Aktuarielles Controlling I (Teil 3)
Basics of IFRS 4 for Life Insurers

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1. Introduction

The implementation of the IFRS accounting standards for insurers is planned in 2 phases:

- **Phase I**, in force since 2005, is documented in **IFRS 4**; it is only an **interim solution with focus on disclosure**
- In **phase II**, the **planned final version of IFRS for insurers with focus on valuation**, the **"Fair Value Concept"** should be introduced for all relevant Balance Sheet items
- The **Fair Value Concept** implies the **valuation of all assets and liabilities** of the Balance Sheet with **market values**, if existing, or with "market-near" values (market consistent valuation; "marktnahe" Werte)

1. Introduction

- The introduction of phase II was originally planned for 2011; but it is delayed for one or two years
- **Coordination** with
  - **Solvency II** (especially concerning the valuation of the liabilities) and
  - **US GAAP**

  is striven for
    - This coordination takes time
- An exposure draft of the new version of IFRS for insurers was published in July 2010 and is now in discussion
  - If this new version is accepted, it will imply a revolution for the accounting system of insurers

1. Introduction

- In this paper the accounting system according to IFRS 4 for life insurers is presented as it is valid in the year 2010

- In a separate paper, the main ideas of the exposure draft of IFRS for life insurers will be presented at the end of this autumn lecture or at the beginning of the following spring lecture

1. Introduction

- According to IFRS 4, three different classes of contracts are distinguished:
  - **insurance contracts**
  - **investment contracts with Discretionary Participation Feature (with DPF)**
  - **investment contracts without DPF**
- In **insurance contracts** there is **significant insurance risk**
- In **investment contracts** there is **significant financial risk, but no or not material insurance risk**

1. Introduction

- If the **policyholders' participation is at the discretion of the insurance company** there is normally a **DPF** (for details on DPF see chapter 12)

- **IFRS 4 is applied to:**
  - **insurance contracts issued**
  - **reinsurance contracts issued or held**
  - **investment contracts with a DPF**

- **IAS 39 is applied to investment contracts without DPF**

1. Introduction

- Since **IFRS 4 is "only" an interim solution, IFRS 4** consists of **general principles**
  - There is **some freedom to define the concrete accounting policy according to IFRS 4**
- **One fundamental principle of IFRS 4 allows the insurer to change its accounting policy if, and only if, the new valuation method is moving in the direction of market values (market consistent valuation)**
  - This is not only possible for a total insurance company or group, but it is even allowed only for special sub-portfolios of a company (see § 22 and § 24 IFRS 4)
- Changes of the accounting policy should increase the reliability or relevance of the financial reporting

1. Introduction

- § 22 IFRS 4 reads as follows:
  - **"An insurer may change its accounting policies for insurance contracts if, and only if, the change makes the financial statements**
    - **more relevant to the economic decision-making needs of users and no less reliable, or**
    - **more reliable and no less relevant to those needs.**
  - **An insurer shall judge relevance and reliability by the criteria in IAS 8."**

1. Introduction

- Consequences of these principles are:
  - **IFRS 4 does not aim at an uniform accounting policy**
  - **IFRS 4 does not provide detailed valuation requirements** (except for valuing invested assets)
  - **IFRS 4 aims pushing the accounting policy towards fair value (market value)**
  - **IFRS 4 does allow to continue current accounting policy** (“grandfathering”)
  - **IFRS 4 introduces significant disclosure requirements**
  - **US GAAP is judged as more market consistent than local statutory**

1. Introduction

- **Continuation of current accounting policy ("grandfathering") includes**
  - **valuation of provisions** (technical reserves)
  - **valuation of insurance assets** (e.g. DAC or PVFP)
  - **valuation of insurance liabilities** (e.g. URL)
  - **income and outgo recognition** (e.g. premiums and benefits)

- **Continuation of current accounting policy ("grandfathering") does not include valuation of invested assets**
  - **For the valuation of invested assets there are specific rules in IFRS 4** (see chapter 5)

1. Introduction

- In **IFRS 4** there are **no prescribed IFRS-specific procedures for valuing**
  - **provisions** (technical reserves)
  - **insurance liabilities** (e.g. URL according to US GAAP)
  - **insurance assets** (e.g. DAC) and
  - **reinsurance contracts held**
- So, there is some freedom in defining the accounting policy for these items
- **But, in IFRS 4** there are **IFRS-specific rules how to value**
  - **invested assets** (see chapter 5)

1. Introduction

- In contrast to this, **US GAAP** consists of **concrete rules** for all items mentioned above
- That is why the US GAAP rules are very often used if IFRS 4 is silent on a topic
- **The concrete implementation of IFRS 4 is at the discretion of the insurer and his external auditor**
- The so called **"First Time Adapter" (FTA) should use this freedom in a favorable manner**
  - A FTA is an insurer who uses the accounting principles of IFRS 4 for the first time
- **US GAAP is judged as more market consistent than local statutory**

1. Introduction

- Concerning the **provisions** § 26 IFRS 4 is relevant; it reads as follows:
  - “An insurer need not change its accounting policies for insurance contracts to eliminate excessive prudence. However, if an insurer already measures its insurance contracts with sufficient prudence, it shall not introduce additional prudence.”

1. Introduction

- Motivation for the above principles is to avoid a huge workload for implementing a new accounting policy which is valid only for a short time and which must be changed when phase II of IFRS for insurer is set in force
- In principle, **US GAAP is assessed as closer to fair value as local statutory**
  - So, if a FTA uses US GAAP, he can go on using US GAAP under IFRS 4, but he is not allowed to go back to local statutory accounting
  - On the other hand, if a FTA uses up to the introduction of IFRS 4 only local statutory accounting,
    - he can go on using local statutory under IFRS 4
    - but he is also allowed, for example, to switch to US GAAP

1. Introduction

- **The First Time Adapter has to decide how IFRS 4 is interpreted and accordingly introduced**

- As a consequence of this freedom, in the consolidated accounts under IFRS 4 of an insurance group
  - there may be a company using **local statutory** accounting policy

  and
  - there may be another company using **US GAAP**
- In addition, it is possible that another company uses only for a special portfolio **fair value provisions**; i.e. the provisions are calculated using current market interest rates

1. Introduction

- For the **technical reserves** of the consolidated financial statements of an insurance group this can imply for different companies in the group that
  - one company uses **unzillmerized reserves** and activated acquisition costs according to local statutory rules
  - another company uses **zillmerized reserves** (without activated acquisition costs)
  - another company uses **US GAAP reserves** and activated acquisition costs according to US GAAP rules and
  - another company uses for a special portfolio **fair value provisions using current interest rates**

1. Introduction

- **As in US GAAP, under IFRS 4 the invested assets may be valued for the Balance Sheet in a different way as for the investment income in the P&L**
- **Under IFRS 4, there is no freedom for defining the accounting policy for the valuation of invested assets**

  (For details on valuation of invested assets see chapter 5)

1. Introduction

- **As in US GAAP, under IFRS 4 it is not allowed**
  - **to have equalization provisions**
  - **to have catastrophe provisions**
  - **to offset reinsurance assets with direct insurance liabilities**
    - So, the direct insurance liabilities are shown gross and the reinsurance assets are shown explicitly; together the presentation of the financial statements is net of reinsurance
    - By using this gross method for reinsurance, the exposition to credit risk of reinsurance is shown

1. Introduction

- Under IFRS 4 **unbundling** of the
  - **insurance (risk) component** and the
  - **deposit (savings) component**

  is introduced to avoid the omission of assets or liabilities from the insurer's balance sheet

  (For details on unbundling see chapter 2)

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2. Contract Classification

- According to IFRS 4, three different classes of contracts are distinguished:
  - **Insurance contracts**
  - **Investment contracts with DPF**
  - **Investment contracts without DPF**
- **For insurance contracts and for investment contracts with DPF the accounting policy is defined by IFRS 4**
- **For investment contracts without DPF the accounting policy is defined by IAS 39**
- **For reinsurance contracts issued or held the accounting policy is again defined by IFRS 4**

2. Contract Classification

According to the appendix A (Defined Terms) of IFRS 4, the definition of an **insurance contract** is as follows:

- An **insurance contract** is "a contract under which one party (the **insurer**) accepts **significant insurance risk** from another party (the **policyholder**) by agreeing to compensate the policyholder if a specified uncertain future event (the **insured event**) adversely affects the policyholder" (annuities in payment?)
- **Insurance risk** is defined as a "risk, other than **financial risk,** transferred from the holder of a contract to the issuer"

2. Contract Classification

- **Financial risk** is defined as "the risk of a possible future change in one or more of a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract."

2. Contract Classification

- In **IFRS 4,** there is **no distinction** of the insurance contracts **according to**
  - **life / non-life insurance**
  - **contracts' duration**
  - **profit participation systems**

  as in US GAAP

2. Contract Classification

- **Examples for insurance contracts according to IFRS 4:**
  - Traditional endowments financed with single or regular premiums
  - Unit-linked endowments financed with single or regular premiums
  - Term insurance contracts
  - Annuities, immediate or in payment
  - Deferred annuities with annuity rates fixed at inception
    - If the annuity rates are fixed when the annuity option is exercised, the contract may not be classified as an insurance contract during the deferment period

2. Contract Classification

- **Examples for insurance contracts according to IFRS 4:**
  - Employee benefit business according to the BVG
  - "Freizügigkeitspolicen" if they have insurance risk

  - **Riders and supplementary contracts** are assessed together with the base contracts

2. Contract Classification

- **The insurance cover can vary during the contract period:**
  - Term insurance: significant insurance risk during the whole contract period
  - Endowment: decreasing insurance risk during the contract period
  - Deferred annuity with annuity rates fixed at inception: during the savings period no insurance risk, during the payment period significant insurance risk

- The following classification principle is used:
  - **Once insurance contract, always insurance contract**

2. Contract Classification

- **Investment contracts** are contracts which **bear significant financial risk, but have no significant insurance risk**
- Those contracts can be either
  - **investment contracts with DPF**

  or
  - **investment contracts without DPF**
    - These contracts are sometimes also called **pure investment contracts**

