



**Preliminary Exposure Draft of
International Actuarial Standard of Practice
A Practice Guideline***

**Embedded Derivatives and Derivatives under
International Financial Reporting Standards
IFRS [2005]**

**A Preliminary Exposure Draft of the
Subcommittee on Actuarial Standards of the Committee on Insurance Accounting
International Actuarial Association / Association Actuarielle Internationale**

**Distributed on November 30, 2005
Comments to be sent to katy.martin@actuaries.org by March 30, 2005**

**Practice Guidelines are educational and non-binding in nature. They represent a statement of appropriate practices, although not necessarily defining uniquely practices that would be adopted by all actuaries. They are intended to familiarise the actuary with approaches that might appropriately be taken in the area in question. They also serve to demonstrate to clients and other stakeholders and to non-actuaries who carry out similar work how the actuarial profession expects to approach the subject matter.*

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This Practice Guideline applies to an actuary only under one or more of the following circumstances:

- If the Practice Guideline has been endorsed by one or more IAA Full Member associations of which the actuary is a member for use in connection with relevant International Financial Reporting Standards (IFRSs);
- If the Practice Guideline has been formally adopted by one or more IAA Full Member associations of which the actuary is a member for use in connection with local accounting standards or other financial reporting requirements;
- If the actuary is required by statute, regulation, or other binding legal authority to consider the Practice Guideline for use in connection with IFRS or other relevant financial reporting requirements;
- If the actuary represents to a principal or other interested party that the actuary will consider the Practice Guideline for use in connection with IFRS or other relevant financial reporting requirements; or
- If the actuary's principal or other relevant party requires the actuary to consider the Practice Guideline for use in connection with IFRS or other relevant financial reporting requirements.

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Embedded Derivatives and Derivatives

1. Scope

The purpose of this PRACTICE GUIDELINE (PG) is to provide advisory, non-binding guidance to ACTUARIES or other PRACTITIONERS that they may wish to take into account when providing PROFESSIONAL SERVICES in accordance with INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRSs) with respect to the identification or measurement of EMBEDDED DERIVATIVES incorporated within INSURANCE CONTRACTS, INVESTMENT CONTRACTS, and SERVICE CONTRACTS and separately issued derivatives of a REPORTING ENTITY under IFRSs. This PG applies where the REPORTING ENTITY is an ISSUER of insurance contracts, investment contracts, or service contracts. It is a class 4 INTERNATIONAL ACTUARIAL STANDARD OF PRACTICE (IASP).

The guidance focuses on the identification of when an embedded derivative must be measured separately from its host CONTRACT and related disclosure requirements. In addition, high level guidance is provided for the measurement of both the embedded derivative and the remaining elements of the host contract. The PG is not intended to provide guidance with respect to derivatives in general or hedge accounting.

Reliance on information in this PG is not a substitute for meeting the requirements of the relevant IFRSs. Practitioners are therefore directed to the relevant IFRSs (see Appendix A) for authoritative requirements. The PG refers to IFRSs that are effective as of xx XXXX 2005, as well as to amended IFRSs not yet effective as of xx XXXX 2006 but for which earlier application is made. If IFRSs are amended after that date, practitioners should refer to the most recent version of the IFRS.

2. Publication Date

This PG was published on [date approved by the Council of the INTERNATIONAL ACTUARIAL ASSOCIATION (IAA)].

3. Background

Derivatives and embedded derivatives are defined in INTERNATIONAL ACCOUNTING STANDARD (IAS) 39.9. FINANCIAL INSTRUMENTS and derivatives, both in the form of assets or liabilities, are within the scope of IAS 32 and IAS 39. IAS 39 includes criteria for identifying a derivative and determining whether a derivative embedded in a non-derivative contract involves elements with different characteristics that must be separated for FINANCIAL REPORTING purposes, or whether the contract involves closely related elements that form a single unit and need not be separately reported as a derivative. For financial reporting purposes, derivatives embedded in another contract may need to be distinguished from their corresponding host contract.

Derivatives usually contain a greater concentration of risk than other contracts, e.g., a similar or larger variance at significantly lower net expected value. IAS 39 requires that

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derivatives be measured at their FAIR VALUE with specific exceptions, e.g., certain derivatives within the scope of IFRS 4.

The most frequently applicable IFRSs pertaining to this PG are given in Appendix A. Due to the complex nature of the topic dealt with by this PG, it may be useful to read the relevant sections of IAS 39 and its Implementation Guidance (IG) and IFRS 4.7–9, INTERNATIONAL FINANCIAL ACCOUNTING STANDARD (IFRS) 4, BC188–194, IFRS 4, IG3–4, and IG Example 2 in connection with this PG.

4. Practice Guideline

4.1 Overview

This PG addresses various aspects of the recognition, measurement, and disclosure of derivatives and embedded derivatives, focusing on the following:

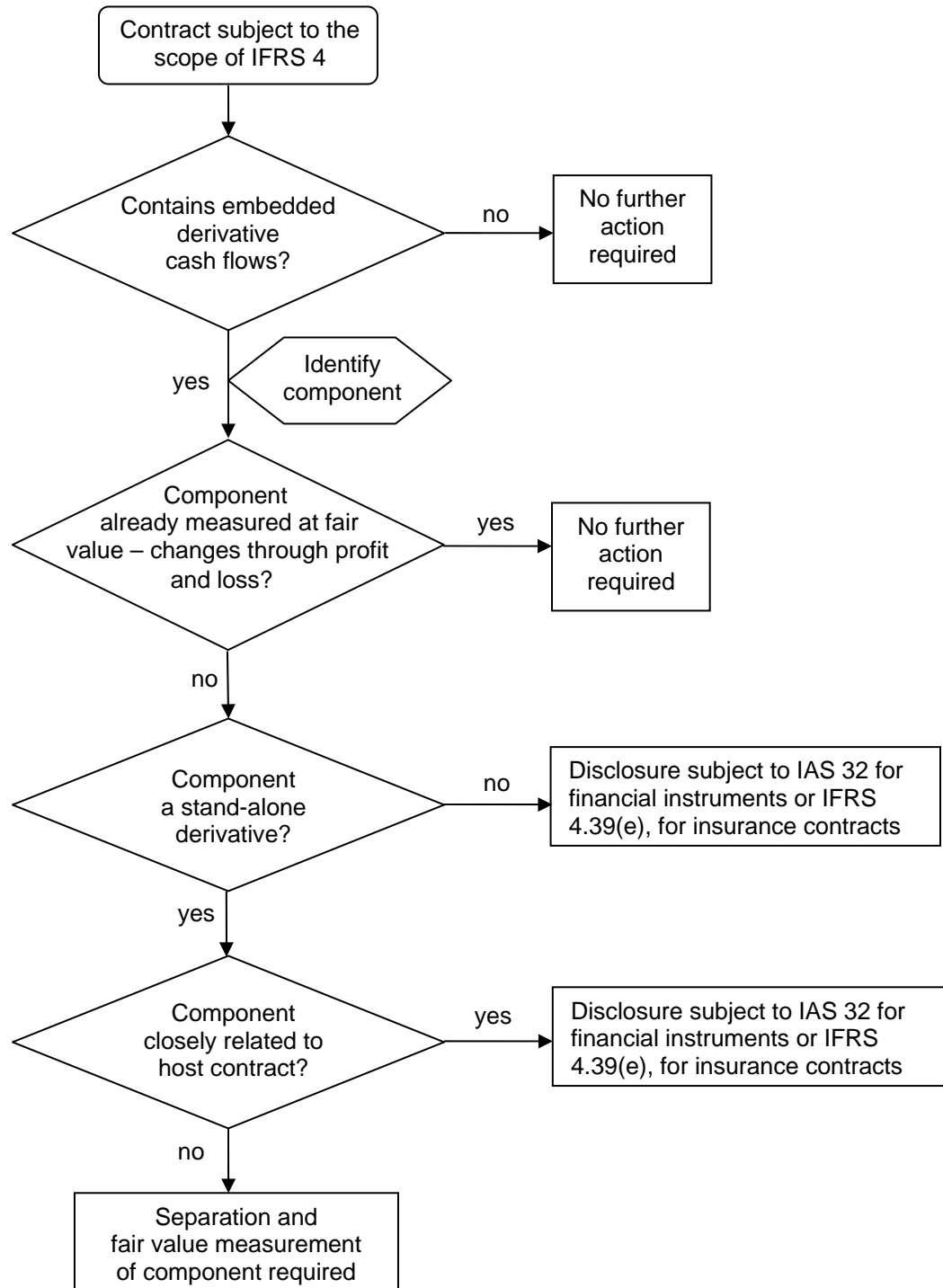
1. The definition of a derivative and its identification, primarily with respect to those characteristics that might be relevant in the case of insurance and other contracts issued by an INSURER;
2. Criteria applied in the identification of contracts that might contain embedded derivatives by reference to their expected cash flows;
3. After identification of a COMPONENT containing EMBEDDED DERIVATIVE CASH FLOWS, the application of the definition of a derivative to the component regarding whether the component would on a stand-alone basis be recognised as a derivative;
4. The assessment of an identified embedded derivative for possible separation under IAS 39; and
5. Some key aspects of required measurement and disclosure.

IAS 32, IAS 39, and IFRS 4 provide primary accounting requirements and guidance for these issues. Other sources of related guidance from the International Accounting Standards Board (IASB) are listed in Appendix A.

In those cases where the entire contract is measured at fair value (as defined in IAS 39.9) with changes through profit or loss, no further action is needed, i.e., the embedded derivative need not be separated from its host contract. Examples include cases in which a contract is a derivative (see 4.2 for further discussion) in its entirety and cases where a financial instrument is classified under IAS 39 as “trading” measurement or “at fair value through profit or loss” (see 4.4.2).

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The following chart provides a high-level overview of the steps for identification decisions for treatment as discussed in this PG (based on IAS 32.4 and 32.4(d); IAS 39.2, 39.2(e), and 39.9–11; and IFRS 4.7–9 and 4.34(d)).



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Notes to the above chart:

1. The first step is to assess the contract to determine whether it contains embedded derivative cash flows (see 4.3 for definition and discussion).
2. If it does, the component containing those cash flows has to be separately determined (see IASP 3, *Classification of Contract under IFRS*, concerning the definition and identification of components of a contract).
3. If the component or any part of the contract containing that component is classified as “at fair value through profit or loss,” no further action is required (see 4.4.2 for further discussion).
4. If the component would, if it were a stand-alone contract, meet the definition of a derivative, the component is within the scope of IAS 39 (see 4.2 as to how to identify a derivative). Note that a component under step 3 above can also be a derivative, but this position has no consequence for financial reporting if the contract is already measured at fair value. Also, a component that would be subject to IFRS 4 is not treated as a “derivative.” In such a case, if the component is an embedded derivative, there are special disclosure requirements (see IFRS 4.39(e)).
5. If the embedded derivative is not measured at fair value or if changes in its fair value are not recognised in profit or loss (see 4.6 for further discussion), then:
 - Where the host contract is an insurance contract, IFRS 4.39(e) requires specific disclosures; and
 - Where the host contract is a financial instrument, the disclosure rules of IAS 32 apply.
6. If the component meets the criteria as a derivative on a stand-alone basis and is not closely related to the host contract (see 4.4.1 for further discussion), the embedded derivative has to be separated and measured at fair value (also see 4.5). If the host contract is within the scope of IFRS 4, embedded derivatives in the form of a surrender right providing fixed surrender values need not be separated. The embedded derivative is also subject to some of the disclosure requirements of IAS 32 (see 4.6 for further discussion).

4.2 Identification of derivatives according to IAS 39

IAS 39.9 defines a derivative as a:

...financial instrument or other contract within the scope of this Standard (see paragraphs 2–7) with all three of the following characteristics:

- (a) its value changes in response to the change in a specified interest rate, financial instrument price, commodity price,

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- 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 (sometimes called the “UNDERLYING”);
- (b) it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in MARKET FACTORS; and
 - (c) it is settled at a future date.

Since the economic substance of contracts offered by insurers can differ significantly from the examples of financial instruments included in the IG and products can vary significantly by jurisdiction, the substance of the contract is looked at rather than its product labels.

The following relates to the scope of IAS 39 and the interpretation of criteria (a) and (b). Criterion (c) is usually not relevant in the case of contracts considered in this PG. In determining whether a contract is a derivative, each criterion outlined in IAS 39.9 is considered individually. Further interpretation is provided in Appendix A of IAS 39, AG9–12. Implementation guidance is included in IAS 39, IG B(2–10), and IFRS 4, IG3–4.

For professional services undertaken in conjunction with the identification of derivatives, all features, conditions, terms, and expected cash flows that would be considered in calculating the fair value of the contract according to IAS 39 would ordinarily be considered.

The categorisation of a derivative is based on its disposition at the outset of the contract. A discussion of the treatment of changes in a contract, including the conditions under which changes are equivalent to establishing a new contract, is included in IASP 3, *Classification of Contracts under IFRS*.

4.2.1 Consideration of scope of IAS 32 and IAS 39

A component of a contract that would on a stand-alone basis be subject to IFRS 4 or that would be a service contract is considered to be an embedded derivative.

