Paper 4–Submission Paper: Investment component

Potential implementation question

1. Description of participating products in China if they are classified as indirect participating products accounted for under the general model (not the Variable Fee Approach):
    a. The participating product provides a profit sharing mechanism for the policyholder.
    b. Profit sharing can arise from interest, mortality, etc.
    c. Typical policyholder benefits include a:
    - fixed death benefit when the insured dies;
    - fixed endowment benefit when the policy matures or a fixed coupon payment every 1 or 3 years until the policy matures;
    - annual dividend payment.

2. The annual dividend is required to be paid to the policyholder based on the surplus performance of the participating portfolio. If the performance of the underlying assets of the participating portfolio is below the guaranteed level, the entity does not need to pay the dividend to the policyholder. The portfolio includes all the participating products of the entity, with new policies continuously being added.

3. Typically, the annual dividend is calculated as such: 70% (as required by the regulator) of the net return of the underlying assets (asset yield minus an interest rate of 2% or 2.5% as stipulated in the contract).

4. If the policyholder surrenders the policy or the insured event happens in the middle of the year, a proportional amount of dividend will be paid out based on the dividend level announced in the current year.

5. The entity usually uses a smoothing mechanism to enable a more stable dividend payout through the lifetime of the contract. The smoothing mechanism works by establishing a fund pool (as part of the underlying asset) to defend against market volatility. For example, if the asset yield is much higher than previous year, say 8%, the company may not calculate the dividend just based on the formula ((asset yield - 2%/2.5%)*70%). Instead that company will keep an excess 2% return and put it into the fund pool. However in the following year, if the asset yield drops to 2%, the company can still decide to announce a dividend at 3% by utilizing the fund pool. This also means that even if the performance of the underlying assets of the participating portfolio drops below the level as stipulated in the contract, a dividend could still be paid to the policyholder due to this smoothing mechanism.

6. In general, experience adjustments due to the short term financial market fluctuation (e.g. interest rate and equity price fluctuation) will arise from the actual dividend paid based on the asset yield and the expected dividend based on yield assumptions embedded in the liability calculation. In this particular fact pattern, the dividend which is paid to the policyholder based on the smoothing mechanism will be different from the expected dividend based on actual returns.

7. Questions: Are the dividend payments (and its related experience adjustments) in participating products a non-distinct investment component? For simplicity, we assume the following discussion is focused on participating products with only interest gain sharing. If the dividend payments (and its related experience adjustments) are not considered an investment component, how should it be accounted for?

Paragraphs of HKFRS/IFRS 17 Insurance Contracts

Appendix A, definition of the "Investment Component": The amounts that an insurance contract requires the entity to repay to a policyholder even if an insured event does not occur.

Paragraph 10 of IFRS 17 states that 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). An entity shall apply IFRS 17 paragraphs 11–13 to identify and account for the components of the contract.

After separating out all distinct components of the contract, paragraph 13 of IFRS 17 states that an entity shall apply IFRS 17 to all remaining components of the host insurance contract.

Paragraph 87(b) of IFRS 17 states that the insurance finance income or expenses (IFIE) includes the change in the carrying amount of the group of insurance contracts arising from the effect of financial risk and changes in financial risk.

Paragraph B31 states that an investment component is distinct if, and only if, both the following conditions are met: (a) the investment component and the insurance component are not highly interrelated; and (b) a contract with equivalent terms is sold, or could be sold, separately in the same market or the same jurisdiction, either by entities that issue insurance contracts or by other parties. The entity shall take into account all information reasonably available in making this determination. The entity is not required to undertake an exhaustive search to identify whether an investment component is sold separately.

Paragraph B32 states that an investment component and an insurance component are highly interrelated if, and only if: (a) the entity is unable to measure one component without considering the other. Thus, if the value of one component varies according to the value of the other, an entity shall apply IFRS 17 to account for the combined investment and 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 IFRS 17 to account for the combined investment component and insurance component.

Paragraph B96(c) states that for insurance contracts without direct participation features, IFRS 17 paragraph 44(c) requires an adjustment to the contractual service margin (CSM) of a group of insurance contracts for changes in fulfilment cash flows that relate to future service, including differences between any investment component expected to become payable in the period and the actual investment component that becomes payable in the period, measured at the discount rates specified in paragraph B72(c).