2. Contract Classification

- **Examples for investment contracts with DPF:**
  - "Freizügigkeitspolicen" with usual bonus, but with no significant insurance risk
  - Financial products with technical interest rates and annually determined participation, but with no significant insurance risk (e.g. financial products in Belgium, Pension Funds in Czech)

2. Contract Classification

- **Examples for investment contracts without DPF:**
  - Unit-linked contracts with no significant insurance risk
  - Financial contracts with technical interest rates linked to interest rates of matching zero bonds without participation and without significant insurance risk (e.g. Pension Funds in Hungary, financial products in Luxembourg)
  - Because of tax reasons, there are **no relevant life products in Switzerland** which are classified as **investment contracts without DPF**

2. Contract Classification

- **Riders and supplementary contracts are not specific contracts; they should be considered together with the main contract as part of that whole contract**
  - Thus, if a rider to a main contract – which would be an investment contract without DPF on a stand alone basis – includes significant insurance risk, then the whole contract should be considered as an insurance contract

2. Contract Classification

- **Unit-linked contracts** have **"automatic participation features"**, as the payments are linked to the performance of a specified pool of assets

- Therefore, unless a risk component or another guarantee qualify them as insurance contracts (including a guaranteed minimum death benefit for instance), **such unit linked contracts are classified as pure investment contracts, i.e. as investment contracts without DPF** and IAS 39 must be applied

2. Contract Classification

- Under IFRS 4 **unbundling** of the
  - **insurance (risk) component**

  and the
  - **deposit (savings) component**

  is introduced to avoid the omission of assets and liabilities from the insurer's balance sheet

2. Contract Classification

- **Unbundling** of a deposit component **is required** if, and only if,
  - the deposit component can be measured separately; i.e. without considering the insurance components

  and
  - the existing insurer's accounting policy fails to recognize all the obligations and rights arising from the deposit component

- **Unbundling is prohibited** if an insurer cannot measure the deposit component separately as mentioned above

2. Contract Classification

- **Unbundling is permitted, but not required,** if
  - the deposit component can be measured separately; i.e. without considering the insurance components

  and
  - the existing insurer's accounting policy requires it to recognize all obligations and rights arising from the deposit component, regardless of the basis used to measure those rights and obligations

- **For unit-linked contracts unbundling is not required**

2. Contract Classification

- **Unbundling given,**
  - the **insurance component** is treated as an **insurance contract according to IFRS 4**

  and
  - the **deposit component** is treated as an **investment contract without DPF** (i.e. as a **pure investment contract**) **according to IAS 39**

- According to a paper of the IAA, there are no deposit components with DPF after unbundling

2. Contract Classification

- For **deposit business**, the savings premiums are not shown as income and the corresponding reserves are not shown as a financial liability; this is the same treatment as in US GAAP

2. Contract Classification

- According to the "Schweizerische Aktuarvereinigung" (**SAV**), for **Swiss life products unbundling is**
  - **only possible for unit-linked contracts**, but not necessary
  - **not allowed for the employee benefit business according to BVG**

- **Hence for Swiss life insurance companies, unbundling is not a very relevant topic**

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3. Expense Classification

- **In IFRS 4**, there are **no detailed rules for classifying expenses**, in contrast to US GAAP
- However, it is necessary to define
  - which part of the acquisition expenses is deferrable to determine the DAC and which part is not deferrable
  - which part of the administration expenses is recognized in the Expected Gross Profits (EGPs) for the DAC amortization and which part is not recognized
- Under IFRS 4, one can use the expense classification according to US GAAP
  - See the same chapter in “Basics of US GAAP for Life Insurers”

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4. BS and P&L Structure

- Concerning the structure of the Balance Sheet and the Profit & Loss account, no new principles are introduced by IFRS 4
  - See the same chapter in "Basics of US GAAP for Life Insurers"
- There are some new elements as for instance the DPF

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5. Asset Classification

- As in US GAAP, there are in IFRS 4 the following three asset classes:
  - **Trading**
  - **Available For Sale (AFS)**
  - **Held To Maturity (HTM)**

- But in contrast to US GAAP, there are according to IFRS 4 a fourth and a fifth asset class which are called:
  - **At Fair Value through P&L (AFV through P&L)**
  - **Loans and Receivables**

5. Asset Classification

- In general, the **treatment of assets** classified as **Trading, AFS or HTM** is **the same in IFRS as in US GAAP except the impairment rules**
  - The rules to value these according to IFRS 4 are specified in IAS 39
  - For details on the general treatment of these assets see the same chapter in "Basics of US GAAP for Life Insurers"

- For **assets classified as Trading** there is no need to define impairment rules because in the Balance Sheet and in the P&L (to determine investment income) **market values are used**

5. Asset Classification

- For **bonds and shares** classified as **AFS**
  - **market values** are relevant for the **Balance Sheet**
  - **amortized cost values** for **bonds** and **cost values** for **shares** are relevant for the **P&L** to determine investment income in the P&L **(P&L values)**

- For **bonds** classified as **HTM amortized cost values** are relevant for the **Balance Sheet** and the **P&L** to determine investment income in the P&L

5. Asset Classification

- For **bonds or shares classified as AFS or HTM market values lower than P&L values** are sometimes accepted in **IFRS 4** as well as in **US GAAP**
  - For **bonds and shares** classified as **AFS** the implied **unrealized losses are explicitly shown in the Balance Sheet under the position Unrealized Gains/Losses (URG) as part of the Accumulated Other Comprehensive Income (AOCI),** which is part of the **equity**
  - For **bonds** classified as **HTM** the implied **unrealized losses are not shown in the Balance Sheet since the amortized cost value is used in the P&L and the BS**

5. Asset Classification

- In the impairment rules it is defined
  - when the assets have to be impaired
  - how the impairment loss is defined
  - how to proceed after an impairment
- It seems, that there is some freedom in IFRS 4 setting the concrete impairment rules

5. Asset Classification

- The **market value of bonds** is influenced by two independent factors:
  - **market interest rates and**
  - **credit rating of the issuer**
- This is reflected in the impairment rules

5. Asset Classification

- In **US GAAP** unrealized losses are accepted as long as they are assessed to be **"temporary"**
  - For **equities** a **significant or prolonged decline** of the market value below the cost value is the reason to do an impairment
    - **"Significant"** is often interpreted as 20% or more
    - **"Prolonged"** is often interpreted as 6 months or more
  - For **bonds** impairments are rather seldom; they depend
    - on **down grading** or similar issues of the issuer (compare the IFRS impairment rules) or
    - on **similar rules as for equities**

5. Asset Classification

- In **IFRS** an asset is impaired if, and only if, there is **objective evidence of impairment**; examples are given by (IAS 39.58):
  - significant financial difficulty of the issuer
  - a breach of contract, such as a default in interest or principal payment
  - high probability that the issuer will enter in bankruptcy
- In addition to the above mentioned examples of objective evidence of impairment, "**a significant or prolonged decline in the fair value of an investment in an equity instrument below its cost value is also objective evidence of impairment**" (IAS 39.61)
  - This is the same procedure as in US GAAP

5. Asset Classification

- For **bonds** impairments are rather seldom
- In **IFRS,** a decline of the market value below the amortized cost value does **not necessarily imply an impairment of a bond:**
  - “For example, a decline in the fair value of an investment in a **debt instrument** that results from an **increase in the risk-free interest rate**" (IAS 39.60)

5. Asset Classification

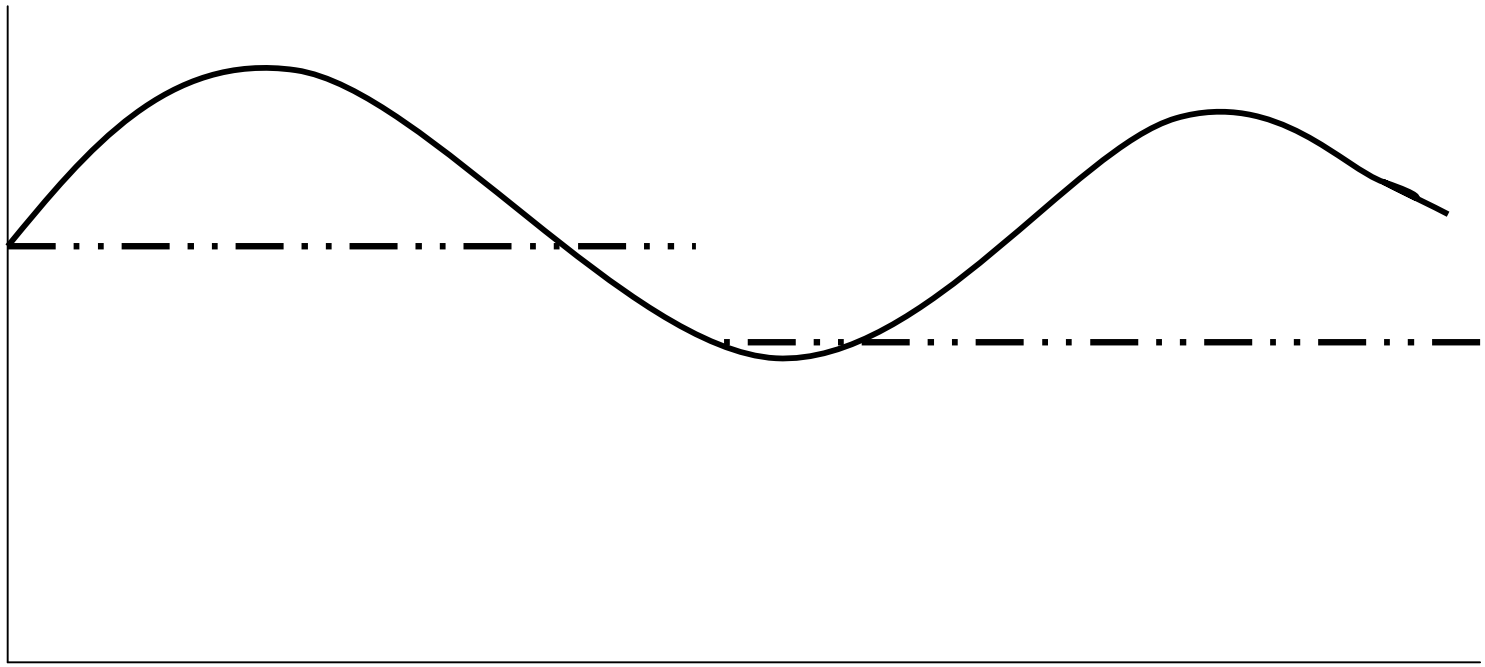
- The general criterions for an impairment seem to be
  - in **US GAAP more quantitative;** the evolution of the **market value** is predominant
  - in **IFRS more qualitative;** e.g. for bonds, they depend on the probability that the **issuer is able to pay in future** the interest and the face value
- The US GAAP criterions seem to be more concrete than the IFRS criterions
- That is why, some insurance companies prefer to follow the more concrete US GAAP rules, even under IFRS

