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International Accounting Standards Board

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These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting: **March 2006, London**

Project: **Insurance contracts (phase II)**
Policyholder participation rights
This note covers agenda papers 7A, 7B and 7C

AGENDA PAPER 7A
POLICYHOLDER PARTICIPATION RIGHTS

Purpose of this paper

1. Some insurance contracts give the policyholder both guaranteed benefits (eg a death benefit) and a right to participate in favourable contract performance, but the insurer has constrained discretion over the amount and/or timing of distributions to policyholders.

2. Similar policyholder participation rights are also found in some investment contracts (ie financial instruments) sold by insurers.

3. This paper discusses whether an insurer should classify policyholder participation rights:

   (a) entirely as a liability, or

(b) entirely or in part as an equity component of a compound contract that also contains a liability component. The liability component is the obligation to provide guaranteed benefits.[1]

4. Agenda paper 7B provides illustrative case studies and agenda paper 7C supplies relevant extracts from IFRS 4 *Insurance Contracts*.

5. We plan to deal with separately with the following, which this paper does not address:

(a) The definition of such policyholder participation rights. (As noted in agenda paper 7C, IFRS 4 describes them as **discretionary participation features**, to capture the combination of discretion and constraints on that discretion.)

(b) Unit-linked (variable) contracts (ie contracts in which some or all of the policyholder benefits are determined directly by the performance of a specified pool of assets and/or related liabilities). The unit-linking feature creates constraints without discretion.

(c) Contracts (such as some of the contracts sometimes called 'universal life' contracts) that give the issuer contractual discretion to set a 'crediting rate' that is used to credit interest or other returns to policyholders. The crediting rate is usually subject to a contractual minimum, but the discretion to credit a higher rate is, arguably, not subject to constraints. We plan to discuss universal life contracts in April.

(d) Measurement of policyholder participation rights. This paper deals only with their classification (ie equity versus liability).

Summary of recommendations

6. This paper recommends the following:

(a) Policyholder participation rights do not create an obligation until a particular policyholder has an unconditional right to a distribution arising from that right. (paragraphs 16-20)

[1] **guaranteed benefits** are benefits to which a particular policyholder has an unconditional right that is not subject to the discretion of the insurer. Guaranteed benefits include past

(b) Nevertheless, participating insurance contracts should be classified in their entirety as liabilities. It is important to inform users about the nature and extent of policyholder participation rights. The staff plans to research further whether this is best done solely by disclosure of the underlying risks and of their mitigation by participation rights, or whether separate classification is desirable and feasible (paragraphs 21-29)

(c) For mutuals (subject to further staff research), the measurement of the insurance liabilities should reflect both the cash outflows relating to guaranteed benefits and the cash outflows relating to expected dividends to current policyholders and (to the extent they originate from existing contracts) future policyholders. It follows that a mutual should classify in equity those profits it expects to retain indefinitely. (paragraph 30)

(d) Participation rights in investment contracts should be classified in the same way as participation rights in insurance contracts. (paragraphs 31-34)

Background

7. Policyholder participation rights limit the aggregate risk borne by the insurer. They enable policyholders to benefit from the pooling of risks, but leave some of the risk of changes in the aggregate risk with the policyholders.

8. To illustrate, suppose first that an insurer issues 1,000 non-participating contracts for which the expected (ie probability-weighted) value[2] of future claims and benefits is CU 80 per contract. The actual claims and benefits will turn out higher than CU 80 for some contracts and lower for others. However, there is a risk that the total claims and benefits will exceed CU 80,000 (1,000 times CU 80). The insurer might charge, say, CU 89 per contract to provide it with a target return of CU 9 as compensation for bearing that risk and for servicing the contract.

9. Consider now what would happen if the contracts were participating contracts. The insurer might charge, say, CU 100 per contract. If the actual claims and benefits turn out

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bonuses or dividends that have been allocated unconditionally to particular policyholders. They also include unconditional surrender values.

[2] To simplify the description, this example ignores the time value of money. A more complete example would refer to the expected **present** value.

to equal the insurer's previously estimated expected value of CU 80 per contract, the insurer will pay a bonus of, say, CU 13 to each policyholder.[3] This will leave the insurer with a margin of CU 7 per contract. In this example, the insurer can achieve a margin of CU 7 per contract if average claims do not exceed CU 93. Below that level, the participating policyholders bear the risks, and above that level the insurer bears the risks. The reduced target margin of CU 7 compensates the insurer for bearing that residual risk and for servicing the contract.

10. The contracts discussed in this paper give the insurer varying types and degree of discretion to affect the amount and timing of distributions to policyholders, but that discretion is usually subject to some constraints (contractual, legal, regulatory or market).

11. The insurer's discretion may arose at either or both of two levels:

    (a) in determining the aggregate amount and timing of allocations to policyholders as a class.

    (b) in apportioning that aggregate amount between different policyholders.

12. One striking feature of policyholder participation rights is that distributions are generally made to all policyholders in a specified class whose contracts are then in force. Thus, part of the profit generated by one generation of policyholders is typically distributed to future generations of policyholders. In many cases, a change in the timing of a distribution means that a different generation of policyholders will benefit (though for a small change in timing, there may be significant overlaps between the generations). In some cases, distribution policies are intended to achieve distribution of the profit generated by a contract over its lifetime, by this is not always intended (and perhaps not always feasible).

13. Distributions to policyholders can take various forms, such as cash, additions to the level of insurance cover or additions to surrender values. Various names are used, such as bonus, dividend, allocation, distribution. This paper treats these names as interchangeable.

[3] As noted before, this entire example ignores the time value of money, because this paper concentrates on classification, not measurement.

14. The Board received a briefing on participating insurance contracts at an educational session in December 2005.

15. The rest of this paper deals with three issues:

    (a) Does the participation right create an obligation? (paragraphs 16-20)

    (b) If the participation right does not create an obligation, should it be classified as an equity component of a compound instrument, or should it be classified together with the stand-ready obligation to pay the guaranteed benefits? (paragraphs 21-30)

    (c) Some non-insurance contracts, typically issued by life insurers, also include policyholder participation rights. How should the issuer classify these rights? (paragraphs 31-34)

Does the participation right create an obligation?