Paragraph B97(a) of IFRS 17 states that an entity shall not adjust the contractual service margin (CSM) for a group of insurance contracts without direct participation features for changes in estimates of fulfilment cash flows in the liability for incurred claims because they do not relate to future service.

IFRS 17 requires that investment components should excluded from insurance revenue and incurred claims. Paragraphs BC33-34 further explains why:

- An investment component is an amount that the insurance contract requires the entity to repay to the policyholder even if an insured event does not occur. Such obligations, if not included within an insurance contract, would be measured and presented in accordance with IFRS 9.
- The IASB decided that when an investment component is interrelated with the insurance components in an insurance contract, it is appropriate to measure both the investment component and the insurance component in accordance with IFRS 17.
- However, the IASB decided that if an entity were to present the receipts and repayments of such investment components as insurance revenue and incurred claims, it would not faithfully represent the similarities between financial instruments within the scope of IFRS 9 and investment components embedded in insurance contracts within the scope of IFRS 17. This is because to do so would be equivalent to a bank recognising a deposit as revenue and its repayment as an expense.
- Accordingly, the requirements of IFRS 17 exclude such investment components from insurance revenue and incurred claims. To achieve this without separating the investment component for measurement purposes, the IASB decided to identify the investment components only at the time revenue and incurred claims are recognised, and to exclude the amounts so identified.

Paragraph BC230(b) of IFRS 17 states that for insurance contracts without direct participation features, the entity's profit from financing activities arises from the difference between: (a) the gains (or losses) from the investments; and (b) the change in the insurance contract liability depicted by the insurance finance income or expenses including the gains (or losses) the entity passes to the policyholder through any indirect participation mechanism.

Analysis of question

View 1: The dividend payments are not an investment component of the contract

8. Under IFRS 17, an investment component is an amount that an insurance contract requires the entity to repay to a policyholder even if an insured event does not occur.

9. For the participating products in question, in substance, the annual dividend payment is a sharing of the 'income' generated by the entity. This is unlike other investment components, such as cash surrender value, which are guaranteed amounts to be repaid to the policyholder.

10. As such, the nature of the dividend payments are viewed to be more like the dividend of common stock, because it is not a guaranteed payment – it only needs to be paid when there is a surplus performance of the participating contracts. Therefore, it is not an investment component and should be accounted in accordance with the relevant IFRS standard.

View 2: The dividend payments are an investment component of the contract

11. Dividend payments are made if there is a surplus performance of the participating contracts. The entity needs to pay the policyholder dividends even when the insured event does not occur. Therefore, it is an investment component.

12. Appling IFRS 17 paragraph B31 to this participating product, the investment component is viewed as non-distinct because the investment component and insurance is highly interrelated – the entity is unable to measure the dividend without considering the performance of the underlying assets of the participating products. That means that the policyholder is unable to benefit from the investment component unless the insurance component is also present. Furthermore, there is no equivalent contract that could be sold separately. As such, IFRS 17 should be applied to account for the combined investment component and insurance component. Furthermore, it is noted that in the year the policy lapses or matures, it does not cause a lapse or maturity of the annual dividend payment immediately. That is, a proportional amount of dividend will be paid out based on the dividend level announced in the current year. However, subsequent to the year that the policy lapses or matures, no other dividend will be paid, meaning that the investment component has also lapsed.

13. Applying IFRS paragraph B96(c), if treating dividends as a non-distinct investment component, the current experience adjustment for the investment component will be required to adjust CSM.

Conclusion

14. We support view 1 for the reasons above. Furthermore, if view 2 were applied, it would mean that the current dividend experience adjustment which is due to financial risk and not future service (e.g. not adjusted for future expectations) would also impact the CSM. However, this appears to be inconsistent with IFRS 17 paragraph B97(a) of IFRS17 which states the CSM should not be adjusted for the effect of financial risk and change in financial risk.

15. In addition, the income statement will present an unstable result during market turbulence. For example: Investment income fluctuates more than the IFIE since the IFIE calculated does not include the changes in financial risk from the dividend payments. Therefore, we suggest that the current

period experience difference of dividend coming from the financial risk (not related to future service) should be presented under IFIE, thus better matching the investment income in current period.

16. Refer to the example in Appendix A for better understanding:
    Method1 assuming dividend experience adjustments impact the CSM
    Method2 assuming dividend experience adjustments are recorded in IFIE.