event, and these payments do not vary with the return on underlying items. However, many insurance contracts also provide payments to

policyholders that vary with the returns on underlying items. We describe the feature in contracts that result in such payments as a participating feature.

5. Insurance contracts that contain participating features vary both within jurisdictions and between jurisdictions. Appendix A describes some characteristics of contracts with participating features and Appendix B describes some of the variations. However, all contracts considered in this paper include the following features:

   (a) The (individual) policyholder transfers insurance risk to the insurer in exchange for a premium, and thus receives insurance protection.[1]

   (b) The entity invests the premium in underlying items, and includes the underlying items in its financial statements (ie the underlying items are treated as assets and liabilities of the entity).

   (c) The overall performance of the underlying items is shared between the entity and the community of policyholders as a whole (the participating feature).

6. This section considers the following characteristics of contracts with participating features:

   (a) Payments to policyholders (paragraphs 7-8);

   (b) Options and guarantees embedded in contracts with insurance contracts (paragraphs 9-11); and

   (c) Sources of profit to the entity (paragraph 12).

Payments to policyholders

7. There is a wide variety in the payments that arise from participating features:

   (a) The payments can be specified in different ways, eg as a share of the returns from underlying items, as an amount credited to the policyholder which is set depending on the performance of underlying items, and the explicit or implicit deduction of fees.

[1] Much of this paper would also apply to investment contracts with discretionary participation featurss, which are within the scope of the proposed Standard. However, those contracts would not transfer any insurance risk.

(b) There may be restrictions on when the policyholder can receive payments, for example on the earlier of an insured event or a specified maturity date, and at specified withdrawal dates. Alternatively, the policyholder's could have unrestricted access but may be subject to surrender penalties.

(c) The underlying items may include specified assets or investments, groups of assets or liabilities or the profits of an entity. In more complex situations, the underlying items may be specified in terms of a combination of mortality experience, expenses and investment returns.

(d) The underlying items can either be held directly by the entity, or be used as a reference point to determine the cash flows that will be paid to policyholders (eg in index-linked contracts or contracts that return the performance of all assets held by the insurer, including those that are not segregated, such as general account assets).

8. The defining characteristic of contracts with participating features is that the entity shares some of the investment risks with the policyholder. However, the contractual terms of the contract may permit an element of management discretion over the extent to which the payments to policyholder follow the returns on the underlying items. For example:

(a) In some cases, the contract may be prescriptive about the amounts that are paid to the policyholder in different circumstances, for example because of options or guarantees embedded in insurance contracts (see paragraphs 9-11).

(b) In other cases, the contract may allow the entity to exercise discretion, for example:

(i) about the amount of the payments to policyholders. The entity may have the discretion to limit the returns on policyholders through an explicit or implicit cap on payments.

(ii) about the timing of the payments to policyholders. A common feature of such contracts is that some payments to policyholders may be specified for the pool of policyholders as a whole, rather than to individual policyholders. This means that the payments owed to a policyholder leaving a

pool may be paid to a new policyholder joining the pool instead.

(iii) about the amount of the fees or charges. Some contracts permit the insurer to determine the fees or charges within a predefined range. In effect, fess or charges reduce or increase the cash outflows to the policyholders.

Options and guarantees embedded in contracts with participating features

9. A common feature of contracts with participating features is that the entity is restricted by the presence of options or guarantees embedded in insurance contracts. Such options and guarantees specify the payments that the entity will not be able to avoid making to policyholders in particular circumstances. The following table contains typical options and guarantees embedded in these contracts.

Examples of options and guarantees

Guaranteed death benefit

The entity makes a payment on the death of the policyholder. The death benefit does not depend on the amount the policyholder has invested.

Guaranteed minimum death benefit (GMDB)

The policyholder invests premiums which accumulate over time. The entity guarantees that there is a minimum amount that the policyholder will receive in event of death. That minimum amount may be based on the amount of premiums invested.

Guaranteed minimum accumulation benefit (GMAB)

The entity makes a payment on surrender or maturity. The entity guarantees that pay outs will be a minimum amount at a point in time.

Guaranteed Annuity Option (GAO)

The policyholder invests premiums which accumulate over time. At a point in the future the accumulated funds are converted to an annuity at a rate at least as favorable as a rate agreed at inception. The entity then makes annuity payments until the policyholder dies.

10. The staff have used the term ‘guarantees’ to describe payments that the entity has no discretion to avoid. Such guarantees include:

(a) insurance guarantees, in which the entity has no discretion to avoid payments to policyholders that occur when an insured event occurs.

(b) financial guarantees to the policyholder about the return on the invested premium that is attributed to the policyholder. Depending on the terms of the contract, the payments to the policyholder could be made on maturity or withdrawal. Financial guarantees provide payments to policyholders that do not vary directly on the returns on the assets that the entity acquired using the premiums paid in by the policyholder. In effect, financial guarantees provide the policyholder with the option to receive the higher of a fixed amount and the returns on the investment.

(c) a combination of an insurance and a financial guarantee, for example in the case of a financial guarantee that is paid only on the occurrence of an insured event.