A component of a contract within the scope of IFRS 4 that satisfies the definition of an embedded derivative that is also within the scope of IFRS 4 (i.e., a component containing significant INSURANCE RISK or containing a DISCRETIONARY PARTICIPATION FEATURE) remains within the scope of IAS 32, that is, if as a stand-alone contract it is considered to be a derivative by the criteria in IAS 39 as outlined in 4.2 above. A derivative embedded in an insurance contract is within the scope of IAS 32 if IAS 39 requires that

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the embedded derivative be accounted for separately (see IAS 32.4(d), IAS 39.2(e), IFRS 4.7, and IFRS 4.34(d) for reference).

Thus, a component of a contract within the scope of IAS 39 that contains significant insurance risk or a discretionary participation feature significant in relation to the component can be an embedded derivative under IAS 39.10, even though not required to be separated according to IAS 39.11(b). Such a component is subject to all other requirements for embedded derivatives, including the disclosure rules in IAS 32. However, if such a component contained in a contract is subject to the scope of IFRS 4, it is not subject to the measurement aspects of IAS 39.

To the extent that a component contains a foreign currency derivative to be separated, an embedded derivative is also subject to IAS 39 (see IAS 39, AG33(d)).

If a component of an insurance contract satisfies the definition of an embedded derivative, even though it falls within the scope of IFRS 4, and would not be a derivative as a stand-alone contract, the disclosure requirements in IFRS 4.39(e) apply if the component is not measured at fair value (IFRS 4, IG66, gives a guaranteed annuity option and a guaranteed minimum death BENEFIT as examples). Embedded derivatives contained in investment contracts with a discretionary participation feature are subject to some requirement of IAS 32 as part of the entire contract, according to IAS 32.4(e).

Other contracts are subject to IAS 39 in their entirety if a derivative is embedded in the contract, except in cases of foreign currency derivatives. A derivative is always a financial instrument if by definition it is subject to the scope of IAS 39. A contract that contains a derivative is also within the scope of IAS 39, since the definition of a financial instrument or other contracts subject to the scope of IAS 39 also covers those contracts. A contract that contains a component complying with that definition is considered a stand-alone contract, except in the case of foreign currency derivatives.

The definition of an embedded derivative in IAS 39.10 does not specifically exclude contracts with significant insurance risk or a discretionary participation feature. In other words, a component of a contract that would itself be a stand-alone insurance contract can satisfy the definition of an embedded derivative in IAS 39.10 (also see IFRS 4.7). Nevertheless, for contracts within the scope of IAS 39, the stand-alone requirement (IAS 39.11(b)) is not the only requirement for the separate measurement of a component to apply IAS 32 and IAS 39.

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IFRS 4.7 indicates that a component of an insurance contract that satisfies the definition of an embedded derivative, but which would be an insurance contract if stand-alone, is subject to IFRS 4. A similar component of an insurance contract with a discretionary participation feature (IFRS 4.34(d), or an investment contract with a discretionary participation feature (IFRS 4.35) that satisfies the definition of an embedded derivative, is also subject to IFRS 4.

A component of a contract within the scope of IAS 39 that contains significant insurance risk or a significant discretionary participation feature in relation to the component can be an embedded derivative under IAS 39.10, even though not required to be separated according to IAS 39.11(b). This component would still be subject to all other requirements for embedded derivatives, including those in IAS 32. IFRS 4 indicates that components of contracts subject to the scope of IFRS 4 need not be separated according to IAS 39 if, as a stand-alone contract, they would be within the scope of IFRS 4. However, components of contracts that would be a derivative as a stand-alone contract within the scope of IFRS 4 would be embedded derivatives.

IFRS 4 provides guidance for components of insurance contracts that satisfy the definition of an embedded derivative but are not measured at fair value (IFRS 4.39(e)), including those components not subject to IAS 39 because as a stand-alone contract those components would fall within the scope of IFRS 4.

Components of service contracts not within the scope of IAS 39 are not subject to the requirements of IAS 39, except in the case of foreign currency derivatives embedded in such contracts.

4.2.2 Interpretation of criterion (a): impact of market factors

This section describes variables that qualify as an underlying, referred to here as market factors, and the required effect they have on the value of the contract.

4.2.2.1 Identification of market factors

Market factors include financial variables such as interest rates, financial instrument prices, commodity prices, foreign exchange rates, indices of prices or rates, credit rating, or credit indices. Based on the definition of a derivative in IAS 39, a market factor is variable in nature.

Contract elements such as GUARANTEES and OPTIONS would ordinarily be reviewed to determine whether the observed or the expected behaviour of

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the counterparty is or could be correlated with a market factor. If a direct relationship exists, such an element may be an embedded derivative.

Non-financial variables can also be considered to be market factors if they are not specific to one of the parties to the contract. IFRS 4, B9 and IAS 39 AG12(a) provide further guidance on interpreting this point. Examples of non-financial variables that are specific to a party to a contract can include:

1. The specific COST actually incurred in managing and settling a service contract (or SERVICE COMPONENTS of a contract); and
2. Claims development with respect to an insurer's portfolio of insurance risks, even if the insurance risk is not significant.

According to IAS 39's definition of a derivative, the underlying has to be specified in the contract. When, for example, the mix of investments is subject to management's discretion and the average duration of the obligation is longer than the average duration of the current assets, the asset portfolio is not normally considered to be directly related to the contractual cash flows. Usually the underlying in a contract includes a factor that affects the amount or timing of its outcome, resulting in certain cash flows, or is at the discretion of one of the parties to the contract. For example, certain call options permit the acquisition of a stock at a predetermined price (or an annuitisation based on a specified annuity rate), even if the acquisition is at the discretion of the holder of the option.

As always, the substance rather than just the form of the contract is considered. Although it is generally sufficient that all affected parties have the specific variable in mind in entering the contract to fulfil this criterion, this can be difficult to determine. The variable does not have to be named explicitly in the written contract. For example, a put option in an equity is a derivative, even though the underlying (the price of the equity) is not explicitly named in the contract and the equity itself is named.

A contract is a derivative that grants one party unilateral rights that affect the contract's cash flows, whose execution might be triggered by market factors not explicitly mentioned in the contract but which can be determined from the contract's intended economic use. A contract whose cash flows are subject to one party's decisions that are dependent on a specific market factor can also be a derivative. Examples include unilateral rights to surrender investments, rights to increase investments at predetermined terms, and prices that are independent from a written condition in the contract. Those rights will generally be executed when

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the economic value of the available alternatives is sufficiently large. As a result, as long as the other criteria required are fulfilled, cash flows from contract surrender can be indirectly impacted by market factors, thus categorising such rights as a derivative.

In any case, according to IAS 39.9, even the non-written alternative has to be identifiable at the outset of the contract to be specified. A market factor that influences the value of the contract arising only after the contract is issued can be viewed as having created a derivative. The fact that rights or obligations inherent in the contract have different values under different market conditions without reference to a specific market factor (such as the market value of an alternative instrument that has similar characteristics at outset) is not sufficient to create a derivative.