5. Asset Classification

- In **US GAAP,** the **impairment losses** are defined as the **difference** between
  - the **current market value** and
  - the **"old" cost value** respectively the **"old" amortized cost value**
- **These losses are recognized in P&L**
- The current market value becomes the **"new" cost value** respectively the **"new" amortized cost value**
- These **impairment losses are irreversible for P&L**
- **Additional future declines** of the market value are treated in the **same way**

5. Asset Classification

- **US GAAP AFS shares:**

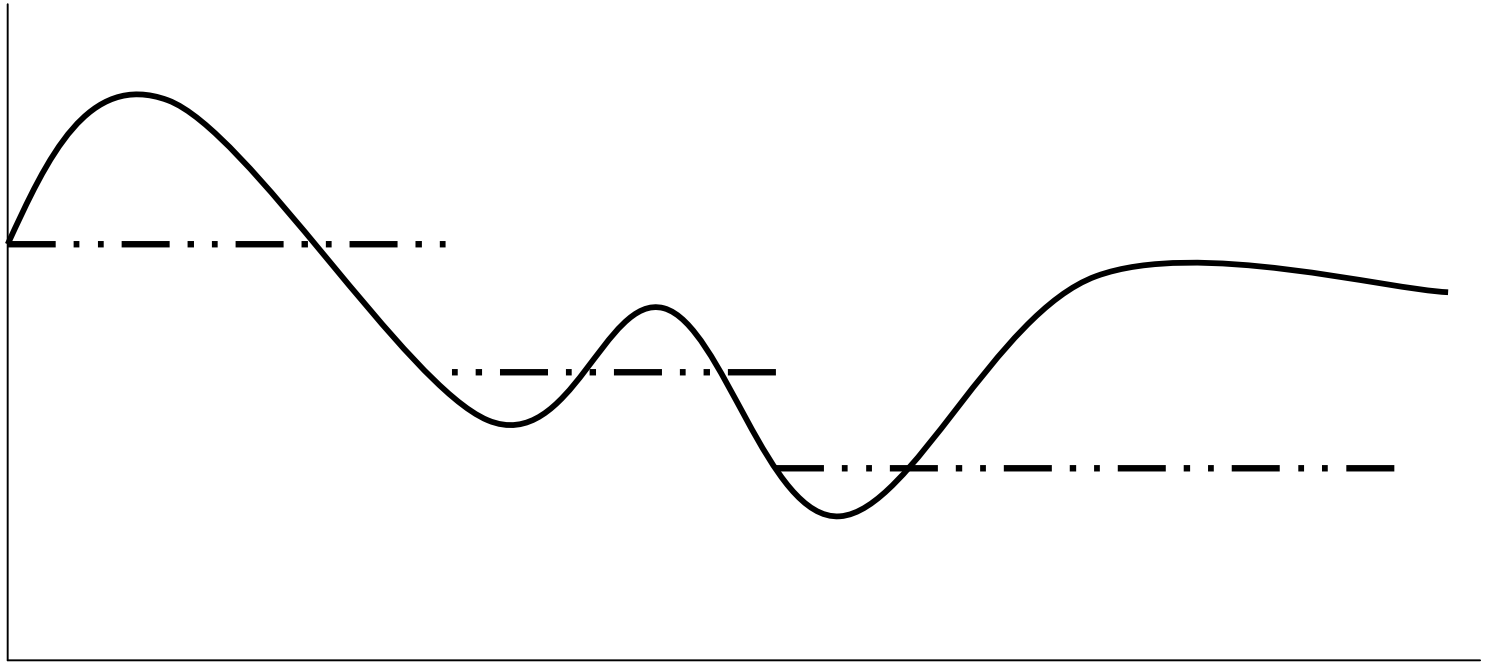


Market Value: ———

Cost Value: — · · — · · P&L Value = Cost Value

5. Asset Classification

- **US GAAP AFS shares:**



Market Value: ———

Cost Value: — · · — · ·

P&L Value = Cost Value

5. Asset Classification

- **The IFRS rules to value assets are defined in IAS 39**
- **In IFRS,** there are the following **impairment rules for shares** classified as **AFS:**
  - If there exists objective evidence of impairment the loss has to be removed from equity; according to IAS 39.61 a significant or prolonged decline in the fair value of an equity below its cost value is a reason for an impairment; this is often interpreted in the same way as in US GAAP (i.e. 20% or more resp. 6 months or more); so, the argument for an impairment of an AFS share can be the same in IFRS and in US GAAP; but the procedure after an impairment is different

5. Asset Classification

- The impairment losses are defined as the **cumulative losses** (IAS 39.67)
- **These losses are recognized in P&L**
- There is **no "new" cost value**
- These **impairment losses are irreversible for P&L** (IAS 39.69; BC 129)
- Since the **impairment losses** are defined on a **cumulative** basis, after a first impairment **future declines** of the market value **below the lowest P&L value** in the past **imply immediate future impairments**

5. Asset Classification

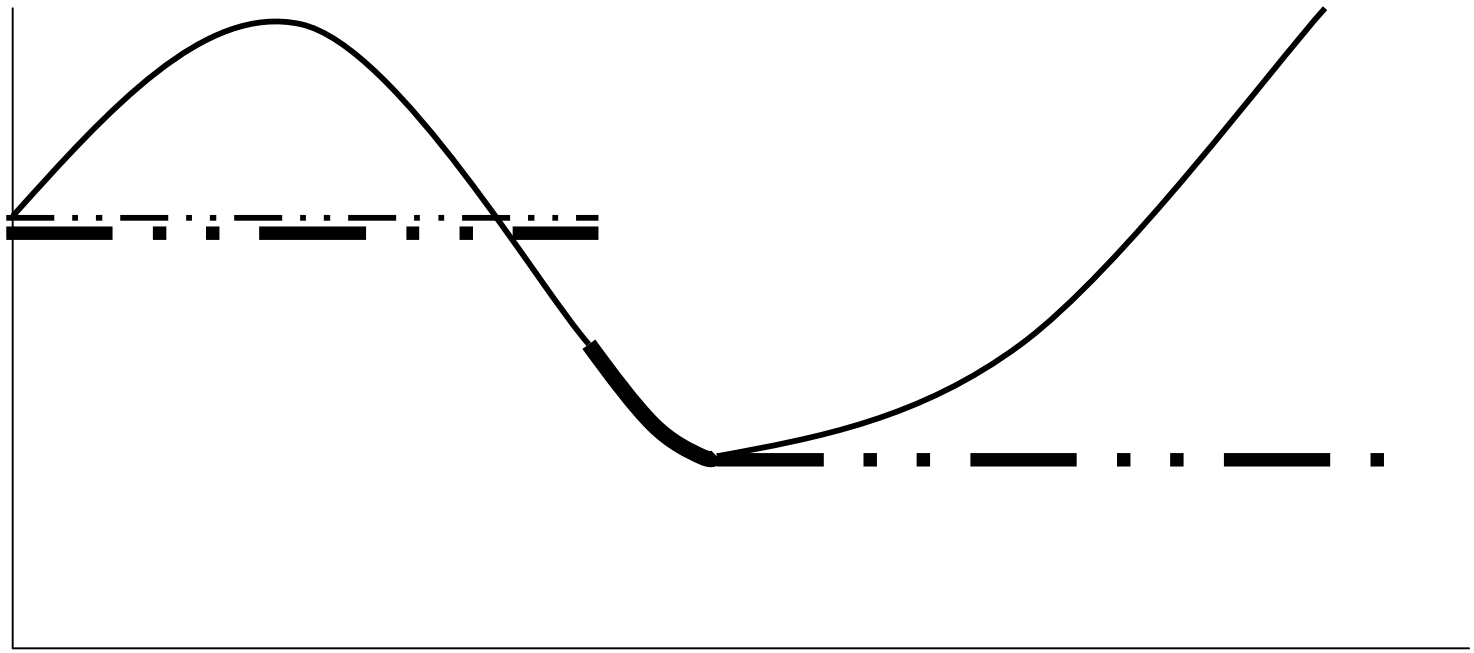
- So under IFRS, if an **AFS share** was **once impaired,**
  - **future declines** in the market value **below the lowest P&L value** in the past **will be immediately recognized in P&L** (**"once impaired, always impaired"**)
  - **future increases** in the market value **will not be recognized in P&L**

5. Asset Classification

- In **IFRS after a first impairment**, the **P&L value** of an **AFS share** is **equal to the lower** of
  - the **market value** or
  - the **lowest P&L value in the past**
- This IFRS valuation method for P&L of an AFS share after a first impairment is comparable to the **strong lower of cost or market principle ("strenges Niederstwert-prinzip")**
- **After a first impairment**, the IFRS treatment of **future declines** in the market value is **different** to the US GAAP treatment