11. Financial guarantees embedded in an insurance contract result in cash flows that are similar to the cash flows in financial instruments that are within the scope of IFRS 9 *Financial Instruments*. Accordingly, the proposals in the ED would have required the entity to unbundle and apply IFRS 9 to financial guarantees that meet the definition of distinct investment components or embedded derivatives. Distinct investment components or embedded derivatives would occur if the terms of the contract clearly specified the payments from the participating feature in all circumstances, and include specified equity-index, commodity index, foreign currency derivatives, and specified minimum interest guarantees with dissimilar risks from the host insurance contract. However, the difficulty arises when the investment component is **not** distinct, because the investment component and the insurance component are highly interrelated as described in paragraph B32 of the ED. Such components are not unbundled, but accounted for together with the rest of the insurance contract as a whole.

Sources of profit for the entity in contracts with participating features

12. An entity may use a combination of fees/charges and expected returns as sources of profits from contracts with participating features:

(a) In some cases, a contract with a participating feature may pass all of the investment returns on underlying items to the policyholder,r subject to

explicit fees, as in the case of some unit-linked contracts. However in most cases, the entity expects to make profits by retaining some of the investment returns from underlying items that were purchased using the premium paid by the policyholder.

(b) An entity may apply a fee or charge, for example cost of insurance charges, mortality charges or asset management charges. Such fees and charges may be flat rate, based on a nominal account balance (ie a fund value) or based on the returns achieved. The fees or charges may be applied when premiums are paid, throughout the contract term, on exit, or any combination of these. Paragraph 10(c) of the 2013 ED propose that an entity should unbundle and apply other applicable standards to a distinct performance obligation to provide services, including asset management services. However, asset management services are sometimes not a distinct performance obligation, for example if the cash flows and risks associated with the service are highly interrelated with the cash flows and risks associated with the insurance components in the contract, and the entity provides a significant service of integrating the good or service with the insurance components. Such asset management fees are not unbundled, but accounted for together with the rest of the insurance contract as a whole

The proposals in the 2013 ED

13. According to the proposals in the 2013 ED, an entity measures an insurance contract at initial recognition at the sum of:

    (a) the amount of the fulfilment cash flows[2]; and

    (b) a contractual service margin, which calibrates the measurement of the insurance contract at initial recognition to the expected premiums.

14. After initial recognition, the insurance contract is measured at the sum of:

    (a) the fulfilment cash flows at that date; and

[2] Fulfilment cash flows are the explicit, unbiased and probability-weighted estimate (ie expected value) of the present value of the future cash outflows less the present value of the future cash inflows that will arise as the entity fulfils the insurance contract, including a risk adjustment.

(b) the remaining amount of the contractual service margin, which is determined as the carrying amount of the contractual service margin at the start of the period, adjusted to reflect:

(i) the accretion of interest on the contractual service margin

(ii) the amount of the contractual service margin recognised in profit or loss in the period. Agenda paper 2C discusses the recognition pattern of the margin for non-participating contracts.

(iii) differences between the current and previous estimates of the present value of cash flows related to future coverage and other future services, subject to the condition that the contractual service margin should not be negative.

15. At its March 2014 meeting, the IASB tentatively decided to adjust the margin after inception to reflect differences between the current and previous estimates of the present value of cash flows and the risk adjustment related to future coverage and other future services. Those differences should be added to, or deducted from, the contractual service margin, subject to the condition that the contractual service margin should not be negative.

16. Thus, the proposals in the ED represent an insurance contract as comprising both:

(a) An obligation to pay net future cash outflows, represented by the fulfilment cash flows; and

(b) An obligation to provide insurance coverage over the coverage period (ie a performance obligation), represented by the contractual service margin.

Together, the fulfilment cash flows and the contractual service margin provide an updated representation of the entity's obligations in the insurance contract.

Applying the general proposals in the ED to contracts with participating features

17. The general proposals in the ED would apply to contracts with participating features as follows:

(a) The entity would measure the insurance contract on the basis of the risk-adjusted expected present value of cash flows (ie the fulfillment cash flows). In determining the fulfillment cash flows:

(i) The entity includes all the cash flows that arise from the rights to share in the returns on underlying items . Such cash flows include contractual and discretionary cash flows, and cash flows arising from existing contracts regardless of whether paid to current or future policyholders.

(ii) The entity discounts the expected cash flows using discount rates that reflect the characteristics of the cash flows of the liability. When the amount, timing of uncertainty of cash flows arising from an insurance contract depends wholly or partly on the returns on underlying items, the characteristics of the cash flows of the liability include that dependence and the discount rate used to measure the insurance contract should also reflect that dependence.

(b) The entity would present in profit and loss the interest expense determined at the date when the contract was initially recognized. For cash flows that vary directly with returns on underlying items, the entity would update those discount rates when it expects changes in those returns to affect the amount of those cash flows. Thus, the interest expense recognised in profit and loss relating to cash flows that vary with the returns on underlying items would be akin to the interest from a variable rate financial instrument measured at amortised cost or fair value through other comprehensive income.

(c) The entity would present in other comprehensive income the difference between:

(i) interest expense determined using the discount rate at reporting date (ie the current discount rate); and

(ii) interest expense recognized in profit or loss.

18. Applying these general proposals in the 2013 ED, the measurement of the insurance contract would reflect current expectations about all the future cash flows paid as a result of investment returns on underlying items, in the same way that the fair value of

the underlying items would reflect current expectations of all the future cash flows from investment returns on underlying items. Accordingly, when the underlying items are measured at fair value through profit or loss, there would be substantially no mismatches between the cash flows from the contract and the underlying items.