16. The key question to consider is whether a policyholder's participation rights create a present obligation. The Framework defines a liability as -'a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits'.

17. In February, as part of the project on the conceptual framework, the Board considered possible revisions to the definition of liability. The Board decided that:

    (a) a liability should continue to be defined directly, with reference to assets,

    (b) it is the present obligation, not the future sacrifice, that is the liability,

    (c) an obligation to forgo a cash inflow or to stand aside can be a liability,

    (d) only an obligation to one or more other entities can be a liability,

    (e) the notion of little or no discretion should be replaced by the notion of compulsion,

    (f) an equitable or constructive obligation can be a liability only if it legally or equivalently compels potential outflows of cash or other potential sacrifices,

(g) the definition need not include probability or other notions of likelihood, which instead belong in recognition criteria or measurement, and

(h) explicit reference to past events is unnecessary.[4]

18. In some respects, the participation right looks like a liability, but in others it looks like equity. It looks like a liability because:

(a) The contract gives the policyholder the right to benefit from bonuses that the insurer declares. The policyholder pays more for a contract with that feature.

(b) The bonuses are just one form of contractual benefit among others. If claims are particularly high, bonuses will be low, and vice versa. In aggregate, they substitute for each other to a large degree (though not necessarily one for one – a change of CU 1 in claims may affect the bonus by more or less than CU 1).

(c) Although the insurer has contractual discretion over distributions, it expects to pay bonuses, and may feel compelled to do so because of market pressures.

(d) Policyholder participation rights deny shareholders access to a portion of the results generated by participating contracts. Amounts expected to be returned to policyholders as bonuses are not expected to become available to the shareholders. Reporting those amounts as a liability would provide information from the perspective of the investors who bear the residual risks, as advocated by the CFA Institute.

(e) In some respects, policyholder interests resemble deferred taxes, particularly when there are temporary differences between the carrying amount of assets and liabilities and the amount attributed to them in determining the amount available for distribution (see agenda paper 7B, case A for an example of this).

(f) If policyholder participation rights were a stand-alone instrument, they would probably not be an equity instrument under the ownership-settlement approach the FASB is exploring in its project on Liabilities and Equity (see FASB 'milestone draft', July 2005 http://www.fasb.org/project/liabeq.shtml)

[4] Reference to a past event is implicit in the reference to a present obligation.

(g) Although irredeemable preference shares are typically classified as equity instruments, policyholder participation rights differ from preference shares in one respect. The rights conferred by irredeemable preference shares typically do not expire[5]. However, policyholder participation rights expire when the host contract expires, matures or is surrendered.

(h) In some instances, policyholder participation rights might rank ahead of some non-policyholder liabilities in a liquidation.

19. In the following respects, the participation right looks like equity:

(a) Although policyholders, as a class (including perhaps future policyholders) may have a collective prior claim on a definable portion of benefits from a group of contracts and that portion may not be available to shareholders, that fact, does not, by itself create an obligation. The insurer cannot be compelled to pay specific amounts at specific times. In some cases, the insurer cannot be compelled to pay anything at all. In other words, the insurer has no present obligation and so the Framework's definition of a liability is not met.

(b) In paying for a participation right, the policyholder is supplying temporary capital to the insurer. That capital is available to bear risks. Although that capital is typically only available to bear risks relating to the participating contracts or a related fund or legal entity, that is also the case for non-controlling interests in a subsidiary. Even though the policyholder expects to get the capital back, with an acceptable return, there is no guarantee that this will happen.

(c) The temporary capital provided by policyholders is analogous to a non-controlling interest in a subsidiary.

(d) Although some funds may be earmarked for policyholders (as opposed to shareholders), the benefit from those funds may flow to future policyholders. It is debatable whether a present obligation can exist if no contractual link yet exists with the potential beneficiary.

[5] A portion of those rights may expire if the dividends are non-cumulative.

(e) The policyholder's participation right is rather like a preference-shareholder's right to receive dividends, if declared. Applying the guidance in paragraph AG26 of IAS 32,[6] policyholder participation rights are typically equity instruments, not liabilities.[7]

(f) In a mutual insurer, the participation right is the only source of capital. If it is classified as a liability, a mutual insurer will report no equity. Although many shareholder-owned insurers probably regard policyholder participation rights as a liability, mutuals are more likely to view them as a component of equity.

(g) Insurers often feel economically compelled to pay dividends to participating policyholders. However, the Board's discussion in February indicated that mere economic compulsion is not enough to create an obligation 'legal or equivalent' compulsion is needed.

Staff recommendation

20. In the staff's view, policyholder participation rights do not create an obligation until a particular policyholder has an unconditional right to a distribution arising from that right.

Split accounting

21. If the policyholder participation right does not create an obligation, that suggests that a participating policyholder is buying a compound instrument with two components: a liability (the stand-ready obligation to pay the guaranteed benefits) and an equity component (the participation right). Should the insurer separate these components and account for them separately? This would be consistent with IAS 32's treatment of compound financial instruments, such as convertible debt.

22. Classifying the participation right in equity would imply the following treatment:

(a) The insurer should not recognise the related portion of the premium in profit or loss but should instead report it as proceeds received for issuing an equity instrument. In

[6] reproduced in the appendix to this paper

[7] In some cases, policyholders have an unconditional right to receive a specified bonus on surrender, though the bonus is typically less than a pro rata share of all items potentially distributable to policyholders. Using the terminology in this paper, that bonus is a guaranteed benefit. Such rights do not normally cover the entire amount of policyholder participation rights, so some residual pool of assets will still remain to be classified.

the earlier example, this would imply recognising CU 89[8] as revenue[9] and CU 11 as equity proceeds.

(b) Distributions to participating policyholders are an allocation of profit, not an expense.