5. Asset Classification

- **IFRS AFS shares:**



Market Value: ———

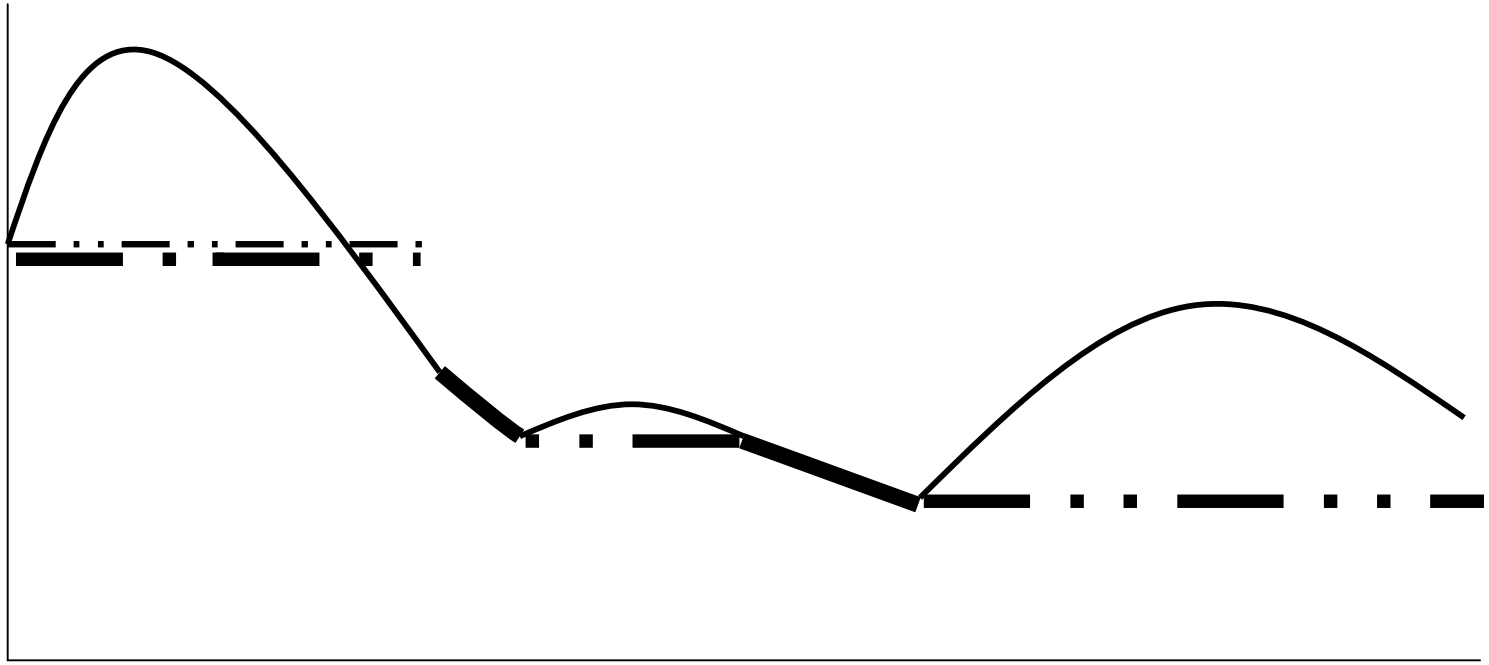
Orig. Cost Value: — · · — · ·

P&L Value = Market Value: ▬▬▬

P&L Value: ▬▬ ▪ ▪

5. Asset Classification

- **IFRS AFS shares:**



Market Value: ———

Orig. Cost Value: — · · — · ·

P&L Value = Market Value: ▬▬▬

P&L Value: ▬ ▪ ▪

5. Asset Classification

- In **IFRS,** for **bonds** classified as **AFS or HTM** the **impairment losses are reversible**.
- Unfortunately, only for bonds classified as HTM an upper limit is explicitly defined IAS 39.65:
  - "The reversal shall not result in a carrying amount of the financial asset that exceeds what the amortized cost value would have been had the impairment not had been recognized at the date the impairment is reversed."
- It seems plausible to assume that the same is valid also for bonds classified as AFS
- In the following, this upper limit defined by the values according to the original amortized cost curve is called **cap**

5. Asset Classification

- **In IFRS,** there are the following **impairment rules for bonds** classified as **AFS:**
  - If there exists objective evidence of impairment the loss has to be removed from equity; in IFRS, there is no quantitative definition of "objective evidence" for bonds; often the quantitative US GAAP definition is used to avoid uncertainties
  - The impairment losses
    - are defined as the **cumulative losses** and
    - are **recognized in P&L** (IAS 39.67)

5. Asset Classification

- The **amount of the cumulative loss** that is removed from equity and recognized in profit and loss shall be the **difference between the acquisition cost net of any principal payment and amortization** (i.e. the current P&L value) **and current fair value, less** any impairment loss on that financial asset previously recognized in profit and loss (IAS 39.68)
- There is **no "new" amortized cost value** for the P&L
- These **impairment losses are reversible through P&L** "when **fair value increases** and the increase can be objectively related to an event occurring after the loss was recognized" (IAS 39.70; BC 127)

5. Asset Classification

- It seems to be plausible to assume that the bond is reversed **up to the original amortized cost value at the date the impairment is reversed, i.e. up to the cap** (IAS 39.65 and 70; BC 127)

- Since the **impairment losses**
  - are defined on a **cumulative** basis
    - after a first impairment **future declines** of the market value **below the cap imply immediate future impairments**

  and
  - are **reversible**
    - **future increases** of the market value **imply immediate revaluations up to the cap**

5. Asset Classification

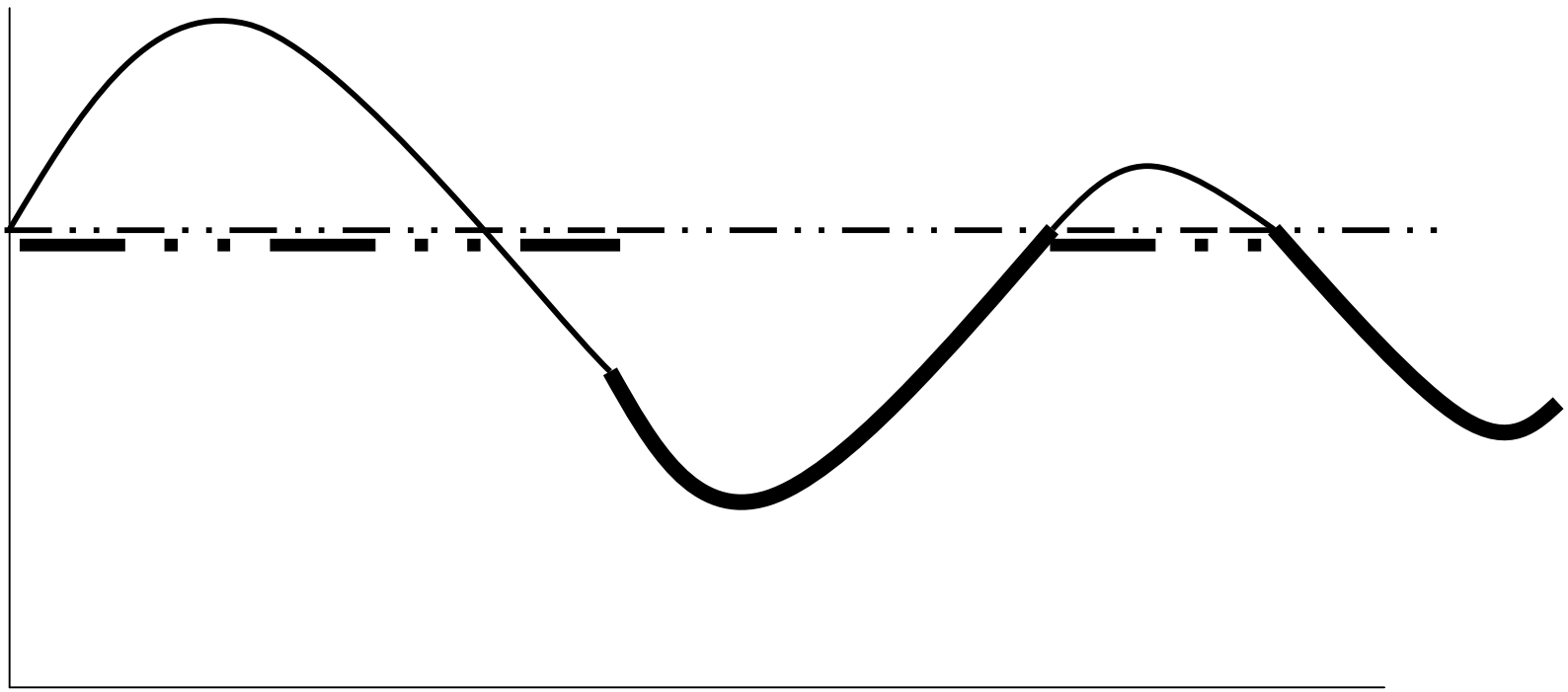
- So in IFRS, if an **AFS bond** was **once impaired,**
  - **future declines in the market value below the cap will be immediately recognized in P&L** (**"once impaired, always impaired"**)
  - **future increases in the market value up to the cap will be immediately recognized in P&L**

5. Asset Classification

- In **IFRS after a first impairment**, the **P&L value** of an **AFS bond** is **equal to the lower** of
  - the **market value** or
  - the **original amortized cost value, i.e. the cap**
- This IFRS valuation method for P&L of an AFS bond after a first impairment is **comparable to the lower of cost or market principle ("Niederstwertprinzip")** with reference to the curve of the **original amortized cost values**
- **After a first impairment**, the IFRS treatment of **future declines and increases** in the market value of an AFS bond is **different**
  - to the US GAAP treatment of an AFS bond and
  - to the IFRS 4 treatment of an AFS share

5. Asset Classification

- **IFRS bonds AFS;** bought at 100%:

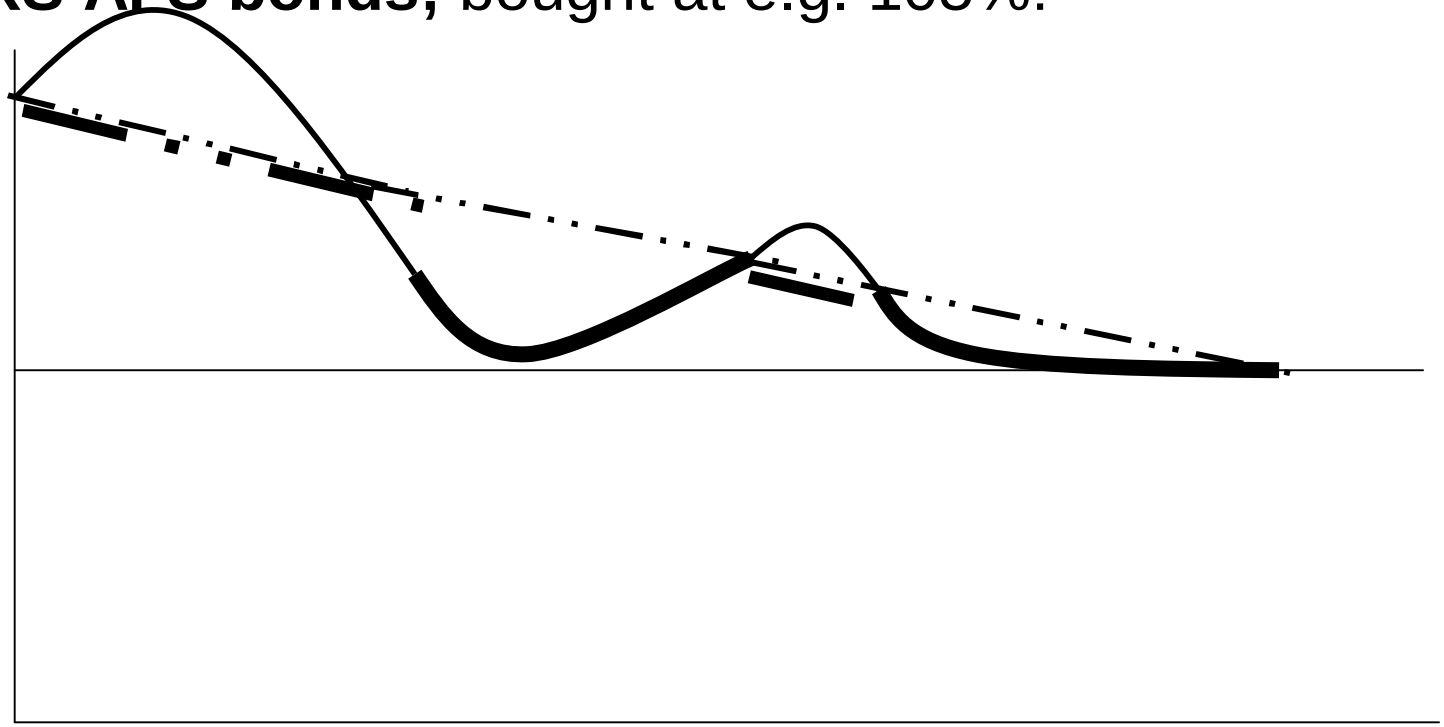


Market Value: ——— P&L Value = Market Value: ▬▬▬

Orig. Amortized Cost Value: — · · — · · P&L Value = AC Value: ▬ ▪ ▪

5. Asset Classification

- **IFRS AFS bonds;** bought at e.g. 105%:

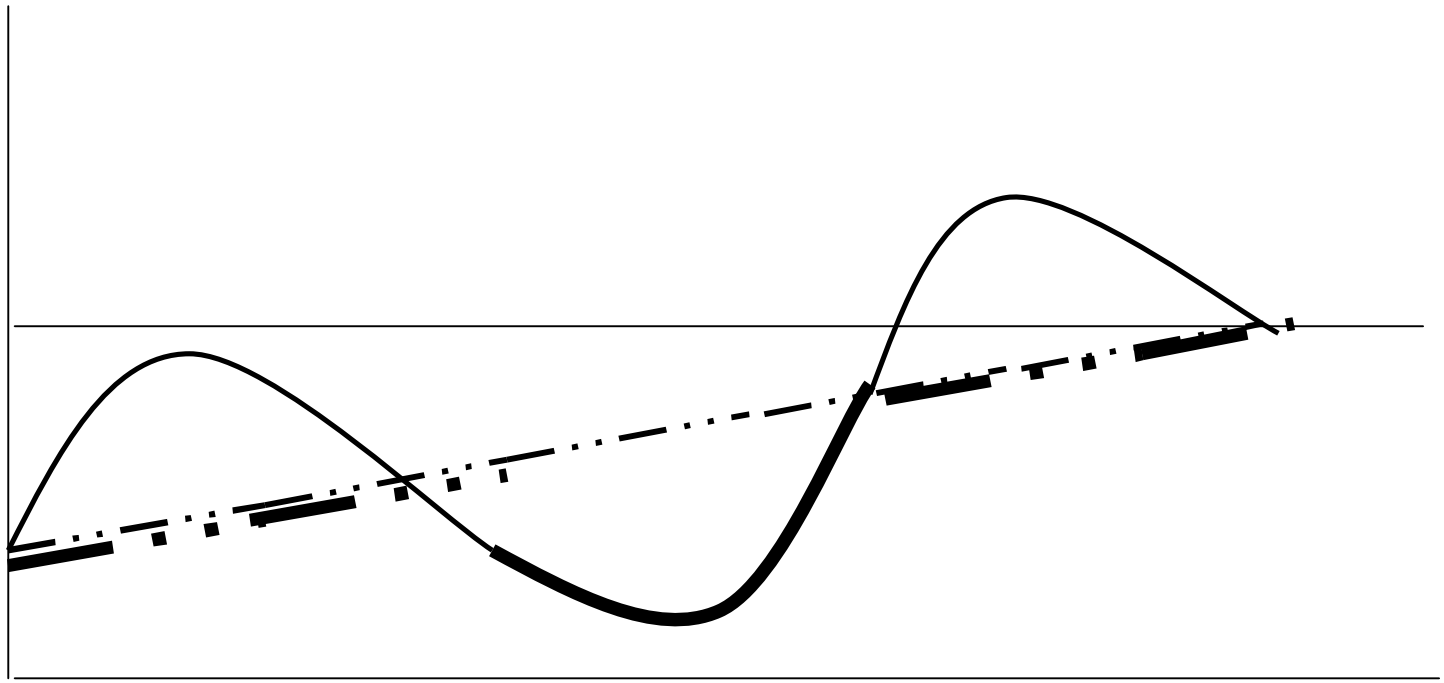


Market Value: ——— P&L Value = Market Value: ▬▬▬

Orig. Amortized Cost Value: — · · — · · P&L Value = AC Value: ▬▬ ▪ ▪

5. Asset Classification

- **IFRS AFS bonds;** bought at e.g. 95%:



Market Value: ——— P&L Value = Market Value: ▬▬▬

Orig. Amortized Cost Value: — · · — · · P&L Value = AC Value: ▬▬ ▪ ▪

5. Asset Classification

- **In IFRS,** there are the following **impairment rules for bonds** classified as **HTM** :
  - If there exists objective evidence of impairment the loss has to be removed from equity; in IFRS, there is no quantitative definition of "objective evidence"; often the US GAAP definition is used to avoid uncertainties
  - Sometimes the following rule (simplified version) is used:
    - **Investment Grade Bonds** are impaired, if there are unrealized losses
      - of **20%** or more **and** for a period of **6 months** or more or
      - for more than **12 months** regardless of the percentage

5. Asset Classification

- The **impairment loss** is defined as the **difference** between (IAS 39.63)
  - the asset's carrying amount, i.e. **the current amortized cost value**

  and
  - the **present value of estimated future cash flows** discounted at the financial asset's original effective interest rate (i.e. the effective interest rate computed at initial recognition)
- **The impairment losses are recognized in P&L**
- **The impairment losses are reversible in P&L up to the cap** (IAS 39.65; BC 128)

5. Asset Classification

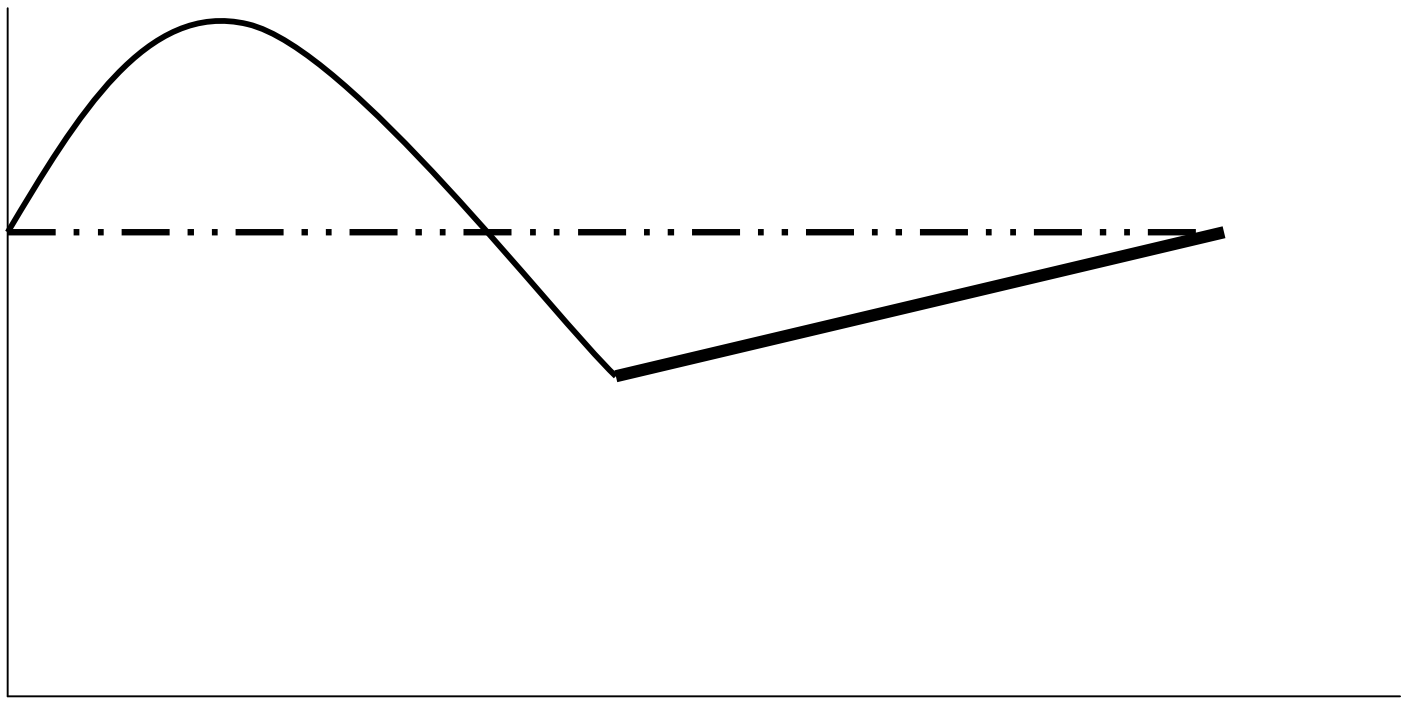
- The question arises how to handle a reversion of impairment losses?