19. However, accounting mismatches could still arise when the underlying items are not measured at fair value through profit or loss. Therefore, the 2013 ED proposed that there should be a measurement and presentation exception for some types of contracts with participating features. This exception is commonly referred to as the "mirroring exception". The mirroring exception was intended to eliminate all accounting mismatches between the cash flows of the contract and the cash flows of the underlying items and would apply only to contracts for which there could be no possibility of an economic mismatch. The ED specified that this would be the case for contracts for which the entity is required to pass on returns from underlying items to the policyholder and for which the entity is required to hold those underlying items.

Applying the mirroring exception

20. To apply the mirroring exception, an entity would identify, and apply different measurement bases to:

    (a) cash flows that varied directly with underlying items, which would be measured on the same basis as the underlying items; as distinct from

    (b) all other cash flows, which would be measured using the general approach in the ED.

    Some refer to the separation of cash flows in this way as bifurcating, or decomposing, the cash flows.

21. An entity would present changes in the cash flows that varied directly with underlying items on the same bases as the presentation of the underlying items. However, there are differences in the presentation of changes in the other cash flows, as follows:

    (a) changes in cash flows that vary indirectly with underlying items would be presented in profit or loss; and

(b) changes in cash flows that are fixed or that do not vary (directly or indirectly) with underlying items are presented in accordance with the general requirements of the ED, ie:

(i) as an offset to the contractual service margin, for changes in estimates of cash flows that relate to future service;

(ii) in profit and loss, for changes in estimates of cash flows that do not relate to future service, and for the risk adjustment; and

(iii) in OCI for the effect of changes in the discount rate.

22. Thus, the Exposure Draft proposed different presentation requirements for changes in the fulfilment cash flows that vary indirectly with underlying items (which are intended to include embedded options and guarantees), depending on whether the contract met the criteria for mirroring, as follows:

(a) When mirroring applies, the changes in the fulfilment cash flows that vary indirectly with underlying items would be presented in profit or loss.

(b) When mirroring does not apply, the changes in the fulfilment cash flows that vary indirectly with underlying items are recognised as described in paragraph 21(b).

The response to the proposals in the comment letters

23. Many constituents disagree that some types of participating insurance contract should be measured and presented on a different basis from other insurance contracts. Those with this view were concerned that this would result in reduced comparability, for example:

(a) between the measurement of contracts to which mirroring applies, and those to which it does not;

(b) between the presentation of the options and guarantees embedded in insurance contracts to which mirroring is applied, and those to which it is not (and to options and guarantees embedded in contracts that are not insurance contracts); and

(c) within the mirroring approach, between an insurance contract for which the entity accounts for the assets backing the contract at amortised cost, and an otherwise identical contract for which the entity accounts for the assets backing the contract at fair value.

24. Some believe that the marked difference in accounting does not reflect the more subtle differences in contract characteristics, and believe the proposals to portray a misleading difference.

25. Question 2 of the ED asked for respondents' views on contracts that would be eligible for the mirroring exception. However, although the ED did not ask an explicit question about the proposals for contracts in which there is dependence on underlying items when the mirroring exception would not apply, some constituents also raised their concerns.

26. Some requested further clarification on most of the aspects of the proposals. It appears that there was widespread confusion on scope of the proposals and how the mirroring exception would be applied to the many variations of contracts with participating features.

27. This section describes a high level summary respondents' views on:

(a) The accounting for contracts with participating features that are not eligible for the mirroring exception (paragraphs 28-33);

(b) The scope of the mirroring exception (paragraphs 34-38);

(c) The accounting for contracts that are eligible for the mirroring exception (paragraphs 39-44); and

(d) Alternative proposals described in the comment letters for the accounting for contracts with participating features (see paragraphs 45-47).

Further details are provided in agenda paper 2B where relevant.

Contracts with participating features that are not eligible for the mirroring exception

28. Some respondents were concerned that the application of the general proposals in the ED would require entities to apply different discount rates to different types of cash

flows within a contract with a participating feature because of the following proposals:

(a) The proposal that discount rates should reflect the extent to which the cash flows depend on asset returns.

(b) The proposal to determine interest expense in profit or loss on the basis of the locked-in discount rate, updated when the entity expects any changes in returns on underlying items to affect the amount of cash flows. Some interpreted this requirement as implying that an entity is required to apply separate discount rates to each set of cash flows.

29. Respondents with this concern believe that any requirement to apply different discount rates to different types of cash flows would result in excessive operational complexity. They recommend instead that a single discount rate should be applied to all cash flows that do not qualify for mirroring.

30. Some observe that in a contract with participating features, the investment returns that are not passed to the policyholder result in profit for the entity. Some believe that changes in estimates of such profits should adjust the contractual service margin, because such amounts would affect the amount of profit the entity is expected to earn from the combined effect of the insurance contracts and the assets held to provide the returns promised in the contract.

31. These suggested adaptions to the general model are discussed further in Agenda paper 2B.

32. Some noted a lack of clarity over the requirements for determining interest expense, as follows:

(a) It was unclear when the entity should update the discount rate to reflect changes in returns on underlying items that affect the cash flows. For example, within a universal life contract, there could be different interpretations about whether a fixed death benefit varies or does not vary directly with returns on underlying items:

(i) If the fixed death benefit is regarded as fixed, the entity would apply a discount rate locked-in at inception.