23. Equity classification would raise several questions:

(a) For recurring premium contracts, would the split between the liability component and the equity component be determined at inception and locked in? If yes, that would arguably be inconsistent with the Board's preference for a measurement model that reflects future cash flows. If no, the need to reperform the analysis for each premium may be costly.

(b) What margin should be used for the liability component? There are three possibilities:

(i) The margin that would apply if there were no participation right (CU 9 in the earlier example, giving a total measurement of CU 89). That might give users information about the characteristics of the liability component in isolation. On the other hand, it would imply that the insurer faces risks that are actually borne, in aggregate, by the policyholders. It would be a measurement of a hypothetical obligation, rather than one that actually exists.

(ii) The margin that reflects the risks actually assumed by the insurer. This might lead to a measurement of, say, CU 88 (expected cash flows of CU 80 plus target margin of CU 7 plus an additional margin of, say, CU 1 to reflect the risk of not achieving the target margin).

(iii) Measure the liability component at CU 89, as in (i), and recognise an asset of CU 1, as an embedded right of recovery from policyholders (analogous to reinsurance), leading to a net position of CU 88, as in (ii).

[8] Paragraph 23(b) discusses whether CU 89 is the appropriate measurement.
[9] We plan to discuss at a future meeting whether some or all insurance premiums should be reported as deposit receipts (ie proceeds of issuing a liability) or as revenue.

(c) Surrender and lapse options may complicate the measurement of the liability and equity components, because in general both components lapse or are surrendered together. Thus, the implicit strike price for each component depends partly on the value of the other component, and so their measurement will be interdependent.

24. Paragraph BC22 of the Basis for Conclusions on IAS 32 gives the following reason for presenting separately the liability and equity components of a single financial instrument: 'It is more a matter of form than a matter of substance that both liabilities and equity interests are created by a single financial instrument rather than two or more separate instruments. The Board believes that an entity's financial position is more faithfully represented by separate presentation of liability and equity components contained in a single instrument.'

25. That argument carries less weight for policyholder participation rights: in practice, such rights would always arise under the same contract as the right to the guaranteed benefits. It is difficult to imagine how a separate contract could create such rights. The participation right is intertwined with the guaranteed benefits. If the guaranteed benefits are higher, distributions to policyholders tend to be lower, and vice versa.

Staff recommendation

26. Although policyholder participation features do not, in the staff's view, create an obligation, splitting a participating insurance contract into a liability and equity component would be conceptually questionable (because of the inverse relationship between the components), and cause practical problems. In addition, the staff suspects that it may sometimes be very difficult to conclude whether the constraints on the insurer are sufficient to create a constructive obligation, and it may not be helpful to base an important classification decision on this difficult decision. The staff also doubts whether it would make it easier for users to understand an insurer's financial position and performance and their implications for shareholders and policyholders. The staff recommends that participating insurance contracts be classified in their entirety as liabilities.

27. The staff also considered an alternative approach that would:

(a) classify the policyholder participation rights as equity, and treat the portion of premiums attributable to those rights as revenue attributable to a specific class of equity (rather than as proceeds of issuing an equity instrument).

(b) treat income and expense attributable to policyholder participation rights as part of net profit for the year. The portion of the profit attributable to those rights would be presented as attributable to those rights, in the same manner as profit attributable to non-controlling interests.

(c) Arguably, guarantees given by shareholders to policyholders collectively, rather than to individual policyholders, do not create an obligation for the entity. Therefore, these guarantees would be recognised as transfers between shareholders' equity and policyholders' equity.

28. The alternative approach would avoid the need to split premiums at the revenue line, which eliminate one practical problem.[10] However, in the staff's view, that approach would not resolve the conceptual tensions that make it difficult to determine the classification of these borderline items. It would still be necessary to make difficult judgmental decisions on whether the constraints on the insurer are sufficient to create an obligation. It would also be incongruous to report through profit or loss the proceeds for issuing an equity instrument. Giving that no perfect solution is available, the staff believes that the simplest and most transparent solution is to classify policyholder participation rights (with a possible caveat for mutuals, see paragraph 30).

29. Policyholder participation rights mitigate risks associated with the guaranteed benefits. Therefore, it is important to inform users about their nature and extent. The staff plans to research further whether this is best done solely by disclosure of the underlying risks and their mitigation by participation rights, or whether separate classification is desirable and feasible.

Mutuals

30. For mutuals, classification of the entire contract as a liability could lead to the conclusion that a mutual has no equity. That might not result in a faithful representation of profits

that a mutual expects to retain indefinitely. The staff plans to research the following approach:

(a) include in the measurement of the insurance liabilities both the cash outflows relating to guaranteed benefits and the cash outflows relating to expected dividends to current policyholders and (to the extent they originate from existing contracts) future policyholders.

(b) to the extent that insurance contracts generate profits that are expected to be retained indefinitely, include them in equity.

Investment contracts

31. Policyholder participation rights are also found in some investment contracts (ie financial instruments) sold by insurers.

32. In some cases, the participation relates to the same pool of assets as similar rights in insurance contracts issued by the same insurer or other entity.

33. The arguments given above for insurance contracts also apply generally to investment contracts, with one exception: by definition, insurance risk is insignificant for an investment contract, so for these contracts, participation relates predominantly to investment risk, lapse risk and expense risk.

Staff recommendation

34. The staff recommends that participation rights in investment contracts should be classified in the same way as participation rights in insurance contracts.

[10] We intend to discuss at a future meeting whether **any** premiums for any insurance contract should be recognised as revenue, or whether all should be recognised as deposit receipts.

