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International Accounting Standards Board

INFORMATION FOR OBSERVERS

Board Meeting: **20 September 2006, London**

Project: **Insurance Contracts Phase II**

Subject: **A portfolio basis for measurement? (Agenda Paper 12D)**
Unbundling: should it be prohibited? (Agenda Paper 12E)
Policyholder participation rights (Agenda Paper 12F)

AGENDA PAPER 12D A PORTFOLIO BASIS FOR MEASUREMENT?

Purpose of this paper

1. Participants in the Insurance Working Group have generally argued that insurers should measure their rights and obligations under insurance contracts on a portfolio basis, rather than contract by contract. This paper discusses:

   (a) whether there is likely to be a material difference between a portfolio measurement and a contract by contract measurement.

   (b) how the unit of measurement should be determined, if portfolio effects are likely to affect measurement materially.

Summary of recommendations

2. This paper reaches the following conclusions:

   (a) In principle, the expected (probability-weighted) cash flows from a portfolio equal the sum of the expected cash flows of the individual contracts. Therefore, the unit of measurement does not affect the expected present value

of future cash flows. To avoid misunderstandings, practical guidance should emphasise that unbiased estimates of cash flows should reflect all relevant inputs, regardless of whether they are derived by contract or in aggregate (paragraphs 4-5).

(b) Risk margins should be determined for a portfolio of insurance contracts that are subject to broadly similar risks and managed together as a single portfolio (paragraphs 6-20). The discussion paper should not express a preliminary view on whether risk margins should reflect the benefits of diversification between (and negative correlation between) portfolios (paragraphs 21-22).

(c) The unit of measurement is not relevant to the resolution of recognition issues relating to policyholder behaviour, future premiums, renewals and related issues (paragraph 23).

Previous discussion

3. The Board discussed an earlier version of this paper in April (agenda paper 7B on unit of account). At that meeting, some Board members questioned whether it was possible for the unit of measurement to affect risk margins. Consequently, Board members did not feel able to conclude at that time on the unit of measurement.

Expected present value of future cash flows

4. Some have suggested that the expected value notion is relevant only for a portfolio, not for an individual contract. However, in principle, the expected (probability-weighted) cash flows from a portfolio equal the sum of the expected cash flows of the individual contracts. Therefore, in the staff's view, the unit of measurement does not affect the expected present value of future cash flows. [1]

5. Nevertheless, in practice, some types of estimate are more easily performed in aggregate for a portfolio, than for individual contracts. For example, IBNR (incurred but not reported) estimates are typically carried out in aggregate. However, conceptually, this is no different from making expected value estimates for individual contracts and aggregating the results. This implies that the unit of

[1] Paragraph 9 discusses whether the unit of measurement might affect the amount of statistical evidence available to support estimates of the expected cash flows in practice.

measurement does not affect the expected cash flows, in principle. Nevertheless, to avoid misunderstandings, practical guidance should emphasise that unbiased estimates of cash flows should reflect all relevant inputs, regardless of whether they are derived by contract or in aggregate.

Risk margins

6. The following paragraphs consider whether risk margins should be determined for each insurance contract individually and then aggregated, or determined directly for some higher level of aggregation.

7. As a preliminary, it is worth considering how aggregation might affect the level of risk. Insurance professionals sometimes distinguish between:

   (a) the pooling of risk (assembling a balanced portfolio of reasonably homogeneous risks to permit reasonable estimates of the likely behaviour of the pool as a whole) For example, a life insurer will wish to assemble a portfolio of policyholders who are believed to have similar mortality characteristics. In doing this, the insurer will consider the trade-off between (i) the need to have a large pool to generate reliable data and smooth out random fluctuations and (ii) the need to subdivide the population into smaller pools with more homogeneous risk characteristics (eg by age, sex, occupation, smoker status, location)

   (b) the diversification of risk (collecting a range of different risks generating random fluctuations that tend, on average, to cancel each other out). For example, a multi-line insurer diversifies risk by engaging in many different lines of insurance. Similarly, by investing in a large number of entities, a mutual fund reduces the risk of large fluctuations caused by factors specific to a particular investee, but does not reduce the risks that are common to all investees (eg business cycle, interest rates).

   (c) the hedging of risk (collecting risks that are negatively correlated so that adverse outcomes for one item tend to be offset by favourable outcomes for other items). For example, term life insurance exposes the insurer to the risk that policyholders will die prematurely, whereas annuities expose the insurer to unexpected longevity. An insurer issuing both kinds of contract is likely to suffer less fluctuation than an insurer that issues only one kind of contract.

8. Some argue that one or more of the following four factors might cause a risk margin to be lower if it is determined for a portfolio than if it is determined individually for each contract and then aggregated, or proportionately lower for a larger portfolio than for a smaller portfolio.

   (a) Statistical evidence (paragraph 9)

   (b) Random fluctuations (paragraphs 10-16)

   (c) Adverse selection (paragraphs 17-18)

   (d) Negative correlations (paragraph 22)

Statistical evidence

9. For a small portfolio, there is less statistical **evidence** about the model that should be used to simulate the underlying process driving future cash flows (model risk) and about the parameters of that process (parameter risk). However, in the staff's view, the measurement of a portfolio should reflect all available information about that portfolio, not just information that originates within the portfolio itself. It follows that the same statistical evidence is used, regardless of whether the portfolio is measured contract by contract or at a higher level of aggregation.