- **One solution may be to carry the bond at the value of the estimated future cash flows discounted at the original effective interest rate**

- **Some companies** prefer another solution and **calculate a new amortized cost curve** after an impairment of a HTM bond; the following diagram gives an example

5. Asset Classification

- **IFRS HTM bonds with new amortized cost value:**



Market Value: ——— Original Amortized Cost Value : — · · — · ·

New Amortized Cost Value: ▬▬▬

5. Asset Classification

- If also for HTM bonds the **impairment losses** are defined as the **cumulative losses using market values** and **the reversals of the impairment losses** are also defined **using market values,** i.e. that both are defined in the same way as for AFS bonds, then after a first impairment the treatment is the same as for AFS bonds:
  - **future declines** of the market value **below the cap imply immediate future impairments recognized in P&L** (**"once impaired, always impaired"**)

  and
  - **future increases** of the market value **imply immediate revaluations up to the cap recognized in P&L**

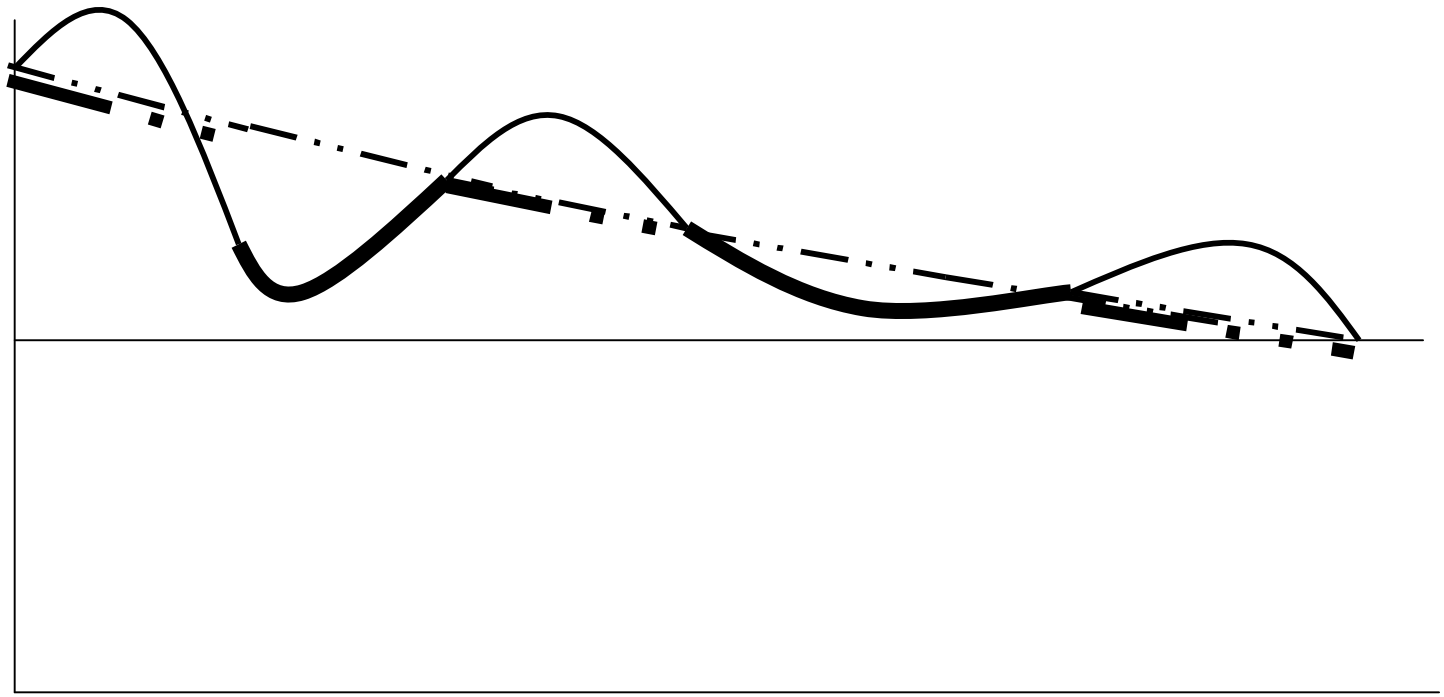
5. Asset Classification

- Again, this IFRS valuation method for P&L of a HTM bond after a first impairment is **comparable to the lower of cost or market principle ("Niederstwertprinzip")** with reference to the curve of the **original amortized cost values**

- **After a first impairment**, all three possible IFRS treatments of **future declines and increases** in the market value are **different** to the US GAAP treatment

5. Asset Classification

- **IFRS HTM bonds losses on cumulative basis:**



Market Value: ——— P&L Value = Market Value: ▬▬▬

Orig. Amortized Cost Value: — · · — · · P&L Value = AC Value: ▬▬ ▪ ▪

5. Asset Classification

- **Bonds classified as HTM can only be sold or reclassified without very serious consequences**
  - if the **amount is insignificant on group level** or
  - in **case of a permissible sale** (e.g. run on the bank or significant deterioration in the issuer's credit worthiness)
- **If none of these two criterions is given**, a sale of HTM bonds in one company implies that all remaining HTM bonds of the total group to which this company belongs are **reclassified as AFS for the last two years**
  - Such a reclassification implies such a huge workload, that insurers often avoid to use the HTM classification

5. Asset Classification

- Compared with US GAAP, in **IFRS 4 the new asset class At Fair Value through P&L (AFV through P&L) is introduced**
- The reason of introducing this new asset class AFV through P&L, is the so called **"Fair Value Option" according to § 24 IFRS 4**
- According to this paragraph one can use the **fair value valuation for the insurance provisions and has then to classify the corresponding assets At Fair Value through P&L**
  - This asset class is introduced for products where the assets and liabilities are perfectly matched

5. Asset Classification

The wording of IFRS 4 § 24 is as follow:

- "An insurer is permitted, but not required, to change its accounting policies so that it remeasures designated insurance liabilities **to reflect current market interest rates** and recognises changes in those liabilities in profit or loss. At that time, it may also introduce accounting policies that require **other current estimates and assumptions for the designated liabilities**. The election in this paragraph permits an insurer to change its accounting policies for designated liabilities, without applying those policies consistently to all similar liabilities as IAS 8 would otherwise require. If an insurer designates liabilities for this election, it shall continue to apply current market interest rates (and, if applicable, the other current estimates and assumptions) **consistently in all periods to all these liabilities until they are extinguished**."

5. Asset Classification

- **Assets classified as At Fair Value through P&L are treated in the same way as assets classified as Trading**
  - I.e. in the **Balance Sheet** as well as for determining the investment income in the **P&L** the **market value is relevant**
  - In addition the **insurance provisions are also valued at fair value**

5. Asset Classification

- The category **At Fair Value through P&L** can be used for non-derivative financial assets that are considered as "designated to the Fair Value Option" (IAS 39.9 (b))
- The **Fair Value Option is permitted** in the following cases:
  - **elimination or significant reduction of accounting mismatch** between measurements of assets and liabilities or gains and losses recognition or
  - **a group of financial assets or/and liabilities is managed and its performance evaluated on a fair value basis,** in accordance with a documented risk management or investment strategy, and information about the group is provided internally on that basis to the entity's key management **(management on fair value basis)**

5. Asset Classification

- A typical **example of accounting mismatch** is given in IFRS 4 and US GAAP if
  - bonds are valued at market values (classified as AFS) and
  - the corresponding liabilities are calculated using a constant technical interest rate (e.g. FAS 120 products)

5. Asset Classification

- The following three **conditions** must be fulfilled **for the classification At Fair Value through P&L**:
  - The designation should be performed **upon initial recognition**
  - The designation is **irrevocable**
  - The determination of the fair value must be **reliable**

- The **difference** between assets classified as **Trading** and assets classified as **At Fair Value through P&L** is due to the fact that the latter are only used when the provisions are also valued at fair value using current market interest rates for discounting

5. Asset Classification

- The fifth asset category in IFRS 4 is called **"Loans and Receivables"**
  - Typical assets in this category are **unquoted debt securities**
  - The valuation method, defined in IAS 39, is similar to HTM; i.e. these assets are valued according to the **amortized cost method**
  - The **differences to HTM** are
    - there is no requirement to hold these assets until maturity

    and
    - there are no tainting rules when selling them before reaching maturity, as for HTM debt securities

5. Asset Classification

- In **US GAAP** there is **no explicit definition** of the asset category **"Loans and Receivables"**
- Generally, these assets are valued at amortized cost; but exceptions are possible and then the are valued at the lower of cost or market fair value

5. Asset Classification

- The **allocation** of a specific asset to one of these five asset categories **depends on the intention of the investor**
  - So, it is possible that different specimen of the same asset are in different asset categories

5. Asset Classification

- In IFRS 4, **real estate** can be valued according to IAS 40
  - at **fair value** with changes in fair value recognized in P&L

  or

  - with the **cost model,** which is specified in IAS 16 and requires an investment property to be measured at its cost value less any accumulated depreciations and any accumulated impairment losses. Any entity that choose the cost model discloses the fair value of its investment property

5. Asset Classification

- In **IFRS 4**, for **real estate**
  - **a reversal of impairment losses is allowed**,
  - **land and building are valued together**
- In **US GAAP,** for **real estate**
  - **a reversal of impairment losses is not allowed**,
  - **land and building are valued separately**
    - **land** is valued at depreciated cost and
    - **buildings** are depreciated over 30 or 40 years

5. Asset Classification

- In **IFRS 4** it is explicitly prescribed to make **impairment tests for the reinsurance assets**
- **Reinsurance assets are impaired** if, and only if, there is objective evidence
  - that not all payments will be recoverable from the re-insurer

  and
  - that relevant negative impact on the cedant is reliable if the re-insurer will fail
- Impairment losses have to be recognized immediately through P&L

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6. Technical Reserves

- **In IFRS 4, there are no explicit rules for reserving**
- Remember, in US GAAP there are different reserving rules according to the different FASes (FAS 60, FAS 97 or FAS 120)
- In **IFRS 4**, there is only the **principle that the reserves must be adequate**
- To test this, it is mandatory to make at each valuation date (at least once a year) a **Liability Adequacy Test (LAT)**
  - This test is comparable with the **Loss Recognition Test (LRT) of US GAAP**
  - For details of the LAT see chapter 8