Appendix

Extract from the appendix to IAS 32

AG26 When preference shares are non-redeemable, the appropriate classification is determined by the other rights that attach to them. Classification is based on an assessment of the substance of the contractual arrangements and the definitions of a financial liability and an equity instrument. When distributions to holders of the preference shares, whether cumulative or non-cumulative, are at the discretion of the issuer, the shares are equity instruments. The classification of a preference share as an equity instrument or a financial liability is not affected by, for example:

(a) a history of making distributions;

(b) an intention to make distributions in the future;

(c) a possible negative impact on the price of ordinary shares of the issuer if distributions are not made (because of restrictions on paying dividends on the ordinary shares if dividends are not paid on the preference shares);

(d) the amount of the issuer's reserves;

(e) an issuer's expectation of a profit or loss for a period; or

(f) an ability or inability of the issuer to influence the amount of its profit or loss for the period.

AGENDA PAPER 7B
POLICYHOLDER PARTICIPATION RIGHTS – CASE STUDIES

Purpose of this paper

1. This paper contains the following case studies to illustrate the discussion in agenda paper 7A of policyholder participation rights:

   (a) Case study A: treatment of unrealised gains if a portion of realised gains must be distributed to policyholders (single premium)

   (b) Case B: as case study A, but recurring premium

   (c) Case study C: Unrealised losses

   (d) Case study D: 90-10 fund

   (e) Case study E: Non-cumulative surplus distributed through dividend scales

   (f) Case study F: Constructive obligation

   (g) Case study G: Mutual

2. This paper does not contain recommendations.

Limitations of the case studies

3. The case studies:

   (a) highlight the items whose classification is under debate, under the heading 'policyholder participation rights' below liabilities. The case studies show these items below non-participating liabilities. This presentation is designed to make it easy for Board members see how different classifications of each item might affect the balance sheet. This presentation is not intended to suggest a 'mezzanine' presentation. The staff takes it as a given that each highlighted item must be classified as a liability or within equity.

   (b) do not address measurement issues. The focus is on classification (liability or equity) rather than measurement.

(c) ignore the capital that an insurer would need to hold. Including capital in the case studies would complicate them unnecessarily, without giving insight into the classification issues.

(d) ignore the time value of money, as this does not affect classification.

Case A Mandatory distribution of realised gains, single premium contract

4. Insurer A issues life insurance contracts with the following features:

   (a) The contracts provide guaranteed benefits (eg death benefit, surrender benefit, maturity benefit).[11] Each contract requires a single premium, payable at inception.

   (b) At the end of each year, the insurer must allocate to policyholders 90% of the year's statutory profit relating to this class of insurance contracts. The remaining 10% of that statutory profit becomes immediately available to shareholders.

   (c) Statutory profit includes realised (but not unrealised gains). It also measures insurance liabilities more conservatively than the basis used for general purpose financial statements.

5. At 1 January X1, after the allocation for X0, the carrying amount of this class of insurance liabilities was CU 9,000 and their statutory measurement was CU 9,300 (difference of CU 300). The carrying amount of the related assets was CU 10,000 and their statutory measurement was CU 9,300 (difference of CU 700). Thus, the net temporary difference between the carrying amounts in general purpose financial statements and the equivalent statutory measurements was CU 1,000 before tax (CU 700 plus CU 300) and CU 700 after tax. (In practice, insurer A would also need to hold capital, but all the case studies ignore capital.) Assume also that income taxes are based on statutory profit and that the income tax rate is 30%. Therefore, there is a deferred tax liability of CU 300.

6. Basis on expected lapse and mortality, the insurer estimates that the temporary differences (CU 700 after tax) will, if ultimately realised, be distributed as follows:

[11] Throughout these case studies, **guaranteed benefits** refer to benefits to which a particular policyholder has an unconditional right that is not subject to the discretion of the insurer. Guaranteed benefits include past bonuses or dividends that have been allocated unconditionally to particular policyholders.

(a) 90% to policyholders: CU 630 (estimated split - existing policyholders: CU 560; possible future policyholders: CU 70). Part of the distribution will go to future policyholders because distributions go to all who are policyholders when the distribution is made.

(b) 10% to shareholders: CU 70

7. If the assets are insufficient to pay the guaranteed benefits, insurer A must pay the shortfall out of its other assets. The following breakdown of the payouts to policyholders (as a class) shows that, in substance, insurer A has issued a guarantee. The payouts are:

   (a) 10% of the guaranteed benefits, plus

   (b) 90% of the assets relating to the contracts, plus

   (c) An option to put 90% of the assets to the shareholders for a strike price equal to the guaranteed benefits.

8. The payouts in (a) and (b) can also be analysed as 100% of the guaranteed benefits plus 90% of the unrealised gains. This second analysis is more consistent with the presentation in the case study, but the first analysis makes it easier to see that the guarantee must also be included.

9. Using option pricing methods, insurer A measures that guarantee at, say, CU 25.

10. The following table summarises the assets, liabilities and equity for this class of contracts. Pending a conclusion on the classification of policyholder participation rights, the table shows them separately at the boundary between liabilities and equity.

Case A - Mandatory distribution of realised gains, single premium contract

	CU		*CU*
Assets		**Non-participating liabilities**	
Investments	10,000	Policyholders - guaranteed benefits	9,000
		Policyholders - put option on 90% of the assets	25
		Deferred tax liability	300
			9,325
		Policyholder participation rights	
		• expected to go to current policyholders	560
		• expected to go to possible future policyholders	70
			630
		Shareholders' equity	
		Interest in unrealised gains	70
		Written put option on 90% of the assets	(25)
			45
Total assets	10,000	Total liabilities and equity	10,000

11. Comments on case A:

(a) Insurer A has (some) discretion over the amount and timing of dividends because it can choose when to sell investments.

(b) If the timing of dividends changes, a different generation of policyholders will receive the dividends (though the generations will overlap)

(c) Depending on the structure, once the aggregate dividend is determined, there is typically a requirement that the allocation between policyholders should be equitable, but an insurer may have some discretion in implementing that requirement.

(d) In some cases, insurers need not allocate the policyholder share of realised gains to particular policyholders immediately. For example, they may be able to delay allocations for up to 8 years. Subsequent losses could reduce or eliminate the gains before that period elapses.

(e) Case A does not illustrate cases where the insurer may allocate more than the required 90% to policyholders. Case F is relevant for this point.