(ii) However, universal life contracts often lapse if the account balance goes to zero, in which case the death benefit will not be paid. Because the account balance is directly dependent on the level of credited rates, which are directly dependent on returns on the underlying items, some consider these death benefit cash flows as varying directly with returns on underlying items. Accordingly they would discount these cash flows using a rate that is updated when there the entity expects any changes in returns from underlying items to affect the amount of cash flows.

(b) Some seek clarification on whether the discount rate should be updated to the current, market-consistent liability rate. Some suggest instead that interest expense presented in profit or loss should be determined as the book yield on the backing assets, ie an amount based on the return on the assets backing insurance contracts that is recognised in profit or loss in the period or an amount calculated using an effective rate/level yield method.

33. Some suggest the use of OCI for presenting specified changes in insurance contract liabilities should be optional. In March 2014, the IASB decided that, for non-participating contracts, entities should choose to present the effect of changes in discount rates in profit and loss or in other comprehensive income as its accounting policy and should apply that accounting policy to all contracts within a portfolio, subject to further guidance that would be developed. We will consider as part of the deliberations on contracts with participating features, whether the IASB should extend that decision to contracts with participating features.

Scope of the mirroring exception

34. The ED proposed that an entity would apply the mirroring exception only if the contract:

(a) Requires the entity to hold the underlying items; and

(b) Specifies a link between the payments to the policyholder and the returns on those underlying items.

35. Many constituents found these requirements unclear. As a result, there was diversity in the interpretation of the scope, and some participants were uncertain whether mirroring would apply to particular contracts. Particular issues identified were:

    (a) In some cases, the requirement to hold assets is specified by a regulator, rather than by the contract. It appears that some had interpreted such contracts as being outside the scope of mirroring.

    (b) In some cases, the payments to policyholders reflect a large number of factors, including management discretion. Some interpreted the proposals as requiring the entity to identify any traceable link to underlying assets, and to apply mirroring to those cash flows.

    (c) Some ask whether the mirroring approach would be applied in cases in which there is discretion over the timing of the distribution or allocation of profits on participating contracts to policyholders.

    (d) Some ask how the mirroring approach would be applied to charges that are based on the amounts attributable to the policyholder.

36. Some think that the proposals would be workable only for the simplest participating contracts, such as those in segregated fund arrangements. For such contracts, almost all the cash flows from the contract would vary directly with the underlying items, and the decomposition of cash flows would not be arbitrary.

37. Some mutual entities questioned the complexity of applying the proposals to participating contracts when the ultimate surplus will ultimately be distributed to policyholders in their capacity as owners. However, some note that the ultimate outcome for a mutual is that the entire surplus must be shared between policyholders and thus think that mirroring would be necessary to avoid accounting mismatches.

38. Some respondents observed that the criteria for the mirroring exception would mean that there would be a relatively narrow number of contracts to which the mirroring exception could apply. Some believe that the complexity that would be introduced by having different accounting approaches for different types of contracts would not be justified because of this narrow scope would mean that only some and not all accounting mismatches would be avoided. In contrast, some suggest retaining the mirroring proposals, but restricting the scope to mutual and unit-linked/segregated

fund contracts, possibly on an optional basis (see paragraphs 36 and 37). The staff plans to consider if a mirroring approach is needed after considering what adaptions are needed to the general model to account for contacts with participating features.

Contracts that are eligible for the mirroring exception

39. Some respondents, for example in Canada and Asia, supported the mirroring exception because it would eliminate accounting mismatches when the terms of the contract mean the entity will not suffer any economic mismatches. They agreed that the mirroring exception would result in a faithful representation of the fact that the amount the entity is obligated to pay is equivalent to the value of the underlying items.

40. However, many constituents had significant concerns about the mirroring proposals in paragraphs 33 and 34 of the ED. While most were sympathetic to the IASB's intention of eliminating accounting mismatches using a mirroring approach, most objected to the specific proposals in the ED for doing so.

41. Some are concerned about the depiction of an insurance contract that is measured using the mirroring exception. In particular, some preparers and regulators are concerned that when the underlying items are measured at cost, the carrying value of the insurance contract would not be a current value. As a result, it would widen the difference between the liability measured for financial reporting purposes, and the liability recognised for regulatory purposes in some jurisdictions.

42. However the main concern about the mirroring exception related to the perceived complexity of applying the approach.

43. Many constituents believe that it would be difficult for entities to identify the component of the insurance contract that would be measured on the basis of the underlying items (especially if the underlying items were measured using different accounting bases), and the component of the insurance contract that would be measured according to the general proposals in the ED. They observe that the IASB's model was designed to treat an insurance contract as a bundle of rights and obligations, and that the IASB had previously decided that there should be limited unbundling of those rights and obligations, on the basis that it would be arbitrary and complex to do so. Accordingly, they believe that it would be difficult to separate and

separately measure part of the probability-weighted estimate of cash flows, particularly if the ED were to require a separation that does not align with the way that many insurers view their products. Their objections are:

(a) Any decomposition of cash flows is arbitrary, yet different methods of decomposition would lead to different valuations of the insurance contract, and arbitrary measurement in the balance sheet or in the profit reported in the statement of comprehensive income.

(b) When the guarantees embedded in the insurance contract vary from year to year, the entity would need to decompose and mirror a different proportion of the liability each year. Some constituents note that this would increase the operational difficulties of applying the mirroring proposals.

(c) Some comment that they can separately measure the time value of options and guarantees under their existing practices. However, they would not be able to divide them into a component to be recognised in P&L and a component to be recognised in OCI.