This can apply in cases where contractual cash flows later become subject to market factors in a way not foreseeable at contract outset. An example might be a term life insurance contract in which a one-time bonus based on favourable mortality experience is granted. This can introduce the effect of a market factor on the contractual cash flows not present when the contract was entered into. In this case, the market factor is not necessarily specified.

4.2.2.2 Required effect of the market factor on the value of a derivative

The definition of a derivative in IAS 39 indicates that the value of a derivative contract changes in response to changes in the underlying. Those changes normally reflect a direct effect on the contract's associated cash flows, but the value might also reflect an assessment of the extent of its adequacy. For example, a derivative may provide for the payment of a cash flow at a fixed time for an amount proportional to a market factor that is an element of a contract. This may occur even if the value of the right to receive that cash flow depends on the interest rate achievable elsewhere in the market.

The value of the contract under consideration is measured at its fair value. IAS 39, AG30(g), does not require a comparison with AMORTISED COST or other book value but only a reference to an approximation of the fair value used for that contract. Usually, an overall assessment is applied to determine whether a fair value measurement is dependent on a market factor.

Typically the measurement of the fair value of a surrender option in a contract with a savings element would reflect the relationship between the interest provided under the contract and market interest rate scenarios,

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which together would be considered a market factor, as well as the surrender value itself. In such a case, it can be assumed that the value of the option changes in response to changes in that market factor.

To qualify as a derivative, a change in the value of the contract that occurs as the underlying changes has to be material. The significance of the change is normally assessed in comparison with its expected value and the uncertainties involved and does not depend on the measurement approach chosen. In some cases, the change might not be significant, such as the effect of market factors on the values of term life insurance contracts. A review of materiality does not usually consider unlikely scenarios and those scenarios in which changes are quite small.

In summary, to qualify as a derivative, the market factor affects the financial character of the contract. Nevertheless, it is not necessary, as in the case of a put or call option for a traded financial instrument, that the value be determined solely by the market factor.

A right to exchange one net right with another one at fair value on the exercise date is not classified as a derivative, since the net value of that right is always zero and is not affected by market factors. An example is a contract with unit-linked benefits payable upon maturity for the market value of the number of units purchased by a single premium that acquired units at their market value. The right to surrender the contract at the fair value of the units at the time of surrender has no value, since the surrender value equals the fair value of the maturity value. However, a precondition for this approach is that the fund underlying the units does not consist of a significant amount of derivatives.

If at the outset of a contract it can be reasonably expected that the ability to settle the obligation is consistent with prices in the relevant market, the value of that obligation depends only on a variable specific to a party of the contract. A typical example regarding a service, e.g., the underwriting service provided by a reinsurance company, can be viewed as being provided at this price or cost of the service.

4.2.3 Interpretation of criterion (b): alternative investments

Criterion (b) of IAS 39.9 indicates that a characteristic of a derivative is that either no net initial investment is required or the amount of net investment required compared with investments involving a similar FINANCIAL RISK is sufficiently small as not to be material.

This section describes the identification of such other investments or contracts that can be used for comparison with the potential derivative.

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For convenience, this PG refers to them as ALTERNATIVE INVESTMENTS. The PG also addresses the determination of whether there is no net investment or a smaller net investment than required in order to be characterised as being the alternative investment.

4.2.3.1 Identification of an alternative investment

The identification of an alternative investment can be a matter of judgment. IAS 39 does not explicitly define the term “investment.” This PG assumes that an alternative investment represents an ordinary type of asset, such as a fixed interest security, an ordinary equity interest in commercial activity, or an interest in a property. By definition, an alternative investment cannot include a derivative.

When identifying an appropriate alternative investment, it is important to include similar services or other features that require payments but whose value is not subject to market factors. For comparison purposes, any feature whose value is subject to market factors is excluded.

The alternative investment is determined by considering some or all of the financial risk transferred by the potential derivative. Typically, a derivative transfers all or some of the volatility in the market price of the ordinary type of asset from a given reference point without involving a portion of the asset, but by requiring a market price based on market expectations regarding the risk of that volatility as an initial net investment. An alternative investment usually funds a commercial activity, while a derivative provides for its expected volatility or transfer of the risk of it deviating from a specified value.

With respect to non-financial variables, special consideration may be needed to identify the appropriate alternative investment. Some of these considerations include the following:

1. If the variable affecting the value of the contract does not involve an economic risk exchanged in a financial market, no alternative investment may be identifiable;
2. A variable that does not represent risk from an ordinary type of asset (as indicated above) may not form the basis of an alternative investment;
3. If an alternative investment is not available, the contract is not recognised as a derivative unless no significant initial net investment is required. For example, a variable that determines the outcome of a bet or game that does not normally constitute the basis of economic

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activity (except, for example, in the case of a casino) is not considered to be a derivative;

4. Some natural events might not affect an observable investment. For example, even if a forest fire influences the cash flows of a contract, it does not necessarily qualify that contract as a derivative; and
5. A contract referring to a risk usually covered by an insurance contract under IFRS 4 that does not require insurable interest is not considered to be an insurance contract. If such a contract is not considered to be a derivative due to a lack of an identifiable alternative investment, special care may be needed in considering the inherent risk involved.

A non-financial variable that reflects an event that is expected to affect a commercial activity can be considered economically relevant. Examples of such variables are weather conditions that affect commercial activities like agriculture or tourism and population longevity that could affect the aggregate cost of living. Investments in such activities could be viewed as being subject to such variables and thus potentially suitable as alternative investments. For example, a life annuity can be seen as an example of an alternative investment subject to longevity risk.

4.2.3.2 Comparison with the alternative investment

The term “initial net investment” referred to in (b) of the definition of a derivative in IAS 39.9 is limited to the cash flows exchanged at the outset of a contract. In contrast, especially in long-term periodic premium contracts, it may represent the present value of the overall contributions payable by the party, e.g., the POLICYHOLDER, to establish the rights that cause the contractual terms to satisfy (a) of the definition of a derivative in IAS 39.9. Particularly when related to insurance contracts, obligations are often priced considering an initial set of voluntary instalments, although not paying the instalments or premiums may place an obligation in jeopardy of losing the INSURABILITY or the price otherwise provided for, which is a difference between an insurance contract and an investment contract.

The criteria are satisfied if the initial net investment in a contract is significantly less than that required of a corresponding investment in an alternative investment. Thus, for insurance as well as other contracts, underpricing, done intentionally or by mistake, does not create the leverage characteristic of a derivative. Underpricing might be explained by assuming that the contract was intentionally priced below cost, or if it indicates that there is no investment or less investment in the contract than in the alternative investment. If it can be demonstrated that a contract is

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an investment contract rather than being inadequately priced, it would not have the character of a derivative.