6. Technical Reserves

- According to **IFRS 4**, it is possible
  - **to carry on the reserving method which was used up to the introduction of IFRS 4 ("grandfathering")**

  or
  - **to change the reserving method, if the new method is closer to fair value than the old one**

6. Technical Reserves

- If there is a **change in the reserving method**, it is possible
  - to introduce **US GAAP** reserving methods

  or
  - to **value the provisions at fair value using current market interest rates for discounting** according to § 24 IFRS 4 and to classify the corresponding **assets as At Fair Value through P&L (Fair Value Option)**
    - But there is no explicit rule to determine the discount rate

6. Technical Reserves

- Concerning the **margins in the reserves**, § 26 IFRS 4 is relevant; it reads as follows:
  - "An insurer need not change its accounting policies for insurance contracts to eliminate excessive prudence. However, if an insurer already measures its insurance contracts with sufficient prudence, it shall not introduce additional prudence.“
  - In IFRS 4, it is not clarified what the wording “sufficient prudence” actually means

6. Technical Reserves

- This implies that in IFRS 4
  - **it is allowed to continue using non discounted provisions**
  - **it is not allowed to introduce non discounted provisions**
- Some authors interpret this as an **allowance to introduce discounted provisions**
  - However, in IFRS 4 there are no rules how to determine the risk discount rate
- **This is especially important for non-life insurance companies**

6. Technical Reserves

- According to these principles, for an insurance group using **IFRS 4** it is possible that
  - one company uses **unzillmerized reserves** and activated acquisition costs according to local statutory rules
  - another company uses **zillmerized reserves** (without activated acquisition costs)
  - another company uses **US GAAP reserves** according to FAS 60, FAS 97 or FAS 120 and activated acquisition costs according to US GAAP rules depending of the relevant FAS and
  - another company uses **fair value reserves** for a special portfolio with corresponding assets At Fair Value through P&L and activated acquisition costs

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7. Deferred Acquisition Costs

- According to **IFRS 4** it is allowed
  - **to capitalize acquisition expenses**

  and
  - **to amortize them over the life time of the contract**
- In IFRS 4 the capitalized acquisition expenses are also called **"Deferred Acquisition Costs" (DAC)**, as in US GAAP

- But, **in IFRS 4 there are no explicit rules**
  - how to capitalize the acquisition expenses

  and
  - how to amortize them

7. Deferred Acquisition Costs

- **In IFRS 4, the company has some freedom to define the explicit rules how to capitalize the acquisition expenses and how amortize them**
- In IFRS 4, it is usual
  - **to capitalize acquisition costs according to the rules of US GAAP**
  - **to amortize the DAC according to the rules of FAS 120 of US GAAP**
- **A recoverability test** should be carried out each year for each main product line, in order to ensure that future profits will be sufficient to recover the DAC

7. Deferred Acquisition Costs

- According to IFRS 4 DAC is used for insurance contracts and investment contracts with DPF

- For investment contracts without DPF, for which IAS 39 is relevant, it is usual to use the following wording:
  - DOC for Deferred Origination Costs (DAC is the US GAAP pendant)
  - DOF for Deferred Origination Fees or UFR for Unearned Fee Reserve (URL or DPL are the US GAAP pendants)

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8. Liability Adequacy Test

- The **Liability Adequacy Test (LAT) applies** to
  - **insurance contracts** according to § 15 IFRS 4

  and to
  - **investment contracts with DPF** according to § 35 IFRS 4
- **Investment contracts without DPF are not subject to the LAT** according to IFRS 4; the provisions of such contracts are determined according to **IAS 39**
- In the following, first the **LAT for insurance contracts** will be presented

8. Liability Adequacy Test

- The **concept of the LAT** is given in § 15 IFRS 4:
  - "An insurer shall assess at each reporting date whether its **recognized insurance liabilities are adequate, using current estimates of future cash flows under its insurance contracts.**"
  - "If that assessment shows that the carrying amount of its insurance liabilities (less related intangibles as DAC and VBI (Value of Business In Force; it is comparable to PVFP in US GAAP)) is inadequate in the light of the estimated future cash flows, the **entire deficiency shall be recognized in profit and loss.**"
  - The existing carrying amount less related intangibles is called **Net Carrying Amount**

8. Liability Adequacy Test

- The **Net Carrying Amount of the LAT of IFRS 4** is the corresponding item to the **Net GAAP Liability of the LRT of US GAAP**
- Concerning the LAT for insurance contracts under IFRS 4
  - there is **no concrete definition** how to produce a LAT
  - there is the above cited **concept of LAT**

  and
  - there are **minimum requirements** in respect of a liability adequacy test used by an insurer, so that this test can be accepted as a LAT in the sense of IFRS 4

8. Liability Adequacy Test

- The **minimum requirements** (§ 16 IFRS 4) are as follows:
  - "The test considers **current estimates of all contractual cash flows, and of related cash flows** such as claims handling costs, as well as cash flows resulting from embedded options and guarantees."
  - **"If the test shows that the liability is inadequate, the entire deficiency is recognized in profit or loss."**
- "Current estimates of all contractual cash flows" means that all cash flows during the whole life time of the contract should be calculated at each valuation date using updated best estimate assumptions

8. Liability Adequacy Test

- If the **liability adequacy test applied** by an insurer **meets the minimum requirements**, IFRS 4 does not impose further requirements
- The test is then applied at the level of aggregation specified in the test
- If the LAT shows that the **existing Net Carrying Amount is sufficient** no further actions are required

8. Liability Adequacy Test

- If the LAT shows that the **existing Net Carrying Amount is not sufficient**
  - the **intangible assets** as DAC and VBI **are written down**

  or
  - the **existing reserves are increased**
  - Usually, first the intangibles are written down
- **The entire deficiency is recognized in profit or loss**

8. Liability Adequacy Test

- The LAT procedure according to IFRS 4 is similar to the **LRT of US GAAP** with one possible exception:
  - In **US GAAP** the **strengthened reserves are locked in**
  - whereas, before introducing **IFRS 4, the LAT can be defined** in such a way that they are **not locked in**, i.e. in IFRS it is possible that the strengthening of the reserves may be released if circumstances become better after the strengthening
    - This is (was) important for every FTA

8. Liability Adequacy Test

- If the liability adequacy **test applied** by an insurer **does not meet the minimum requirements**, then, according to IFRS 4.17, the insurer has to compare
  - the **existing carrying amount** of the relevant liabilities less related intangibles as DAC and VBI (Value of Business In Force)

  with
  - the **carrying amount that would be required for the relevant insurance liabilities according to IAS 37**
- The test shall then be applied at the level of a portfolio of contracts that are subject to broadly similar risks and managed together as a single portfolio

8. Liability Adequacy Test

- The **measurement principles of IAS 37** are given in § 36 as follows:
  - **"The amount recognized as a provision shall be the best estimate of the expenditure required to settle the present obligation at the balance sheet date."**
  - According to § 37, this best estimate should be interpreted as "the amount that an entity would rationally pay to settle the obligation at the balance sheet date or transfer it to a third party at that time."

8. Liability Adequacy Test

- According to § 45, if the "**time value of money is material**, the amount of a provision shall be the **present value of the expenditures expected** to be required to settle the obligation."
  - Hence the **provision** is the **present value of expected future cash flows using current best estimate assumptions**
- According to § 47, the used **risk discount rate should reflect current market conditions** and the calculation method of the original liability; e.g.
  - if it was calculated with a spread, then this spread should be used in the risk discount rate

8. Liability Adequacy Test

- if it was calculated without discounting as a loss reserve, then the risk discount rate for the provision according to IAS 37 should be the risk free rate
- This is important especially for non-life insurance companies

- In **Solvency II,** in addition to these best estimate provisions the present value of the cost of required capital is required in such a situation

8. Liability Adequacy Test

- If the test shows that the existing net carrying amount is lower than the current best estimate liability according to IAS 37
  - the **intangible assets as DAC and VBI are written down**

  or
  - the **existing reserves are increased**
  - Usually, first the intangibles are written down
- The entire deficiency is recognized in profit or loss
- In contrast to US GAAP, the strengthened reserves are not locked in

8. Liability Adequacy Test

- The change in provisions is described in § 59 as follows:
  - **" Provisions shall be reviewed at each balance sheet date and adjusted to reflect the current best estimate. If it is no longer probable that an outflow of resources embodying economic benefits will be required to settle the obligation, the provision shall be reversed."**

8. Liability Adequacy Test

- If under IFRS 4 an **insurer follows the US GAAP rules, the corresponding LRT is an accepted** substitute of the LAT
- The question arises whether under IFRS 4 the **LAT has to be done before or after shadowing?**
  - There are insurers who do it after shadowing
  - If the LAT is done after shadowing open issues arises **how to treat policyholder's participation**
    - If the ex post bonus is not guaranteed it should not be recognized in the test
    - If the ex ante annuity bonus may be reduced in the test one can reduce the bonus or increase the reserves if necessary

8. Liability Adequacy Test

- In **US GAAP, the LRT can be done**
  - **before shadowing** using the unrealized gains and losses in determining the assumptions (e.g. the earned rate curve)

  or

  - **after shadowing** with the same questions as in IFRS 4

8. Liability Adequacy Test

- For **investment contracts with DPF**, the treatment of the DPF depends on whether the **DPF is entirely classified as a liability** or whether the **DPF is classified in part or in total as a separate component of equity**
- According to § 35 (a) IFRS 4, for **investment contracts with DPF, which is classified entirely as a liability, the procedure is the same as for insurance contracts; i.e.**
  - The LAT is made for the whole contract, i.e. for the guaranteed part together with the DPF
  - The amount according to IAS 39 for the guaranteed part need not be calculated

8. Liability Adequacy Test

- According to § 35 (b) IFRS 4, for **investment contracts with DPF, which is classified in part or entirely as a separate component of equity, "the liability recognized for the whole contract shall not be less than the amount that would result from applying IAS 39 to the guaranteed element."**
- According to a paper of the IAA, "there is a debate about whether the **IAS 39 minimum liability** is
  - a **requirement in addition** to the requirement to perform liability adequacy testing,

  or
  - **in lieu of** liability testing."