These concerns are similar to those described in 28 and 29 about applying different discount rates to different sets of cash flows.

44. Finally, some preparers are concerned that if an entity applies the mirroring approach at initial recognition, the contractual service margin could be mis-stated if the underlying items are not measured at fair value. Some note that the IASB would need to clarify that the contractual service margin should be determined on the basis of non-mirrored cash flows.

Alternative proposals for the accounting for contracts with participating features

45. Some doubt that the IASB would be able to resolve the practical difficulties with applying the mirroring proposals. In addition, some observe that, as a principle, accounting mismatches are best dealt with by consistency of measurement approaches rather than by exceptions. Accordingly, some suggest that there should be no measurement and presentation exception for participating contracts, but that the

general approach should instead be used to measure all insurance contracts at a current value.

46. However, views on how to address accounting mismatches between the cash flows of the insurance contract and the cash flows of the underlying items differ:

    (a) some propose that all insurance contract liabilities should be measured using the general proposals of the ED, and that any accounting mismatch should be dealt with by modifying the accounting for the underlying items instead.

    (b) some observe that the main problem that the mirroring exception aims to solve could be dealt with much more simply, by allowing use of other comprehensive income to be optional rather than mandatory, as described in paragraph 33.

47. Some think that the general model proposed in the ED could be adapted for contracts with participating features, to address the concerns described in paragraphs 28-33. However, others propose alternative models for contracts with participating features. These alternative models are discussed in agenda paper 2B, which considers the possible adaptations to the general model proposed in the ED to reflect contracts with participating features.

Appendix A: Examples of participating contracts

This appendix sets out an extract from Appendix B of agenda paper 3Fof the March 2011 Joint Board meeting.

A1. The following information on country-specific types of participating contracts is based on an (internal) survey by members of the Insurance Accounting Committee of the International Actuarial Association (IAA). We thank them for providing the information. They are not responsible for how the staff have summarised the information.

A2. Belgian participating contracts provide a contractual right to share in surplus, but usually do not give specific guidance on how the policyholder participates in the surplus or which share belongs to the policyholder. The insurer determines annually the policyholders' share of surplus, which is solely based on the insurer's discretion (the insurer is entirely free to pay the policyholder any amount between 0 to 100% of the surplus). After determining the policyholders' share in surplus for the current year, the Belgian regulators require the insurer to pay out 80% of the amounts set aside for allocation to policyholders in the following year. The remaining 20% are to be payable to policyholders in later periods.

A3. Finnish participating contracts determine the policyholders' share entirely based on the insurer's discretion. Actual payments are only driven by competitive market pressure. The insurer decides when to realise surpluses, the individual policyholder's share in that surplus and the timing of the actual allocation. The regulator ensures that the insurer does not allocate surpluses if doing so potentially endangers the insurer's financial stability.

A4. South African life insurers have discretion on the policyholders' share in surplus, as well as on the amount and timing of its allocation or distribution to the individual policyholder. The amounts set aside for policyholders can be negative if they are expected to be recovered during the following three years.

A5. In Australia the policyholders' share in surplus is set aside and allocated to the individual policyholder according to a formula. Legally, the insurer is obliged to set aside 80% of the surplus for policyholders. Some contracts grant an even higher percentage. The amount set aside may become negative and carried forward. If the insurer voluntarily pays more than 80% (or whatever contractually is required), that can be carried forward, thus reducing future amounts to be set aside to pay dividends to future policyholders

A6. Canadian participating contracts require an annual allocation of amounts to individual policyholders, payable immediately in the following year. Law requires that the directors must adopt a formal dividend policy and adopt methods for allocation, which an appointed actuary must approve. In Canada there is little discretion in determining the amount or timing of the surplus once allocated. The contribution principle is followed, with the Appointed Actuary recommending dividends to the entity's Board.

A7. Most Japanese participating contracts force the insurer to immediately set aside policyholders' contractually specified share in the realised surplus. These amounts are not immediately payable to the individual policyholder, but rather are aggregated over time. The timing of the irrevocable allocation is at the discretion of the insurer, even though the surplus is already realised. The amounts set aside are revocable and loss absorbing, including those referring to future periods of the individual contract.

A8. In the US, the types of contracts are diverse, partly due to significantly different state regulations. Some states allow insurers to apply significant discretion in declaring dividend scales; however, overall they are subject to regulatory control. Regulators are expected to intervene in case of inadequate dividend scales, but that remains untested since in the past all insurers acted in accordance with regulatory rules. If stock insurers issue participating contracts, the amounts distributable to stockholders may be limited by some state laws.

A9. In the UK participating features are contractually and legally established. The sources to determine the surplus need to be specified and may include sources from non-participating contracts. Policyholders' individual share is typically required to be at least nine times of any allocation to shareholders from aggregated unallocated surplus, to be allocated immediately to policyholders when amounts are allocated to shareholders.

A10. In the Czech Republic and Slovakia participating contracts determine the policyholder's share as a fixed percentage of the realised surplus. The insurer's only discretion is when to realise the surplus, as there is no discretion on timing of allocation or amount of payment to the individual policyholder.

A11. Norwegian law prescribes that the policyholders' share in surpluses has to be two thirds of each annual surplus (partly including unrealised gains). When policies terminate, there is an obligatory payment of 75% of any surpluses (including unrealised gains) determined at that point in time. Insurers can decide when to realise gains (apart from terminating contracts), but there is no further discretion available.