(f) If part or all of the policyholder participation right is classified as a liability, it will give rise to a deductible temporary difference if distributions to policyholders are deductible for tax. In that case, the policyholder participation right would be measured at CU 900 (CU 800 relating to existing policyholders and CU 100 relating to possible future policyholders) and the deferred tax liability would be CU 30 (relating only to the shareholder interest in the unrealised gains.)

Case B Mandatory distribution of realised gains, recurring premiums

12. Case B has the same fact pattern as case A, with the following changes:

(a) The contracts are recurring premium contracts. The expected (present) value of the future premiums under existing contracts is CU 8,000. The expected value of the incremental guaranteed benefits resulting from those premiums is CU 6,000.

(b) Thus, the expected value of the overall net benefit (before policyholder participation) is CU 2,000. After tax at 30%, the expected value of these benefits is CU 1,400. The expected split of the after tax benefit is:

(i) 90% to existing and possible future policyholders: CU 1,260 (expected split - existing policyholders: CU 1,000; possible future policyholders: CU 260)

(ii) 10% to shareholders: CU 140

(c) The estimated value of the guarantee is only CU 15, compared with CU 25 in case A. Its value is higher because expected future premiums under the existing contracts are expected (but not guaranteed) to generate a margin that reduces the probability that the assets will be insufficient.

(d) The deferred tax liability is CU 900. CU 300 relates to the unrealised gains (as in case A) and CU 600 relates to the customer relationship.

13. The following table summarises the rights and obligations in case B.

Case B – recurring premiums

	CU		*CU*
Assets		**Non-participating liabilities**	
Investments	10,000	Policyholders - guaranteed benefits	9,000
		Policyholders - put option on 90% of the assets	15
Customer relationship		Deferred tax liability	900
Future premium	8,000		9,915
Future benefits	(6,000)	**Policyholder participation rights**	
	2,000	• expected to go to current policyholders	560
		• expected to go to possible future policyholders	70
		• interest of current policyholders in customer relationship	1,000
		• interest of possible future policyholders in customer relationship	260
			1,890
		Shareholders' equity	
		Interest in unrealised gains	70
		Interest in customer relationship	140
		Written put option on 90% of the assets	(15)
			195
Total assets	12,000	Total liabilities and equity	12,000

14. Comments on case B:

(a) An alternative presentation might show the customer relationship net of the policyholder interest in that relationship (and net of the policyholder portion of the related deferred tax). In essence, this would be similar to some existing 'net premium' measurement methods that include only that portion of future premiums (from existing contracts) that is needed to pay for the guaranteed benefits.

(b) As discussed in February, continuation of premiums may be beneficial to insurer B for some contracts and unfavourable to insurer B for others. Case B implicitly offsets the customer relationship associated with the beneficial contracts against the stand-ready obligation associated with the unfavourable contracts.

(c) The shareholder's interest in the customer relationship is CU 140. This does not necessarily imply that insurer B has recognised an overall profit because of the contract. Insurer B may have incurred acquisition costs at inception, and since inception is likely to have recognised other income and expenses relating to the contract.

Case C unrealised losses

15. Case C has the same fact pattern as case B, with the following changes:

(a) The carrying amount of the liability to pay guaranteed benefits is CU 9,000 (as in cases A and B). To simplify this case, the statutory measurement of that liability is also CU 9,000.

(b) The assets have a carrying amount of CU 8,000 and the same basis is also used for statutory measurement, and for income taxes.

(c) There is a cumulative loss of CU 1,000 on the assets. No bonus can be paid until the carrying amount of assets exceeds the carrying amount of the guaranteed liability.[12] Thus, bonus will not arise until either gains arise on the investments or future premiums are received in excess of the resulting guaranteed obligations. Put differently, the deficit of CU 1,000 reduces the potential future bonuses for both policyholders and shareholders. Because bonuses are paid to all policyholders at the time of distribution, the reduction in potential future bonuses affects both existing and possible future policyholders (expected split: CU 850 current and CU 50 future).

(d) The deferred tax liability is now CU 600, and arises solely from the taxable temporary difference associated with the customer relationship.

(e) Because there is more risk than in cases A and B that the assets will prove insufficient, the policyholders' written put option on 90% of the assets has more value (assumed to be CU 190).

16. The following table summarises the rights and obligations in case C.

[12] The insurer also has to provide capital, but this example does not show the capital.

Case C – recurring premiums, unrealised losses

	CU		*CU*
Assets		**Non-participating liabilities**	
Investments	8,000	Policyholders - guaranteed benefits	9,000
		Policyholders - put option on 90% of the assets	190
Customer relationship		Deferred tax liability	600
Future premium	8,000		9,790
Future benefits	(6,000)	**Policyholder participation rights**	
	2,000	• expected recovery from reduction in future bonuses to current policyholders	(850)
		• expected recovery from reduction in future bonuses to possible future policyholders	(50)
		• interest of current policyholders in customer relationship	1,000
		• interest of possible future policyholders in customer relationship	260
			360
		Shareholders' equity	
		Interest in unrealised losses	(100)
		Interest in customer relationship	140
		Written put option on 90% of the assets	(190)
			(150)
Total assets	10,000	Total liabilities and equity	10,000

17. Comments on case C:

(a) If lapses are high, insurer C will suffer a significant loss.

Case D 90-10 fund

18. Insurer D issues life insurance contracts with the following features:

(a) Premiums are paid into a legally separate fund. Investment returns are added to the fund and expenses (eg running costs) are deducted from the fund. All policyholder benefits are paid out of the fund.

(b) If the assets in the fund are insufficient, the insurer must use its other assets to pay the guaranteed benefits.

(c) Each year, the insurer may declare a dividend out of the fund. There is no legal requirement to declare any dividend at all, though declared dividend rates are an important marketing feature (and may, arguably, create a constructive obligation in some cases).

(d) The amount available for dividend is the cumulative undistributed statutory profit. The same profit is recognised in general purpose financial statements and statutory reports.

