

STAFF PAPER

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REG IASB Meeting

Project	Insurance contracts		
Paper topic	Financial instruments with discretionary participation features - definition		
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Paper overview

The Board will need to discuss this paper only if it agrees with the staff recommendation in paper 14B that financial instruments with discretionary participation features should be within the scope of the insurance contracts standard.

- 1 This paper considers the proposed definition of a ‘discretionary participation feature’. In particular, it considers feedback on the exposure draft proposal to add to the existing definition (in IFRS 4 *Insurance Contracts*) a requirement for the contracts to share in the performance of the same pool of assets as insurance contracts.
- 2 The staff recommend that this requirement *should not* be added to the definition—the definition should be the same as the existing definition in IFRS 4.

IASB exposure draft proposals

3 The IASB exposure draft proposed to define 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,

provided that there also exist insurance contracts that provide similar contractual rights to participate in the performance of the same insurance contracts, the same pool of assets or the profit or loss of the same company, fund or other entity.

(Emphasis added)

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.

4 The definition of a discretionary participation feature would play a less significant role in the new insurance contracts standard than it plays in IFRS 4 at present. In IFRS 4, the definition applies to both participating insurance contracts and other participating investment contracts, and it serves to permit specified practices to continue until the Board replaces IFRS 4. In contrast, the only function of the definition in the new standard would be to identify the contracts within the scope of the standard.

5 The definition proposed in the exposure draft is identical to the existing definition in IFRS 4, *except* for the addition of the final criterion shown in italics. This final

criterion would limit the scope of the insurance contracts standard to financial instruments that share in the performance of the same pool of assets¹ as insurance contracts.

- 6 The IASB proposed to add this criterion to strengthen the case for treating financial instruments with discretionary participation features in the same way as participating insurance contracts. If two contracts participate in the same pool of assets, differing treatments could lead to odd results. The criterion also helped to allay the concerns of those Board members who were worried about what they saw as a risk of structuring.
- 7 The IASB proposed to add the criterion on the understanding that financial instruments with discretionary participation features issued by insurers *always* share in the performance of the same pools of assets as insurance contracts.

Feedback

- 8 The IASB exposure draft invited comments on the proposed definition of a discretionary participation feature. Approximately one third of respondents commented. The only aspect of the definition that gave rise to significant comment was the proposed additional criterion.

¹ This paper uses 'pool of assets' as shorthand for the complete range of items and entities (ie insurance contracts, pools of assets, funds, companies and other entities) listed in the exposure draft.

Support for proposed definition

- 9 A small number of respondents said they agreed with the definition proposed in the exposure draft. They were typically accounting standard setters and accountancy professional bodies, and typically from North America, Asia and Oceania (where the instruments are less common). They included only a handful of insurers (none from Europe) and one group of actuaries (the Czech actuaries).
- 10 Most of these respondents gave little or no reason for their support. Those who gave a reason expressed a view that the proposed new criterion:
- (a) was consistent with the business practice of many insurers;
 - (b) would make the boundary of the definition clearer; or
 - (c) was a practical anti-avoidance measure, which would help limit the scope to contracts that are designed and managed alongside insurance contracts.
(Nobody mentioning this point gave any examples of avoidance that might occur in the absence of the criterion.)

Opposition to the proposed additional criterion

- 11 Most respondents commenting on the exposure draft definition opposed the proposal to restrict it to contracts that participate in the performance of the same pool of assets as insurance contracts. These respondents included most of the insurers and actuaries, all of the insurance regulators and the only financial statement user commenting on the matter.
- 12 Many of these respondents noted that the financial instruments with discretionary participation features issued by insurers do *not* always share in the performance of the same pool of assets as insurance contracts. Regulators in some jurisdictions, such as Italy, require the pools to be segregated. Regulators in other jurisdictions, such as Germany, require the pools to be segregated in some circumstances, for example if the proportion or value of the instruments that are not insurance contracts exceeds a specified threshold. If the insurance contracts model applied only to contracts that

shares in the performance of the same pool of assets as insurance contracts, insurers would need to apply different accounting models to essentially identical transactions, with the categorisation of contracts made on the basis of an ‘arbitrary’ or ‘artificial’ boundary.

- 13 In some cases, the accounting would depend solely on whether a policyholder chose to add optional insurance cover to an investment contract, or whether the proportion or value of an insurer’s financial instruments exceeds a threshold set by the regulator. The applicable standard could change from one period to the next, if during that time an insurer exceeded a regulatory threshold and was required to segregate assets. The objective—a single accounting model for all the contracts with discretionary participation features—would not be met, undermining the usefulness of the financial statements and requiring insurers to implement more complex systems and processes.
- 14 Some respondents, including an insurance regulator, also raised a concern that including the criterion could lead to accounting arbitrage opportunities. The applicable accounting standard could depend on how an insurer *chose* to pool its assets. They could divide the pools differently to achieve the valuation method that suited them better. Further inconsistencies could arise if entities reached different interpretations of the criterion, eg on the meaning of ‘similar’ contractual rights or on the number or volume of insurance contracts needed to satisfy the criterion.
- 15 A few respondents suggested alternatives. They suggested that, if the boards wanted to narrow the range of financial instruments to which the insurance contracts standard applies, they could instead restrict it to contracts that are:
- (a) issued by insurers; or
 - (b) managed alongside insurance contracts.