4.3 Identification of embedded derivatives according to IAS 39**4.3.1 In a hybrid (combined) instrument**

According to IAS 39.10, “An embedded derivative is a component of a hybrid (combined) instrument that also includes a non-derivative host contract – with the effect that some of the cash flows of the combined instrument vary in a way similar to a stand-alone derivative. An embedded derivative causes some or all of the cash flows that otherwise would be required by the contract to be modified according to a specified” market factor.

Thus, a hybrid (combined) instrument consists of a combination of separable economic features, each of which could stand alone as an independent contract. For example, a unit-linked contract that does not provide options or a set of benefits, other than that payable determined in reference to the current value of the contractually defined units, does not include separable economic features. A unit-linked contract providing a minimum benefit, e.g., based on the sum of premiums accumulated at a fixed interest rate in addition to benefits based on the current value of units, contains a separable economic feature. In other cases, a contract providing benefits based on premiums accumulated at a fixed interest rate and additional benefits associated with results more favourable than the current value of units of a fund contains a separable feature incorporating conditions that determine those additional benefits.

The application of substance over form nevertheless suggests that, even if the entire contract could satisfy the requirements of a derivative, its recognisable hybrid character would usually be reflected. In some cases, the entire contract might not meet the criteria of a derivative as outlined in 4.2 if the effect of the component with a derivative feature is not significant in relation to the entire contract.

A non-derivative contract is not split in an artificial manner into two offsetting derivatives or into a derivative and an embedded derivative.

If premium refunds are an integral part of the entire contract and cannot be separated based on their own economic features, they would not constitute a contract component. If at outset the expected cash flows can be significantly affected by refunds of premiums reflecting the cost of other benefits, the refund conditions do not constitute conditions that modify cash flows in a way that would otherwise be contractually required.

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Rather, where the split in conditions is the result of different benefit characteristics, they are viewed in combination, together with the cash flows whose effect on performance is considered.

4.3.2 Modifying conditions

If identifiable conditions (such as benefits expressed in terms of an external financial index) exist that can affect the cash flows of a component of a contract, the component can constitute an embedded derivative. Conversely, if these conditions do not exist, the cash flows will not change in a corresponding manner.

These conditions have to be explicitly identifiable in the contract with their effect being measurable. A contractual cash flow not subject to such explicit contractual conditions cannot be separated as an embedded derivative. Nevertheless, the entire contract can still be a derivative in such a case if it meets the criteria for a derivative.

A cash flow denominated in a foreign currency is an exception to this rule, e.g., premiums for insurance contracts or prices charged for service contracts. If a foreign currency is involved, it is assumed that the cash flow is determined by the contract in the functional currency (as defined in IAS 21) and the contract feature determining how it is translated into foreign currency is an embedded derivative. IAS 39, AG33(d), recognises the following as functional currency:

- (i) the functional currency of any substantial party to that contract;
- (ii) the currency in which the price of the related good or service that is acquired or delivered is routinely denominated in commercial transactions around the world (such as the U.S. dollar for crude oil transactions); or
- (iii) a currency that is commonly used in contracts to purchase or sell non-financial items in the economic environment in which the transaction takes place (e.g., a relatively stable and liquid currency that is commonly used in local business transactions or external trade).

If the cash flow is denominated in the functional currency, the contract does not contain an embedded foreign currency derivative.

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4.3.3 Identification of embedded derivative cash flows

The modified cash flows that meet the definition of an embedded derivative in IAS 39.10 are referred to in this PG as embedded derivative cash flows. To identify components that may constitute an embedded derivative, the effect of the contract cash flows is reviewed to determine whether the conditions unaffected by market factors are modified in response to a market factor in a manner similar to the cash flows of a derivative.

The financial risk inherent in such contractual cash flows can give rise to derivative characteristics. Any contractual influence affecting (i.e., increasing or decreasing) that financial risk or changing its distribution function contributes to that financial risk. Affected cash flows subject to a (positively or negatively) correlated financial risk are considered together on a combined basis. If the impact of the market factor on that net cash flow is significant, then the net cash flow is an embedded derivative cash flow.

Derivatives can be based on market factors that affect only the value of the derivative without affecting the cash flows by affecting the inherent time value of money. Embedded derivatives are based on market factors directly affecting the cash flows.

Relevant impacts on cash flows include those (1) that can be directly triggered by market factors (i.e., contractual terms linking cash flows directly to market factors); (2) that can be affected by compound market factors; (3) where other factors not related to an underlying trigger whose market factor impacts cash flows (double-triggers); and (4) where market factors indirectly influence counter-parties in executing options.

Typical conditions in insurance contracts that can modify cash flows otherwise required by the contracts include participation or premium adjustment clauses, retentions, layers, and additional investment returns affected by market factors. In some cases, the modification is not subject to a market factor.

4.3.4 Impact of certain non-financial variables

The following are two examples of non-financial variables that can affect the cash flows of an embedded derivative:

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1. Behaviour of parties

The behaviour of parties to a contract, e.g., policyholders, can be considered to be a non-financial variable and hence not a market factor. Nevertheless, the behaviour of counterparties can be influenced by market factors so that the contractual terms and conditions by themselves do not reflect all the relevant economic conditions. In those cases, the effect on cash flows of this behaviour, e.g., in executing options, may be represented as an embedded derivative cash flow.

In other cases, non-financial factors specific to one party can influence the counterparties' behaviour to an extent that market factors do not have a significant influence on the cash flows. If this influence can be demonstrated by observable market data and by the relevance of those factors, then the related contractual rights may not give rise to embedded derivatives. Such factors might include GUARANTEED INSURABILITY options and changes in tax law and social insurance rules. In such cases, options contain only limited discretion in executing them, e.g., factors that are not market factors can "force" holders of those rights to execute them only in a limited manner, and the applicability of market factors can be limited by uncertain events such as unemployment or disability that reflect insurance risk. For example, in some cases policyholders are obliged or encouraged to purchase insurance (e.g., private health insurance that can substitute for a state-organised plan, fire insurance for houses with mortgages, and car insurance for leased cars). Although the contract provides the option to surrender the contract at the policyholder's discretion, the policyholder's incentive to surrender the policy bears little, if any, relationship with changes in any market factor; rather, its continuation can be based on the specific individual legal situation or continued need for insurance.

In some cases, counterparty behaviour may offset the effect of an underlying, directly affecting cash flows. One example is a contract that requires increases in premiums through a market factor, while the counterparty has a right to refuse or negotiate such increases. In that case, both effects would be considered together.

Whenever options exist that provide a right to choose between alternatives of similar fair value, it may be seen as a rebuttable presumption that the behaviour of the holder of the right relates to a financial variable specific to the party. This includes cash values that are close to the fair value of the future net benefits under the contract and to any similar features (e.g., certain forms of persistency bonuses and some participation clauses). A performance-linkage feature under long-term contracts under which it is uncertain which investments will generate relevant future cash flows can

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be assumed to provide surrender values sufficiently close to fair values if these are based on the current dividend allocation basis (i.e., a notional amount for future dividend allocations).