(e) 90% of each dividend is attributed to policyholders. At the same time, 10% of the total dividend becomes available for the insurer's general operations (and may, for example, be distributed to shareholders). Shareholders (and the insurer's general creditors) can gain no access to the assets of the fund, except through such dividends.

19. The details of the fund are as follows at 1 January X1:

(a) The fund has assets with a fair value of CU 10,000 and liabilities of CU 9,000 relating to guaranteed benefits. The expected split of the net assets of CU 1,000 is:

(i) 90% to policyholders: CU 900 (expected split CU 800 to existing policyholders and CU 100 to possible future policyholders).

(ii) 10% to shareholders: CU 100.

(b) Details of the customer relationship are the same as in cases B and C.

(c) The policyholders have an implicit option to put 90% of the fund's assets to the shareholders. The insurer estimates the value of that option at CU 190.

Case D – 90-10 fund

	CU		*CU*
Assets		**Non-participating liabilities**	
Investments	10,000	Policyholders - guaranteed benefits	9,000
		Policyholders - put option on 90% of the assets	190
Customer relationship		Deferred tax liability	600
Future premium	8,000		9,790
Future benefits	(6,000)	**Policyholder participation rights**	
	2,000	• interest in fund: current policyholders	800
		• interest in fund: future policyholders	100
		• interest of current policyholders in customer relationship	1,000
		• interest of possible future policyholders in customer relationship	260
			2,160
		Shareholders' equity	
		Interest in fund	100
		Interest in customer relationship	140
		Written put option on 90% of the assets	(190)
			50
Total assets	12,000	Total liabilities and equity	12,000

20. Comments on case D:

(a) This case differs from cases A-C because the assets stay in the fund until they are distributed. Thus, policyholders have an interest in the cumulative undistributed profits. In cases A-C, their interest is in the current period profit and in the temporary differences.

(b) Temporary differences would arise in this case if the statutory measurement differed from the measurement in general purpose financial statements.

(c) Case D does not consider what happens to the fund if the insurer stops issuing new contracts. If Board members think information about this would be relevant to the classification question, we may need to investigate that issue.

(d) Sometimes, if fund balances have grown over many years, there may be uncertainty about whether a portion that originated many years ago 'belongs' ultimately to policyholders or to shareholder (this problem is sometimes known as the 'orphan estate').

(e) Case D does not consider what happens if an insurer has a practice of paying more than the specified minimum portion (eg 90%) to policyholders. Case F is relevant.

Case E, non-cumulative surplus distributed through dividend scales

21. Insurer E issues contracts with the following features:

(a) The contracts provide guaranteed benefits (specified death benefit, specified surrender benefit, specified maturity benefit). Regular premiums are due.

(b) The insurer must adopt a dividend scale that specifies the basis for allocating dividends to policyholders (both as a class, and to individuals within the class). The scale is filed with the regulator and remains in force until the insurer adopts a new dividend scale. There are no legally enforceable requirements for minimum dividend scales, though the regulator may exert pressure if it regards a scale as inconsistent with policyholder expectations.

(c) The amount available for dividend is the statutory profit for the period. The same profit is recognised in general purpose financial statements and statutory reports.

(d) After the distribution of dividends in accordance with the current scale, the rest of the profit for the year becomes immediately available to shareholders without restriction (unless the shareholders need to inject capital to meet solvency requirements).[13] In this respect, this arrangement differs from the fund in case D.

22. At 1 January X1, the details for these contracts are as follows:

(a) The assets have a carrying amount of CU 9,000. The liabilities relating to guaranteed benefits also have a carrying amount of CU 9,000.

(b) Details of the customer relationship are the same as in cases B-D.

[13] As in the rest of this paper, this case study ignores solvency capital.

(c) This case study takes the position that the policyholders have no implicit option to put 90% of the fund's assets to the shareholders. This position may be debatable if insurer E's dividend policy is similar, in substance, to a contractual requirement to pay a portion of the asset returns to policyholders.

Case E - Non-cumulative surplus distributed through dividend scales

	CU		*CU*
Assets		**Non-participating liabilities**	
Investments	9,000	Policyholders - guaranteed benefits	9,000
		Deferred tax liability	600
Customer relationship			9,600
Future premium	8,000	**Policyholder participation rights**	
Future benefits	(6,000)	• interest of current policyholders in customer relationship	1,000
	2,000	• interest of possible future policyholders in customer relationship	260
			1,260
		Shareholders' equity	
		Interest in customer relationship	140
			140
Total assets	11,000	Total liabilities and equity	11,000

23. Comments on case E:

(a) In this example, statutory profit is the same as profit for general purpose financial statements. Case studies A-C would be relevant for any temporary differences.

(b) An insurer might have a strategy of setting credit rates on a basis that is tied very closely to asset returns. If that is the case, the payouts might be very similar to payouts on a contract that ties the distribution explicitly to asset returns (though the insurer would still have to discretion to depart from the planned strategy if it so wishes).

Case F Constructive obligation

24. Case F is the same as case A, with one exception. Although insurer F is contractually required to distribute 90% of the statutory profit to policyholders, it has a practice of distributing more than this. It estimates that it will, for the foreseeable future, distribute 95% in total to policyholders. It estimates that this practice would lead to distributions (from statutory profit generated by existing contracts) of CU 31 to current policyholders and CU 4 to existing future policyholders.

Case F - Constructive obligation

	CU		*CU*
Assets		**Non-participating liabilities**	
Investments	10,000	Policyholders - guaranteed benefits	9,000
		Policyholders - put option on 90% of the assets	25
		Deferred tax liability	300
			9,325
		Policyholder participation rights	
		• expected to go to current policyholders (90%)	560
		• expected to go to current policyholders (5%)	31
		• expected to go to future policyholders (90%)	70
		• expected to go to future policyholders	4
			665
		Shareholders' equity	
		Interest in unrealised gains	35
		Written put option on 90% of the assets	(25)
			10
Total assets	10,000	Total liabilities and equity	10,000

25. Comments on case F:

(a) In some cases, the regulator may be able to take action, or exert pressure, so that the insurer distributes more than the contractually required minimum to meet policyholder expectations. It may sometimes be difficult to tell whether there is an enforceable obligation.