A12. In Italy the participation feature is guaranteed by law to be an entity-wide average of 85% of the realised surpluses (unrealised gains and losses excluded). The exact policyholder's share in the surplus is specified in the individual contract as a specific percentage of investment earnings. The individual policyholder receives its share every year according to the results of the previous year.

A13. French life insurers issue participating investment contracts with a guaranteed minimum annual rate of return on premiums paid, a distinct share in investment returns on the entire surplus of the entity. Under French law the insurer can immediately forward shares in realised surplus to individual policyholders. The remaining amount of the overall required share for policyholders is set aside. However, the insurer has some discretion regarding the timing of the allocation to the individual policyholder. The allocation has to be done within 8 years. The amount set

aside can be used to cover subsequent losses to some extent and there might be as well a loss carry forward to be recovered by future surplus.

A14. In some states in the US, e.g. New York, state law requires that the insurer sets a minimum percentage of surplus aside for ultimate distribution to policyholders each year. At the same time the law grants insurers some discretion regarding its ultimate allocation. The contribution principle is considered in this allocation.

A15. In Germany, virtually all life insurance contracts are participating contracts. There are strict rules determining the share of recognised surplus that has to be set aside for participation of policyholders. Although the subsequent allocation of the amount set aside to individual policyholders is at the discretion of the insurer, the contribution principle is applied. Losses of a period are generally borne by the insurer. Unallocated amounts can be used to cover subsequent losses if otherwise the insurer would be in financial danger. If contracts terminate for any reason, the policyholder receives an appropriate share of unrealised gains allocable to its contract.

The following table provides a summary of the different mechanisms for allocating performance according to the types of participating contracts. It was adapted from HUB group discussion paper *Accounting for Insurance Contracts with Participating Features: Current-current through OCI with a Floating Residual Margin* dated 23 April 2012 , and is reproduced without change from agenda paper 2B for the IASB's meeting in December 2012.

Description of some types of participating contracts	**Types of benefits**			
	Guaranteed fixed by formula	**Discretionary** determined and paid at the discretion of the entity	**Terminal** determined and paid when the contract terminates	**Unit-linked** benefit linked to unit prices of an investment fund
Discretionary 90/10 The policyholder is legally or contractually entitled to receive at least 90% of the (post-tax) statutory result of the business. The insurer usually decides to pay more than the 90%. The actual amount to be paid is unknown until declared each year by the insurer.	✓	✓		
Fixed 90/10 The insurer is only entitled to receive 10% of earnings on the business. All other earnings must be paid to policyholders. However, dividends are not necessarily paid in the year earned.	✓			
With profits The returns on the underlying items are typically volatile; consequently, a large proportion of the returns are distributed at the end. The annual bonus (ie regular or reversionary bonus) is often small, reflecting the uncertainty in the sustainability of current returns. Bonuses are declared when deemed supportable/certain. The insurer may choose not to declare annual bonuses if returns are unsustainable. The final bonus (ie terminal bonus) is calculated when the policy matures, or is surrendered close to maturity, and is determined so that the policyholders get their fair share of the returns. The insurer's share in the distribution of surpluses is in direct proportion to the provision of the guaranteed bonuses over the duration of the contract.	✓		✓	
No guaranteed participation rate Participation is not typically guaranteed. Dividends are determined annually by the board of directors. There may not be a fixed spread or other element that determines the amount paid. Terminal bonuses are often paid but are not generally important.		✓		
Variable/Unit-linked A contract for which some or all of the benefits are determined by the price of units in an internal or external investment fund (ie a specified pool of assets held by the insurer or by a third party and operated in a manner similar to a mutual fund).				✓

Appendix B: ED proposals for contracts with participating features

From the standard

Relating to separating components from an insurance contract (paragraphs B31–B35)

9 An insurance contract may contain one or more components that would be within the scope of another Standard if they were separate contracts. For example, an insurance contract may include an investment component or a service component (or both). Such a contract may be partially within the scope of this [draft] Standard and partially within the scope of other Standards. An entity shall apply paragraphs 10–11 to identify and account for the components of the contract.

10 An entity shall:

(a) separate an embedded derivative from the host contract and account for the embedded derivative in accordance with IFRS 9 if, and only if, it meets both of the following criteria:

(i) the economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host contract (see paragraphs B4.3.5 and B4.3.8 of IFRS 9); and

(ii) a separate financial instrument with the same terms as the embedded derivative would meet the definition of a derivative and would be within the scope of IFRS 9 (for example, the derivative itself is not an insurance contract).

The entity shall measure the embedded derivative as if it had issued it as a stand-alone financial instrument that is initially measured in accordance with IFRS 9 and attribute any remaining cash flows to the other components of the insurance contract.

(b) separate an investment component from the host insurance contract and account for it in accordance with IFRS 9 if that investment component is distinct (see paragraphs B31–B32). The entity shall measure a distinct investment component as if it had issued it as a stand-alone financial instrument that is initially measured in accordance with IFRS 9 and attribute any remaining cash flows to the other components of the insurance contract.

(c) separate from the host insurance contract a performance obligation (as defined in [draft] IFRS X Revenue from Contracts with Customers) to provide goods or services (see paragraphs B33–B35). The entity shall account for a distinct performance obligation to provide goods or services in accordance with paragraph 11 and other applicable Standards if that performance obligation to provide goods and services is distinct.