2. Insurance risk and guaranteed insurability

In the same way that cash flows triggered by both insurance risk and other variables are insurance contracts rather than derivatives (see IFRS 4, B11), options can be influenced by insurance risk. If the effects of financial risks are insignificant, the affected cash flows are not the basis of an embedded derivative. However, if the insurance risk is significant, although the component can be a derivative, it is outside the scope of IAS 32 and IAS 39. The significance of insurance risk is assessed in relation to the component containing the cash flow affected by a market factor (IFRS 4, B28).

The feature of insurance contracts that extends the period of coverage after a fixed duration can include a guaranteed insurability option. In some cases, such guaranteed insurability rights can create significant insurance risk in comparison with the component reflecting the option for that contract modification. This can also arise if the overall contract is not otherwise an insurance contract.

Guaranteed insurability can be significant if it is expected that the holder of these rights considers the right significant and the guarantee potentially creates significant insurance risk. Especially in the case of term life insurance contracts, health insurance contracts, and other forms of insurance contracts with little or no surrender value and without maturity value (i.e., without an explicit saving feature), the guaranteed insurability option that can be chosen by one of the parties can be an important consideration in the execution of options under a contract, resulting in the relatively insignificant size of financial risk in these contracts.

In some cases, an INSURED EVENT can generate a benefit, e.g., a disability benefit that provides a non-life contingent benefit, which can continue even though insurance coverage is no longer provided. In such a case, the contract continues to be an insurance contract for its entire duration. Policyholder rights that can affect future cash flows after the end of the insurance or investment coverage period can give rise to embedded derivative cash flows if they are affected by market factors. Such rights might therefore result in an embedded derivative.

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4.3.5 Identification of the component

The existence of an embedded derivative is indicated by the existence of embedded derivative cash flows among the contractual cash flows (IAS 39.10). After identifying such embedded derivative cash flows, the component (as defined in IASP 3, *Classification of Contracts under IFRS*) containing those embedded derivative cash flows needs to be identified.

This component does not include cash flows of the host contract (i.e., cash flows that are modified by the embedded derivative). The next step is to determine whether the overall contract qualifies as a derivative. IAS 39 requires that an embedded derivative be represented by an explicit contract clause modifying the contract's cash flows resulting from other contract clauses that are not part of the embedded derivative.

In addition, if a component on a stand-alone basis would satisfy the requirements of a derivative, then the component is an embedded derivative, even though this determination is not reached as a result of the definition. The identification of a derivative is discussed in 4.2 above.

4.4 Separation requirement of IAS 39.11

An embedded derivative is measured separately at its fair value with changes through profit or loss if all three criteria of IAS 39.11 are satisfied, except in cases described in IFRS 4.6:

An embedded derivative shall be separated from the host contract and accounted for as a derivative under this Standard if, and only if:

- (a) the economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host contract (see Appendix A, paragraphs AG30 and AG33);
- (b) a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative; and
- (c) the hybrid (combined) instrument is not measured at fair value with changes in fair value recognised in profit or loss (i.e. a derivative that is embedded in a FINANCIAL ASSET or FINANCIAL LIABILITY at fair value through profit or loss is not separated). (IAS 39.11)

Before a conclusion can be drawn from the definition of derivatives or embedded derivatives, the principle of “substance over form” is considered. Even if a contract or a part of a contract satisfies the definition of a derivative according to

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its contractual terms, it is not one if it does not reflect the economic reality or the intentions of the reporting entity (IAS 39, IG A.1, discusses the established intentions of the entity overriding the contract terms).

This section discusses criteria (a) and (c). Criterion (b) has already been discussed, since without it the component of a contract in the scope of IFRS 4 would not be subject to IAS 39.11.

Section 4.4.3 addresses IFRS 4.8–9.

4.4.1 Interpretation of criterion (a): close relationship

The identification of a close relationship requires judgment. The following discusses several special cases often present in insurance contracts.

4.4.1.1 The principle

The separation and reporting at fair value of an embedded derivative is not required if the risks and economic characteristics of the embedded derivative are closely related to those of the host contract. The main focus of this requirement is on those risks and characteristics that qualify the component of the contract as an embedded derivative.

The economic characteristics and risks of an embedded derivative can be seen as closely related to the host contract if (1) the financial risk inherent in the embedded derivative or an economically similar financial risk is present in the host contract; and (2) it is not possible to split the contract in a manner such that the financial risk is entirely in a part that can satisfy the criteria of an embedded derivative and another part that is not a derivative.

To identify closely related risks, it is useful to review the variables influencing the pricing (the effective relationship of prices and benefits) of the host contract and the embedded derivative. The embedded derivative is closely related to the host contract if it can be demonstrated that the embedded derivative is closely related to either another component of the contract or the host contract.

IAS 39 and IFRS 4, IG, Example 2, provide examples of where embedded derivatives are assessed as either closely related or not. Some of the examples given provide simplified and easy-to-follow guidance to the practical application of the applicable rules.

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4.4.1.2 Consideration of time value of money in pricing

In many cases, insurance pricing, as well as the inherent time value of money, is fixed at the outset of a contract. If the pricing of an embedded derivative is performed on the same basis as the pricing of the host contract, the risk inherent in the embedded derivative resulting from that fixed time value of money can be viewed as closely related to that of the host contract. A typical example is a traditional life insurance product, whose prices are based on a fixed discount rate for both future death and maturity benefits. The risk inherent in the fixed discount rate affects the pricing of the INSURANCE COMPONENT, as well as that of the savings component. However, if at the contract's outset those fixed conditions are significantly more advantageous to the policyholders than the current market conditions, the risks are not closely related (see splitting of deficiencies between host contracts and embedded components in IASP 3, *Classification of Contracts under IFRS*).

If the effective pricing of an embedded derivative is not fixed at outset, e.g., because it depends on the future condition of non-specific variables while the pricing of the host contract is fixed, the resulting risk from the embedded derivative is not closely related to that of the host contract. For example, unit-linked life insurance contracts are sometimes priced using a fixed discount rate, while the maturity benefit is determined based on the development of the units. In contrast, if the pricing of the host contract also reflects that variable, the resulting embedded derivative can be viewed as being closely related.

4.4.1.3 Relevance of periods where variables are causing effects

The existence of a close relationship depends not only on the type of variable itself but also on whether both components are subject to the same variations in that variable, i.e., are subject to the same variable at the same time. For example, a right to continue a contract in an unlimited manner with respect to an investment component that exceeds a related insurance coverage is normally not seen as being closely related to the insurance coverage, even if the guarantees associated with the investment component were closely related to the insurance coverage during the insurance coverage period (IAS 39, AG30(c)). The decision of policyholders to make use of that right is triggered by changes in the variable after termination of the insurance coverage.