(b) In some cases, the insurer's past conduct and published practices may create an expectation that the insurer will distribute more than the contractual minimum. Could this result in a recognisable constructive obligation?

(c) In some cases, the contractual minimum distribution may be zero, but insurers may have a long standing practice of making significant distributions.

Case G Mutual

26. Case G is the same as case B, with the following changes.

(a) Insurer G is a mutual. It estimates how much it will distribute to current and future policyholders from the statutory profit that existing contracts will generate. It will retain the rest of its retained earnings indefinitely to provide continuing capital.

(b) Insurer G has an additional CU 5,000 of assets representing retained statutory profits.

Case G – mutual

	CU		*CU*
Assets		**Non-participating liabilities**	
Investments	15,000	Policyholders - guaranteed benefits	9,000
		Policyholders - put option on 90% of assets	15
Customer relationship		Deferred tax liability	900
Future premium	8,000		9,915
Future benefits	(6,000)	**Policyholder participation rights**	
	2,000	• expected to go to current policyholders	560
		• expected to go to possible future policyholders	70
		• interest of current policyholders in customer relationship	1,000
		• interest of possible future policyholders in customer relationship	260
			1,890
		Permanent equity	
		Retained profit	5,000
		Interest in unrealised gains	70
		Interest in customer relationship	140
		Written put option on 90% of relevant assets	(15)
			195
Total assets	17,000	Total liabilities and equity	17,000

27. Comments on case G

(a) Unlike in the case of a shareholder-owned insurer, mutual G's only source of equity is retained earnings.

AGENDA PAPER 7C
POLICYHOLDER PARTICIPATION RIGHTS – EXTRACTS FROM IFRS 4

Purpose of this paper

1. This paper provides extracts from IFRS 4 *Insurance Contracts*, relating to discretionary participation features (DPF). It is provided for background only and we do not plan to discuss it during the meeting.

2. After this meeting, we will assess whether the definition of a DPF needs to change.

Comments

3. The following points are worth noting:

   (a) The definition of a DPF combines requirements for:

      (i) contractual discretion on the part of the insurer, with

      (ii) a contractual link to performance.

   (b) The definition of a DPF requires the existence of a guaranteed element alongside the DPF. Without this restriction, some might have argued that some types of share met the definition.

   (c) The main objective of the approach in IFRS 4 was to avoid prejudging the phase II question of the classification of the DPF.

   (d) The existing definition does not include an unconstrained discretion to set crediting rates (eg universal life contracts).

Appendix

Extracts from IFRS 4

Definitions

discretionary participation feature	A contractual right to receive, as a supplement to **guaranteed benefits**, additional benefits: (a) that are likely to be a significant portion of the total contractual benefits; (b) whose amount or timing is contractually at the discretion of the issuer; and (c) that are contractually based on: (i) the performance of a specified pool of contracts or a specified type of contract; (ii) realised and/or unrealised investment returns on a specified pool of assets held by the issuer; or (iii) the profit or loss of the company, fund or other entity that issues the contract.
guaranteed benefits	Payments or other benefits to which a particular **policyholder** or investor has an unconditional right that is not subject to the contractual discretion of the issuer.
guaranteed element	An obligation to pay **guaranteed benefits**, included in a contract that contains a **discretionary participation feature**.

Extract from body of IFRS 4

Discretionary participation features in insurance contracts

34 Some insurance contracts contain a discretionary participation feature as well as a *guaranteed element*. The issuer of such a contract:

(a) may, but need not, recognise the guaranteed element separately from the discretionary participation feature. If the issuer does not recognise them separately, it shall classify the whole contract as a liability. If the issuer classifies them separately, it shall classify the guaranteed element as a liability.

(b) shall, if it recognises the discretionary participation feature separately from the guaranteed element, classify that feature as either a liability or a separate component of equity. This IFRS does not specify how the issuer determines whether that feature is a liability or equity. The issuer may split that feature into liability and equity components and shall use a consistent accounting policy for that split. The issuer shall not classify that feature as an intermediate category that is neither liability nor equity.

(c) may recognise all premiums received as revenue without separating any portion that relates to the equity component. The resulting changes in the guaranteed element and in the portion of the discretionary participation feature classified as a liability

shall be recognised in profit or loss. If part or all of the discretionary participation feature is classified in equity, a portion of profit or loss may be attributable to that feature (in the same way that a portion may be attributable to minority interests). The issuer shall recognise the portion of profit or loss attributable to any equity component of a discretionary participation feature as an allocation of profit or loss, not as expense or income (see IAS 1 *Presentation of Financial Statements*).

(d) shall, if the contract contains an embedded derivative within the scope of IAS 39, apply IAS 39 to that embedded derivative.

(e) shall, in all respects not described in paragraphs 14-20 and 34(a)(d), continue its existing accounting policies for such contracts, unless it changes those accounting policies in a way that complies with paragraphs 21-30.

Discretionary participation features in financial instruments

35 The requirements in paragraph 34 also apply to a financial instrument that contains a discretionary participation feature. In addition:

(a) if the issuer classifies the entire discretionary participation feature as a liability, it shall apply the liability adequacy test in paragraphs 15-19 to the whole contract (ie both the guaranteed element and the discretionary participation feature). The issuer need not determine the amount that would result from applying IAS 39 to the guaranteed element.

(b) if the issuer classifies part or all of that feature as a separate component of equity, the liability recognised for the whole contract shall not be less than the amount that would result from applying IAS 39 to the guaranteed element. That amount shall include the intrinsic value of an option to surrender the contract, but need not include its time value if paragraph 9 exempts that option from measurement at fair value. The issuer need not disclose the amount that would result from applying IAS 39 to the guaranteed element, nor need it present that amount separately. Furthermore, the issuer need not determine that amount if the total liability recognised is clearly higher.