(d) apply this [draft] Standard to the remaining components of an insurance contract. Throughout this [draft] Standard, the components of an insurance contract that remain after separating the components within the scope of other Standards in accordance with (a)–(c) are deemed to be an insurance contract.

11 After applying paragraph 10 to separate any cash flows related to embedded derivatives and distinct investment components, an entity shall, on initial recognition:

(a) attribute the remaining cash inflows between the insurance component and any distinct performance obligations to provide goods or services in accordance with [draft] IFRS X Revenue from Contracts with Customers; and

(b) attribute the remaining cash outflows between the insurance component and any distinct performance obligations to provide goods or services in a way that attributes:

(i) cash outflows that relate directly to each component to that component; and

(ii) any remaining cash outflows on a rational and consistent basis, reflecting the costs that the entity would expect to incur if it had issued that component as a separate contract.

B31 Paragraph 10(b) requires an entity to separate a distinct investment component from the host insurance contract. Unless the investment component and insurance component are highly interrelated, an investment component is distinct if a contract with equivalent terms is sold, or could be sold, separately in the same market or same jurisdiction, either by entities that issue insurance contracts or by other parties. The entity shall take into account all information that is reasonably available in making this determination. The entity need not undertake an exhaustive search to identify whether an investment component is sold separately.

B32 An investment component and insurance component are highly interrelated if:

(a) the entity is unable to measure the one without considering the other. Thus, if the value of one component varies according to the value of the other, an entity shall apply this [draft] Standard to account for the whole contract containing the investment component and the insurance component; or

(b) the policyholder is unable to benefit from one component unless the other is also present. Thus, if the lapse or maturity of one component in a contract causes the lapse or maturity of the other, the entity shall apply this [draft] Standard to account for the whole contract containing the investment component and insurance component.

Relating to cash flows

B66 Cash flows within the boundary of an insurance contract are those that relate directly to the fulfilment of the portfolio of contracts and include:

…

(k) payments arising from existing contracts that provide policyholders with a share in the returns on underlying items (see paragraph 33), regardless of whether those payments are made to current or future policyholders.

B67 The following cash flows shall not be considered when estimating the cash flow that will arise as the entity fulfils an existing insurance contract:

(a) investment returns on underlying items. The investments are recognised, measured and presented separately. However, the measurement of an insurance contract may be affected by the cash flows, if any, that depend on the investment returns.

(b) ….

B68 Paragraph 30 requires an adjustment to the remaining amount of the contractual service margin for a difference between the current and previous estimates of the cash flows that relate to future coverage and other future services. Accordingly:

…

(d) the contractual service margin is not adjusted for changes in estimates of cash flows that depend on investment returns if those changes arise as a result of changes in the value of the underlying items. Such changes do not relate to services provided under the contract.

(e) the contractual service margin is adjusted for changes in estimates of cash flows that are expected to vary directly with returns on underlying items only if those cash flows relate to future services under the insurance contract. For example, changes in cash flows relating to asset management services that are provided under a contract relate to future services under the insurance contract. Gains or losses on the underlying items do not relate to unearned profit from future services from the insurance contract and are recognised in accordance with the Standards relevant to the underlying items.

Relating to discount rates

26 Estimates of discount rates shall be consistent with other estimates used to measure the insurance contract to avoid double counting or omissions, for example:

(a) to the extent that the amount, timing or uncertainty of the cash flows that arise from an insurance contract depends wholly or partly on the returns on underlying items, the characteristics of the liability reflect that dependence. The discount rate used to measure those cash flows shall therefore reflect the extent of that dependence.

…

B73 To the extent that the amount, timing or uncertainty of the cash flows that arise from an insurance contract depends on the returns on underlying items, paragraph 26(a) requires the characteristics of the liability to reflect that dependence. The discount rates used to measure those cash flows shall therefore reflect the extent of that dependence. This is the case regardless of whether that dependence arises as a result of contractual terms or through the entity exercising discretion, and regardless of whether the entity holds the underlying items.

B75 In some circumstances, the most appropriate way to reflect any dependence of the cash flows that arise from an insurance contract on specified assets might be to use a replicating portfolio technique (see paragraphs B46–B48). In other cases, an entity might use discount rates that are consistent with the measurement of those assets, and that have been adjusted for any asymmetry between the entity and the policyholders in the sharing of the risks arising from those assets.

Relating to the presentation of interest expense

60 An entity shall recognise in profit or loss:

…

(h) unless paragraph 66 applies, interest expense on insurance contract liabilities determined using the discount rates specified in paragraph 25 that applied at the date that the contract was initially recognised. For cash flows that are expected to vary directly with returns on underlying items, the entity shall update those discount rates when it expects any changes in those returns to affect the amount of those cash flows.

66 If an entity applies paragraphs 33–34 because the insurance contract requires the entity to hold underlying items and specifies a link to returns on those underlying items, an entity shall recognise:

(a) changes in the fulfilment cash flows that result from applying paragraphs 33–34 in profit or loss or other comprehensive income on the same basis as the recognition of changes in the value of the underlying items;

(b) changes in the fulfilment cash flows that are expected to vary indirectly with those returns on underlying items in profit or loss; and

(c) changes in the fulfilment cash flows that are not expected to vary with those returns on underlying items, including those that are expected to vary with other factors (for example, with

mortality rates) and those that are fixed (for example, fixed death benefits), in profit or loss and in other comprehensive income in accordance with paragraphs 60–65.