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4.4.1.4 Prepayment rights

Prepayment rights, if they can be executed in an amount that is close to the fair value of the net rights arising from continuation of a contract, do not normally constitute an embedded derivative.

IAS 39, AG 30(g), provides guidance regarding when prepayment rights embedded in insurance contracts are not seen to be closely related. A prepayment right can be closely related if the amount at which the right can be executed is similar to the carrying amount of the entire contract, regardless of which basis is chosen as the ACCOUNTING POLICY under IFRS 4. In that case, the utilisation of the prepayment right does not give rise to a profit or loss for the reporting entity and can, therefore, for simplicity, be ignored.

IAS 39, AG33(g), indicates that a prepayment right involving the receipt of the fair value of units in a unit-linked contract is closely related to the host contract, assuming that the benefits of the host contract are also based on the fair value of those units. If the units were acquired at their fair value at the contribution payment date, such a prepayment right is not an embedded derivative. Another prepayment right that can be exercised for an amount based on an equity or commodity price or index would not be closely related to a host contract providing fixed benefits (IAS 39, AG30(a)).

Limited continuance rights are reasonably equivalent to premature surrender rights, given a maximum possible contract duration. The host contract and embedded derivative would in this case be subject to the same continuance conditions.

The prepayment right described in the rule given in IFRS 4.8–9 does not necessarily result in the contract feature being closely related. This rule thus constitutes an exception from IAS 39.11 (see 4.4.3).

4.4.1.5 Index-linked benefits

If the contract provides benefits based on a principal amount plus fixed or market-dependent interest, and includes an additional PROVISION to adjust that interest based on an equity or commodity index, that additional provision is not closely related to the host contract (IAS 39, AG30(d)). On the other hand, if a unit-linked contract directly provides benefits based on the fair value of units of an internal or external fund, the split of those benefits into a fixed interest amount and an adjustment to the fair value of units might prove to be artificial, and therefore such a split would not normally be required.

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If the right to receive such benefits is an embedded derivative (e.g., if the premiums payable are significantly smaller than those required for a direct investment in the internal or external fund that determines the benefits), it is closely related to the host contract (IAS 39, AG33(g)). In such cases, the overall contract is considered in determining whether the contract is already a derivative, such as if the premiums required are significantly lower than those required for a direct investment in an internal or external fund, or if the fund includes a significant amount of derivatives.

4.4.1.6 Leverage, cap, floors, and interest adjustments

An interest adjustment based on an interest-related variable that adjusts the interest otherwise payable, the effect of which would not cause interest earned to be negative, is closely related to the host contract. Similarly, a doubling of the original interest or the doubling of the market interest rate for comparable products is also closely related to the host contract (IAS 39, AG33(a)). This rule thus provides quantitative guidance for the proper interpretation of “closely related.”

An embedded derivative can also be viewed as closely related in cases where the initial net investment deviates significantly from that required for an alternative investment but is similar to that described by a zero return on net investment and twice the return of the alternative investment, or a maximum of double the market interest rate at contract outset. Note that in long duration contracts, the difference between a zero discount rate and a discount rate of double the market interest rate can give rise to a very substantial difference in initial net investment. Nonetheless, IAS 39 refers to the effect on interest rates. Considering the purpose of the rule, it might be appropriate to recognise that in such cases the risks may not be closely related.

An embedded minimum amount of interest rate payable (e.g., a minimum guarantee or floor) where interest is otherwise determined based on market interest rates is closely related to the host contract if that minimum amount is below market interest at the outset of the contract (IAS 39, AG33(b)). Similarly, the right to limit a floating interest rate to a maximum amount (cap) is closely related if the cap is above market interest rate at outset of the contract (IAS 39, AG33(b)).

In the case of a leveraged financial risk, a primary financial instrument whose cash flows are artificially affected by variations in interest rates can change the character of the financial instrument. In this case, leveraging is not closely related to the financial risk inherent in the host contract. If the host contract is not a derivative because the required initial net investment

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is close to that required for an alternative investment, the embedded derivative adds the same or similar uncertainty associated with cash flows. If the required net investment is not sufficient, the additional change in cash flows is also not closely related.

4.4.1.7 Interdependence to a degree that the component is not separately measurable

If an embedded derivative and a host insurance contract are interdependent to an extent that the embedded derivative cannot be measured separately, the risks inherent in both are assumed to be closely related (IAS 39, AG33(h)), especially when the remaining part of the contract is used as a basis for measurement of the embedded derivative.

4.4.2 Interpretation of criterion (c): fair value measurement of the hybrid contract

The separation of an embedded derivative in a contract that is measured at fair value with changes through profit or loss is not required. As long as the contract is subject to IAS 39, the requirement is straightforward. In the case of insurance contracts or other contracts subject to the provisions in IFRS 4, an accounting policy might apply that is not based on an IAS 39-definition of fair value. Judgment may be required to determine whether this measurement complies with the definition of fair value in IAS 39. If the accounting policy does not comply fully with the requirements of IAS 39, resulting in a significant difference in the measurement of the embedded derivative in question, the contract is not measured at fair value.

If the liability measurement is based on observable market prices, as is often the case with unit-linked contracts, assuming no other features affect the fair value of the liability, its determination would be straightforward. In other cases of testing comparability with the IAS 39 definition of fair value, suitable examples of contracts in question may need to be split into a DEPOSIT COMPONENT containing the embedded derivative, an insurance component according to IFRS 4.10, so that the measurement of the deposit component under the existing accounting policy and its fair value under IAS 39 can be compared. If the difference is not significant, the measurement is assumed to be at fair value according to IAS 39. For this conclusion to hold, the measurement of the remaining part of the contract cannot offset the changes in the value of the deposit component under the existing accounting policy.

According to IAS 39, fair value is at least the amount payable on demand discounted from the first date that this amount could be required to be

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paid. Some accounting methods require that the liability for an insurance contract be at least the guaranteed surrender value. It cannot be assumed that such amounts are the fair value of the contract unless it can be demonstrated that the fair value of the contract, including any embedded derivative, cannot be greater than the guaranteed surrender value to be reported as a liability under the entity's existing accounting policies.

IAS 39 also requires that the fair value be based on a discount rate reflecting current risk-free market interest rates of (risk-adjusted) expected cash flows of the same timing as those being discounted. A measurement under current existing accounting policies that uses different discount rates or reports the deposit component of the contract at a level less than the guaranteed surrender value may not provide a fair value in accordance with IAS 39.

4.4.3 Fixed surrender values

Prepayment rights that can be executed at a predetermined amount or at a predetermined amount plus interest are not, according to IFRS 4.8–9, required to be separated in contracts subject to the scope of IFRS 4.