Staff analysis

- 16 The IASB proposed to amend the definition of a discretionary participation feature on the understanding that the amendment would not have any significant effect in practice

- for insurers—ie, having been told that participating financial instruments issued by insurers *always* share in the performance of the same pools of assets as insurance contracts.
- 17 The exposure process has identified that this is not in fact the case. Including the additional criterion would require insurers to adopt two different accounting models for essentially the same contractual obligations (the applicable model depending on how the insurer organises its business) creating additional costs for insurers and making the amounts reported in financial statements less comparable.
- 18 To avoid these unintended consequences, the boards could:
- (a) *change* the criterion to a requirement that the contracts are issued by insurers, or a requirement that the contracts are managed alongside insurance contracts, as suggested by some respondents; or
 - (b) *omit* the additional criterion completely, ie keep the existing IFRS 4 definition.
- 19 In favour of changing the criterion to a requirement for the contracts to be issued by insurers or managed alongside insurance contracts, it could be argued that including such a requirement could reduce any risk of structuring and avoid interpretation questions. (The IFRS Interpretations Committee was asked to consider one such question—concerning real estate investment trusts—in 2009.)
- 20 In favour of omitting the additional criterion completely, ie keeping the existing IFRS 4 definition, it could be argued that:
- (a) responses do not indicate that the Board needs to take active steps to avoid structuring or address any specific interpretation questions. No respondents identified any specific concerns about applying the existing IFRS 4 definition. And although the Interpretations Committee was asked to provide an interpretation on real estate investment trusts, it concluded that an interpretation was not required. (The rejection notice is reproduced in the appendix to this paper.) None of the respondents to the exposure draft raised any concerns about the Interpretations Committee decision.

- (b) any criterion that restricts the scope of the insurance contracts standard to contracts issued by insurers would have the effect of creating an industry standard. The applicable standard would not depend solely on the nature of the transaction: it would also depend on the nature of the entity's other transactions. Such an outcome would be contrary to the overall objectives of the insurance contracts standard.
- (c) a requirement for contracts to be 'managed alongside' insurance contracts could be difficult to interpret. Further guidance might be required, and it might be difficult to identify a meaningful principle to underpin the guidance.

Staff conclusions and recommendations

- 21 For the reasons in paragraphs 17 and 20, the staff recommend that the definition of a discretionary participation feature should be the same as that in IFRS 4 at present. The Board should not add a requirement for the contracts to share in the performance of the same pool of assets as insurance contracts.

Question for the Board

Do you agree that the definition of a discretionary participation feature should be the same as that in IFRS 4 at present—the Board should not add a requirement for the contracts to share in the performance of the same pool of assets as insurance contracts?

APPENDIX: IFRIC Agenda Decision on Real Estate Investment Trusts

A1. The January 2010 IFRIC *Update* included the following rejection notice:

IFRS 4 Insurance Contracts and IAS 32 Financial Instruments: Presentation - Scope issue for REITs

In some jurisdictions, a Real Estate Investment Trust (REIT) is a tax or regulatory designation used for an entity investing in real estate that meets certain criteria, for example to attain preferential income tax status. In some of these cases, the contractual terms of the ownership units of such REITs require it to distribute 90 per cent of the Total Distributable Income (TDI) to the investors. The remaining 10 per cent of TDI may be distributed at the discretion of management. The IFRIC received a request to provide guidance on whether the discretion to distribute the remaining 10 per cent of TDI met the definition of a Discretionary Participation Feature (DPF) as defined in IFRS 4. If the DPF definition is met, IFRS 4 permits the ownership units to be classified as a liability, rather than assessing the instrument for financial liability and equity components in accordance with IAS 32.

The IFRIC noted that the objective of IFRS 4 is to specify the financial reporting for insurance contracts. The IFRIC noted that the definition of DPF in Appendix A of IFRS 4 requires, among other things, that the instrument provides the holder with guaranteed benefits and that the DPF benefits are additional to those guaranteed benefits. Furthermore, the IFRIC noted that there must be guaranteed benefits to the holder for the definition to be met and that such guaranteed benefits are typically those present in insurance activities. The IFRIC noted that providing guidance on this issue would be in the nature of application guidance, rather than interpretative guidance. Consequently, the IFRIC decided not to add the issue to its agenda.