8. Liability Adequacy Test

- **For investment contracts without DPF the provisions are calculated according to IAS 39**

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9. Shadow Adjustments

- According to § 30 IFRS 4, there are **no new principles concerning shadow adjustments**; see the same chapter in "Basics of US GAAP for Life Insurers"
- Concerning shadow accounting, in § 30 IFRS 4 is stated:
  - "An insurer is permitted, but not required, to change its accounting policies so that a recognized but unrealized gain or loss on an asset affects those measurements (insurance assets e.g. DAC or PVFP, insurance liabilities e.g. URL) in the same way that a realized gain or loss does. The related adjustment to the liabilities, DAC or PVFP shall be recognized in equity if, and only if, the unrealized gains or losses are recognized directly in equity."

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10. Legal Quote

- **No new principles to handle a Legal Quote** are introduced by IFRS 4
  - See the same chapter in "Basics of US GAAP for Life Insurers"

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11. Purchase Accounting

- By IFRS 4, **no new principles concerning Purchase Accounting** are introduced **with the following exception:**
  - There is no VBI (PVFP) for investment contracts without DPF
- For the treatment of the other items, see the same chapter in "Basics of US GAAP for Life Insurers“
  - For goodwill regularly an impairment test is done (as in US GAAP)

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13. Embedded Derivatives

14. Investment Contracts without DPF (IAS 39)

12. Discretionary Participation Feature

- A **Discretionary Participation Feature (DPF)** is a contractual right to receive, as **a supplement to guaranteed benefits**, **additional benefits** (IFRS 4, App. A):
  - 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**

  and
  - that are **contractually based** on:

12. Discretionary Participation Feature

– (that are **contractually based** on):
  - the **performance** of a specified pool of contracts or a specified type of contract

  or
  - realised or/and unrealised **investment returns** on a specified pool of assets held by the issuer

  or
  - the **profit or loss** of the company, fund or other entity that issues the contract.

12. Discretionary Participation Feature

- The **decision** of whether a contract contains a DPF or not is made **at the inception of the contract**; a **reassessment is possible** at each valuation date, but one should be aware of the consequences; so there is the tendency not to change the classification
- The **result of the decision** depends on
  - the **likelihood** that an additional benefit is paid
  - the **amount** of the additional benefit
  - the fact that the **insurer is free** to decide
    - **which amount** will be paid as an additional benefit

    and
    - **at what point** in time the additional benefit will be paid

12. Discretionary Participation Feature

- and the **additional benefit is contractually based** on one of the three sources of capital mentioned in the definition above

- The **concept of DPF** can be interpreted as the **pendant of Deferred Bonus Reserve (DBR) under a Legal Quote**, if there is no Legal Quote, but if there is only a **so called "Market Quote"**

12. Discretionary Participation Feature

- For an **insurance contract with a DPF**:
  - The **DPF** may be recognized
    - **together** with the **guaranteed benefits** or
    - **separately** from **guaranteed benefits**
  - If they are **recognized together**, the **whole contract is a liability**
    - The **LAT** should be carried out for the **entire contract**; i.e. for the guaranteed liabilities and the DPF
  - If the **DPF** is **recognised separately**, the DPF can be treated **as liability or equity** or can **be split** between these categories
    - The **guaranteed benefits** are always **liabilities**

12. Discretionary Participation Feature

- For an **insurance contract with a DPF**:
  - The DPF must not be an intermediate between equity and liability
  - Policy for allocation must be consistent over time and across the company.

12. Discretionary Participation Feature

- For the Swiss individual life business, concerning the determination of the DPF there are still some open issues
  - **Example: Swiss individual life business**
    - The **total free bonus reserve** is treated as a **DPF** liability, because according to the new version of the VAG all amounts in the bonus funds have to be allocated to the policyholders
    - Concerning the **unrealized capital gains**, the companies are free to decide how to treat them and the auditors will follow; possible solutions are:
      - 100% as equity (as former times or in US GAAP)
      - 60% as DPF liability and 40% as DPF equity

12. Discretionary Participation Feature

- **Unit-linked contracts** can be considered to **have "automatic participation features"**, as their return is contractually based on a specified pool of assets, but the amount and timing is not at the discretion of the insurer
- **So, unit-linked products do not have a DPF, unless** it is present in addition to the basic unit-liked feature
  - E.g. there may be a DPF for an ex post risk bonus

12. Discretionary Participation Feature

- For an i**nvestment contract with a DPF,** in addition to the rules relevant for an insurance contract including a DPF, the following applies:
  - If the **entire DPF** is classified as a **liability**, the **LAT** should be carried out for the **entire contract**; i.e. for the guaranteed liabilities and the DPF
    - The IAS 39 fair value comparison is no more required
  - If a **part or all of the DPF** is classified as a **separate part of equity**, the liability for the whole contract shall not be less than the amount that would result from applying IAS 39 to the guaranteed element
    - So, the **IAS 39 fair value comparison** is required, but IAS 39 value needs not to be published

12. Discretionary Participation Feature

- For an **investment contract with a DPF** (continued):
    - The IAS 39 value needs not to be calculated if clearly lower than liability held
  - The insurer may continue to recognize the premiums of these contracts as revenue and the increase of the reserves as an expense

12. Discretionary Participation Feature

- The **DPF** may become **negative**, if for example policyholders participate in investment gains and losses and if there are enough **unrealized losses**.
- A **negative DPF** may be treated in the same way as a positive DPF, as far as the guarantees benefits are not reduced
- In addition, it must be considered that a **negative DPF is an asset**
  - The question arises, whether a negative DPF fulfils the definition of an asset under IFRS
  - The same issue arises for a negative DBR, if there is a Legal Quote

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12. Discretionary Participation Feature

13. Embedded Derivatives

14. Investment Contracts without DPF (IAS 39)

13. Embedded Derivatives

- According to the **SAV**, the **embedded derivatives are not an issue for Swiss life products**; the reasons are given in the two following statements

- IN10 (a) reads as follow:
  - "The IFRS 4 clarifies that an insurer need not account for an embedded derivative separately at fair value if the embedded derivative meets the definition of an insurance contract”

13. Embedded Derivatives

- § 7 IFRS 4 reads as follow:
  - “IAS 39 requires an entity to separate some embedded derivatives from their host contract, measure them at fair value and include changes in their fair value in profit or loss. IAS 39 applies to derivatives embedded in an insurance contract unless the embedded derivative is itself an insurance contract”

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12. Discretionary Participation Feature

13. Embedded Derivatives

14. Investment Contracts without DPF (IAS 39)

14. Investment Contracts without DPF

- Contracts are classified as **investment contracts without DPF, if they do not have**
  - **sufficient insurance risk** to classify them as an insurance contract
  - **nor a Discretionary Participating Feature (DPF)** to classify them as an investment contract with DPF
- That is why they must be accounted for **as financial instruments** according to **IAS 39**
  - This implies **deposit accounting**
- These contracts are also called **"pure investment contracts"**

14. Investment Contracts without DPF

- The **US GAAP pendant** are **investment contracts with no significant insurance risk classified as FAS 97**

- **Because of tax regulation, this product category is not relevant for the Swiss life insurance market**

14. Investment Contracts without DPF

- The **liabilities** of investment contracts without DPF are valued either
  - **at fair value through P&L** (e.g. unit-linked investment contracts with no significant insurance risk)

  or
  - **at amortised cost** (e.g. non-unit-linked investment contracts with no significant insurance risk)
- Deposit accounting is used for both categories of contracts
- Typically, **most of the investment contracts without DPF are unit-linked contracts with no significant insurance risk**
  - As unit-linked contracts, they have an "automatic participation feature" and so they cannot have a DPF

14. Investment Contracts without DPF

- The **Fair Value Valuation** is based on IAS 39 requirements:
  - current economic and non economic assumptions are used
  - where ever possible market values are used

- The **Amortized Cost Valuation** is based on **Effective Interest Method (EIM)**
  - Estimate future cash flows are based on best estimate including surrender rates and transaction costs

14. Investment Contracts without DPF

- Examples of a non-unit-linked investment contracts are
  - index-linked investment contracts
  - fixed term certain annuities
- Non-unit-linked investment contracts can be valued at fair value or at amortized cost

14. Investment Contracts without DPF

- For investment contracts without DPF the following principles **do not apply:**
  - **Shadowing**
  - **Deferred participation**; for unit-linked contracts, there is "automatic" participation and no discretionary participation feature
  - **Liability adequacy test** (LAT)

14. Investment Contracts without DPF

- Under IFRS 4, **premium received** from an investment contract without DPF **are not revenues and should be recognized as deposits**
- Premiums from investment contracts without DPF are reported as **deposits net of any loadings and policy fees**
- **Revenues from these contracts** consist of **loadings and policy fees** for the cost of issuance of contracts, investment management, administration and surrender of the contract

14. Investment Contracts without DPF

- A **Deferred Origination Fee (DOF) or Unearned Fee Reserve (UFR)** has to be set up if the fees are not received uniformly over the contract life
  - DOF or URF are comparable with the US GAAP Deferred Profit Liability (DPL) or with the US GAAP Unearned Revenue Liability (URL)

14. Investment Contracts without DPF

- For investment contracts without DPF there are **origination expenses (acquisition expenses)**
  - which **are not deferrable** or
  - which **are deferrable and can be capitalized**
- For financial instruments, it is defined in IAS 18 and IAS 39 which expenses can be deferred; unfortunately this refers to bank products and not to insurance products
- As a consequence there is some judgement for insurance products how to proceed; this issue is not solved in IFRS 4
- There is a broad discussion concerning the deferrability of origination expenses

14. Investment Contracts without DPF

- There are no clear rules for insurance products in IFRS 4 resp. IAS which origination expenses are deferrable and which are not
- Each insurance company together with its external auditor has to look for a pragmatic solution

14. Investment Contracts without DPF

- The capitalized expenses are called **Deferred Origination Costs (DOC)**
- The **DOC is amortized in proportion to the estimated level fees** collected over the life time of the contract
- The principles of handling the DOC (e.g. roll forward, recoverability test etc.) are similar to those of DAC in US GAAP or DAC in IFRS 4 for insurance contracts