In the case of such contracts, the right to receive on demand premature benefits in lieu of the maturity benefit (or parts of the maturity benefit) at terms fixed at outset where the determination of the amount payable does not depend on market factors after outset is not required to be separated even if it is an embedded derivative and satisfies the requirements in IAS 39.11. Considering that the amount of the maturity benefit depends on past premium payments, the amount payable in case of surrender (or partial surrender) also depends indirectly on past premium payments. Even if the right to pay additional premiums might constitute an embedded derivative that could be separated, the right to surrender such a contract at fixed terms based on corresponding reductions to the maturity value is not an embedded derivative to be separated.

The right included in contracts within the scope of IFRS 4 to pay additional premiums in a predetermined limited amount that will generate an additional maturity value based on fixed terms agreed at outset, similar to the fixed surrender option, is also not an embedded derivative that has to be separated. That right is equivalent to a contract with fixed (i.e., mandatory) subsequent premium payments, a predetermined maturity benefit and a partial surrender right, with surrender values and a reduction of maturity value at terms fixed at outset. A contract requiring fixed subsequent premium payments and a predetermined maturity benefit, does not include an embedded derivative, since no variable influences the

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values of the contract. The surrender right by itself does not add an additional embedded derivative that is required to be separated.

Although IFRS 4.34(d) requires full application of IAS 39, the application of fair value to these embedded derivatives in insurance contracts and investment contracts with discretionary participation features also applies (IFRS 4.8–9).

4.5 Measurement issues

4.5.1 Measurement of embedded derivatives

An embedded derivative separated as a consequence of IAS 39.11 is reported at its fair value determined according to IAS 39 with changes through profit or loss. IASP 4, *Measurement of Investment Contracts and Service Contracts under IFRS*, describes the determination of the fair value of a financial instrument.

Regarding embedded derivatives that are not required to be separated, according to IFRS 4, IG3, “separation and fair value measurement of such an embedded derivative are not prohibited if the insurer’s existing accounting policies require such separation, or if an insurer changes its accounting policies and that change meets the criteria in paragraph 22 of the IFRS.”

4.5.2 Measurement of the host contract

The measurement of the host contract is determined in accordance with its contract classification. For a discussion of host contracts not subject to IFRS 4, see IASP 4, *Measurement of Investment Contracts and Service Contracts under IFRS*.

The measurement of host contracts subject to IFRS 4 is determined according to the entity’s accounting policies. If the accounting policy’s measurement approach explicitly separates the cash flows of the embedded derivative, those cash flows are not considered in the measurement used in the application of the accounting policy to the host contract.

If the existing accounting policy does not explicitly consider these cash flows to be separated and is based on assumptions determined at outset without further change, the initial fair value of the embedded derivative would usually be deducted from the initial value for initial measurement of the host contract (including the embedded derivative). Subsequent measurement of the host contract (excluding the value of the embedded

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derivative) can be determined by applying existing accounting policy to the embedded derivative by using the initial fair value assumptions and deducting this result from the amount determined for the entire contract. Another approach sometimes used is to apply the existing accounting policy to the host contract alone.

4.6 Disclosure issues

Requirements relating to the disclosure of embedded derivatives are included in IAS 32 and in IFRS 4.39(d)–(e).

There are no specific requirements for disclosure of embedded derivatives in host contracts subject to IAS 39, except for those provided in IAS 32 that generally provide for the disclosure of financial risks inherent in embedded derivatives.

Embedded derivatives in host insurance contracts are subject to disclosure requirements according to IFRS 4.39(e) if they are not measured (either separately or together with the host contract) at fair value through profit or loss according to existing accounting policy, IAS 39, or IFRS 4. Embedded derivatives where the host contract is measured at fair value through profit or loss are not subject to these disclosure requirements. Otherwise, disclosure regarding interest rate risk or market risk inherent in those embedded derivatives is required.

Embedded derivatives in host insurance contracts that are separated according to IAS 39.11 are subject to the same disclosure requirements of IAS 32 as if they were stand-alone financial instruments within the scope of IAS 32. See the PG on *Disclosure* for further discussion.

IFRS 4.39(d) requires disclosure of information about interest rate and credit risks inherent in insurance contracts in a manner consistent with the requirements of IAS 32. That includes risks inherent in embedded derivatives, regardless of whether they are measured at fair value and in components that do not qualify as embedded derivatives, since they are outside the scope of IAS 39 or are not separated for other reasons.

Embedded derivatives in host insurance contracts with discretionary participation features are subject to the same disclosure requirements as other insurance contracts regarding embedded derivatives, even though IFRS 4.34(e) does not specifically refer to IFRS 4.36–39.

Embedded derivatives in host investment contracts with discretionary participation features are subject to the disclosure requirements of IAS 32.

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Appendix A – Relevant IFRSs

The most relevant International Financial Reporting Standards and International Accounting Standards for this International Actuarial Standard of Practice are listed below.

- IAS 1 (2001 April) Presentation of Financial Statements
- IAS 8 (2004 March) Accounting Policies, Changes in Accounting Estimates and Errors
- IAS 18 (2004 March) Revenue
- IAS 21 (2003 December) The Effects of Changes in Foreign Exchange Rates
- IAS 32 (2003 December) Financial Instruments: Disclosure and Presentation
- IAS 36 (2004 March) Impairment of Assets
- IAS 37 (1999 July) Provisions, Contingent Liabilities and Contingent Assets
- IAS 38 (2004 March) Intangible Assets
- IAS 39 (2005 August) Financial Instruments: Recognition and Measurement
- IFRS 1 (2005 June) First-Time Adoption of International Financial Reporting Standards
- IFRS 3 (2004 March) Business Combinations
- IFRS 4 (2005 August) Insurance Contracts

In addition, the IASB *Framework* is relevant.

*Embedded Derivatives and Derivatives***Appendix B – List of terms defined in the Glossary**

The first time that these terms are used in this IASP, they are shown in small capital letters. The definitions of these terms are included in the IAA Glossary.

Accounting policy	Reporting entity
Actuary	Service component
Alternative investment	Service contract
Amortised cost	Underlying
Benefit	
Component	
Contract	
Cost	
Deposit component	
Discretionary participation feature (DPF)	
Embedded derivative	
Embedded derivative cash flow	
Fair value	
Financial asset	
Financial instrument	
Financial liability	
Financial reporting	
Financial risk	
Guaranteed insurability	
Guarantee	
Insurability	
Insurance component	
Insurance contract	
Insurance risk	
Insured event	
Insurer	
International Accounting Standard (IAS)	
International Accounting Standards Board (IASB)	
International Actuarial Association (IAA)	
International Actuarial Standard of Practice (IASP)	
International Financial Reporting Standard (IFRS)	
International Financial Reporting Standards (IFRSs)	
Investment contract	
Market factor	
Option	
Policyholder	
Practice Guideline (PG)	
Practitioner	
Professional services	
Provision	