(c) although these contracts are financial instruments, the issuer may continue to recognise the premiums for those contracts as revenue and recognise as an expense the resulting increase in the carrying amount of the liability.

Extract from Basis for conclusions

DISCRETIONARY PARTICIPATION FEATURES

BC154 Some insurance contracts contain a discretionary participation feature as well as a guaranteed element. The insurer has discretion over the amount and/or timing of distributions to policyholders, although that discretion may be subject to some contractual constraints (including related legal and regulatory constraints) and competitive constraints. Distributions are typically made to policyholders whose contracts are still in force when the distribution is made. Thus, in many cases, a change in the timing of a distribution means that a different generation of policyholders will benefit.

BC155 Although the issuer has contractual discretion over distributions, it is usually likely that current or future policyholders will ultimately receive some part of the accumulated surplus available, at the reporting date, for distribution to holders of contracts with discretionary participation features (ie distributable surplus). The main accounting question is whether that part of the distributable surplus is a liability or a component of equity. The Board will explore that question in phase II.

BC156 Features of this kind are found not only in insurance contracts but also in some investment contracts (ie financial liabilities). Requiring a particular accounting treatment in phase I for investment contracts with these features would create the risk that the Board might decide on a different treatment in phase II. Furthermore, in some cases, holders of insurance contracts and investment contracts have a contractual right to share in discretionary payments out of the same pool of assets. If the Board required a particular treatment for the discretionary participation features of the investment contracts in phase I, it might prejudge the treatment of these features in insurance contracts that are linked to the same pool of assets.

BC157 For these reasons, the Board decided not to address most aspects of the accounting treatment of such features in phase I, in either insurance contracts or investment contracts. However, paragraphs 34 and 35 of the IFRS confirm that it is unacceptable to classify a discretionary participation feature as an intermediate category that is neither liability nor equity, because this would be inconsistent with the Framework. If a balance sheet item does not meet the Framework's definition of, and recognition criteria for, assets or liabilities, that item is included in equity.

BC158 Furthermore, ED 5 proposed a requirement for the issuer of an investment contract containing such a feature to recognise a liability measured at no less than the amount that would result from applying IAS 39 to the guaranteed element of the contract. Because issuers need not determine the IAS 39 measurement of the guaranteed element if the total recognised liability is clearly higher, ED 5 noted the Board's expectation that issuers would not need extensive new systems to comply with this requirement.

BC159 Some respondents objected that determining the result of applying IAS 39 to the guaranteed element would either have virtually no effect (in which case the requirement would be unnecessary) or require extensive new systems (causing costs exceeding the likely benefit to users). In finalising the IFRS, the Board adopted a more flexible approach that limits the need for systems to apply IAS 39 to the guaranteed element alone, while still requiring some rigour to avoid the understatement of the financial liability. Specifically, paragraph 35 permits two approaches for a discretionary participation feature in a financial liability:

(a) The issuer may classify the entire discretionary participation feature as a liability, but need not separate it from the guaranteed element (and so need not determine the result of applying IAS 39 to the guaranteed element). An issuer choosing this approach is required to apply the liability adequacy test in paragraphs 15-19 of the IFRS to the contract.

(b) The issuer may classify part or all of the feature as a separate component of equity. If so, the liability recognised cannot be less than the result of applying IAS 39 to the guaranteed element. The issuer need not determine that measurement if the total liability recognised is clearly higher.

BC160 There may be timing differences between accumulated profits under IFRSs and distributable surplus (ie the accumulated amount that is contractually eligible for distribution to holders of discretionary participation features). For example, distributable surplus may exclude unrealised investment gains that are recognised under IFRSs. The resulting timing differences are analogous, in some respects, to temporary differences between the carrying amounts of assets and liabilities and their tax bases. The IFRS does not address the classification of these timing differences because the Board will not determine until phase II whether the distributable surplus is all equity, all liability or part equity and part liability.

BC161 The factor that makes it difficult to determine the appropriate accounting for these features is constrained discretion, in other words, the combination of discretion and constraints on that discretion. If participation features lack discretion, they are embedded derivatives and within the scope of IAS 39.

BC162 The definition of a discretionary participation feature does not capture an unconstrained contractual discretion to set a 'crediting rate' that is used to credit interest or other returns to policyholders (as found in the contracts described in some countries as 'universal life' contracts). Some view these features as similar to discretionary participation features because crediting rates are constrained by market forces and the insurer's resources. The Board will revisit the treatment of these features in phase II.

BC163 Some respondents asked the Board to clarify the treatment of premiums received for financial instruments containing discretionary participation features. Conceptually the premium for the guaranteed element is not revenue, but the treatment of the premium for the discretionary participation feature could depend on matters that will not be resolved until phase II. Furthermore, requiring the premium to be split could involve system changes that might become redundant in phase II. To avoid unnecessary disruption in phase I, the Board decided that entities could continue presenting premiums as revenue, with a corresponding expense representing the change in the liability.

BC164 Conceptually, if part or all of a discretionary participation feature is classified as a component of equity, the related portion of the premium should not be included in profit or loss. However, the Board concluded that requiring each incoming premium to be split would require systems changes beyond the scope of phase I. Therefore, the Board decided that an issuer could recognise the entire premium as revenue without separating the portion that relates to the equity component. However, the Board confirmed that the portion of profit or loss attributable to the equity component is presented as an allocation of profit or loss (in a manner similar to the presentation of minority interests), not as expense or income.

BC165 Some suggested that investment contracts containing a discretionary participation feature should be excluded from the fair value disclosure required by IAS 32. They noted both conceptual and practical problems in determining the fair value of an instrument of this kind. However, instead of creating a new exclusion from the required disclosure of fair value, the Board added new paragraph 91A to IAS 32.[14]

[14] This exemption is now in paragraph 29(c) of IFRS 7 *Financial Instruments: Disclosures*.

This extends existing requirements in IAS 32 governing those unquoted equity instruments whose fair value cannot be determined reliably.