Relating to disclosure

80 If an entity applies the requirements of paragraphs 33–34 and 66 to insurance contracts that require the entity to hold underlying items and specify a link to returns on those underlying items:

(a) the entity shall disclose the amounts in the financial statements that arise from the cash flows to which the entity has applied paragraphs 33–34 and 66; and

(b) if the entity discloses the fair value of underlying items that are measured on a basis other than fair value, it shall disclose the extent to which the difference between the fair value and the carrying amount of the underlying items would be passed on to policyholders.

Relating to the mirroring exception

33 An entity shall apply paragraph 34 if the contract:

(a) requires the entity to hold underlying items such as specified assets and liabilities, an underlying pool of insurance contracts, or if the underlying item specified in the contract is the assets and liabilities of the entity as a whole; and

(b) specifies a link between the payments to the policyholder and the returns on those underlying items. The entity shall determine whether the contract specifies a link to returns on underlying items by considering all of the substantive terms of the contract, whether they arise from a contract, the law or regulation.

34 When paragraph 33 applies, the entity shall, at initial recognition and subsequently:

(a) measure the fulfilment cash flows that are expected to vary directly with returns on underlying items by reference to the carrying amount of the underlying items (meaning that paragraphs 18–27 do not apply); and

(b) measure the fulfilment cash flows that are not expected to vary directly with returns on underlying items in accordance with paragraphs 18–27. Such cash flows include fixed payments specified by the contract, options embedded in the insurance contract that are not separated and guarantees of minimum payments that are embedded in the contract and that are not separated in accordance with paragraph 10.

B83 Paragraph 34 specifies requirements that eliminate accounting mismatches between the cash flows from an insurance contract and underlying items when the terms of the contract mean that the entity will not suffer any economic mismatches. That is the case when the criteria in paragraph 33 are met, ie when the contract specifies a link to those underlying items.

B84 The criteria in paragraph 33 would not be met if either of the following apply:

(a) the payments arising from the contract reflect the returns on identifiable assets or liabilities only because the entity chooses to make payments on that basis. In that case, the entity may choose to avoid economic mismatches by making payments that are expected to vary directly with returns on underlying items, but it is not required to do so. However the entity is not required to avoid the economic mismatches that would arise if it held other assets or liabilities.

(b) the entity could choose to hold the underlying items and so could avoid the economic mismatches, but is not required to hold those underlying items.

B85 For contracts meeting the criteria in paragraph 33, an entity determines the fulfilment cash flows that are expected to vary directly with returns on underlying items and measures those fulfilment cash flows on a different basis from the other fulfilment cash flows. An entity shall decompose the cash flows in a way that maximises the extent to which the measurement both:

(a) expresses the cash flows in a way that illustrates the extent to which they are expected to vary with returns on underlying items; and

(b) maximises the minimum fixed payment that the policyholder will receive.

B86 For example, if a contract promises to pay a policyholder a minimum of CU1,000 plus 90 per cent of the increase in the fair value of underlying items ('A') above an initial fair value of CU1,000, the cash flows could be decomposed in the following ways:

(a) as a fixed amount plus a written call option, ie

CU1,000 + [90% Å~ the greater of (A – CU1,000) and CU0];

(b) as 100 per cent of the assets plus the value of the guarantee (a written put option) less the value of the entity's 10 per cent participation in the upside (a call option held), ie

A + [the greater of (CU1,000 – A) and CU0] – [10% Å~ the greater of (A – CU1,000) and CU0]; or

(c) as 90 per cent of the assets plus a fixed payment of CU100 plus 90 per cent of the increase in the assets above CU1,000, ie

[90% Å~ A] + CU100 + [90% Å~ the greater of (CU1,000 – A) and CU0].

However, only (c) would meet the conditions in paragraph B85 because it expresses the cash flows in a way that maximises the extent to which they are expected to vary with returns on underlying items, and the minimum fixed payment the policyholder will receive.

B87 The general requirements in paragraphs 60–65 for presentation in profit or loss or other comprehensive income would not apply to those cash flows that are expected to vary directly with returns on underlying items. However, the entity would apply the requirements in paragraphs 60–65 to the cash flows in contracts that are not expected to vary with returns on underlying items.

From the Basis for Conclusions

To avoid undue length, the staff has not reproduced extracts of the Basis for Conclusions relating to participating contracts. The following table provides references to the appropriate sections of the Basis for Conclusions

Topic	Relevant paragraphs in the Basis for Conclusions
Separating components from an insurance contract	BCA189-BCA208
Adjusting the contractual service margin by changes in the carrying amount of underlying items	BC38-BC41
Cash flows that are expected to vary with returns on underlying items	BC42-BC44 BCA58-BCA63
Discount rate when cash flows depend on assets	BCA84-BCA88
The mirroring exception: Contracts that require the entity to hold underlying items and specify a link to returns on those underlying items	BC45-BC50
Changes in value of options embedded in insurance contracts	BC51-BC53
Complexity from the need to decompose cash flows	BC56-BC62
Alternative proposals for scope of mirroring exception	BC63-BC71
Determining interest expense in profit or loss: applying general model	BC117-BC124
Determining interest expense in profit or loss: in the mirroring exception	BC125-BC132
Identifying assets that back insurance contracts	BC146-BC147
Using a book yield to determine interest expense	BC158-BC159