Random statistical fluctuations

10. A small portfolio is more exposed than a large portfolio to random statistical fluctuations. For example, if a coin is tossed once, the average number of heads is 0.5 with a standard deviation[2] of 0.5. For a hundred tosses, the average number of heads is 50, with a standard deviation of 5. In other words, the standard deviation for 100 coin tosses is only ten times the standard deviation for one toss, not 100 times. If the risk margin is, for example, a multiple of the standard deviation, the risk margin for 100 coin tosses is less than 100 times the risk margin for one toss.

11. The Board has tentatively concluded that it does not intend to prescribe specific methods for determining risk margins, but instead to give guidance on criteria that risk margins would need to meet to be consistent with a current exit value measurement attribute.[3] Actuaries and other insurance professionals are currently

[2] The standard deviation of the mean (probability-weighted average) is often called the standard error.
[3] The Board discussed a draft of those criteria in March.

focussing most of their development work on two techniques for determining risk margins:

(a) Cost of capital approaches: determining how much economic capital is needed to bear the risk in question, and determining the cost of holding that capital.

(b) Quantile approaches: setting a margin equal to a given point on the estimated probability distribution (eg the 75th percentile).

12. In the staff's view (as noted in the Board discussion in March), both approaches have advantages and disadvantages and at this stage it seems unlikely that either should be either required in all circumstances or prohibited in all circumstances. In either approach, the risk margin will inevitably depend on the unit of measurement.

13. Some will disagree with this position because it appears to conflict with some asset pricing models, such as the capital asset pricing model (CAPM). These models take the position that efficient markets do not reward participants for bearing risks that can diversified, on the grounds that other market participants would quickly arbitrage away those rewards. In these models, risk margins are not proportionately larger for a small portfolio.

14. CAPM and similar models are based on idealised assumptions, such as a perfect and liquid market, rational behaviour by investors, minimal transaction costs and the existence of arbitrage traders whose activities will force market prices to converge rapidly to levels that eliminate arbitrage opportunities. Some argue that these assumptions do not reflect reality for most insurance markets. Also, because there is a cost to obtaining information, risks that are diversifiable in theory may not be fully diversifiable in practice.

15. Reinsurers sometimes charge lower premiums than those a direct insurer charges for the same exposure. One reason for such differences is the fact that the insurer may be diversifying the exposure more broadly. Some see that as further evidence that pricing models that ignore diversifiable risk do not reflect how insurance markets work.

16. Conceptually, the staff is attracted to some extent by the notion that risk margins should relate only to risks that are not diversifiable.[4] However, it seems likely that practical techniques for determining risk margins will not be able to exclude the effect of diversifiable risks. Furthermore, those techniques seem to reflect the way insurance professionals think about pricing.

Adverse selection

17. A large portfolio may provide some protection against **adverse selection** (risk that new or continuing policyholders will be drawn disproportionately from higher-risk groups). For example, a transferee would rather take the whole portfolio, rather than individual contracts selected by the transferor. This factor might affect the price that a transferee would require.

18. It follows that an insurer would not normally contemplate transferring some individual contracts out of a portfolio because the price would be extremely disadvantageous to the transferor, to protect the transferee against adverse selection. Therefore, the only plausible transaction that could occur is for portfolio of contracts that forms a natural unit, so minimising the transferee's fear of adverse selection. This suggests that risk margins should not consider the additional risk of adverse selection that would be considered in the price for the transfer of individual contracts.

Defining the unit of measurement

19. The above comments on random fluctuations and on adverse selection suggest that the natural starting point for measuring risk margins is a portfolio of contracts. The essence of an insurer's business is to pool the risks transferred by individual contracts. Determining risk margins for individual contracts and then aggregating those margins is likely to be both difficult and of limited relevance to users.

20. How might a portfolio of contracts be defined? The [European] CFO Forum and GNAIE have suggested that the unit of measurement should be 'a group of contracts that are managed together when assessing risk'. IFRS 4 refers to a liability adequacy test for a 'portfolio of contracts that are subject to broadly similar risks and managed together as a single portfolio'. The two descriptions are broadly similar and neither is watertight. The staff sees no obvious way to

[4] Even if the risk margin does not reflect diversifiable risks, those risks would still affect the expected value.

improve them significantly. The staff prefers the description from IFRS 4 and recommends it.

Diversification between portfolios

21. Insurers benefit from diversification between portfolios (though those benefits may be limited if excess capital in one portfolio is not fully and immediately available to cover capital shortages in other portfolios). Should the risk margins be determined for each portfolio in isolation, or should they also consider the benefits of diversification between portfolios? The staff would like to research this question further and believes it is not critical to include a preliminary view in the discussion paper.

Negative correlations

22. Some portfolios of contracts may create risks that are negatively correlated with the risks from other portfolios (eg term life insurance and annuities). If the unit of measurement includes both portfolios, the risk margin would reflect both the benefits of diversification between the portfolios and the negative correlations between them.

Recognition issues

23. We have discussed separately policyholder behaviour, future premiums, renewals and related issues. Some argue that these issues can be 'resolved' by using a portfolio approach. However, our consideration of these issues is based on an analysis of rights and obligations associated with individual contracts. Aggregating them into a portfolio does not bring new contractual rights into existence, nor does it eliminate individual contractual obligations. Therefore, in the staff's view, the unit of measurement is not relevant to the resolution of these issues.

AGENDA PAPER 12E UNBUNDLING: SHOULD IT BE PROHIBITED?

Purpose of this paper

1. The Board concluded in April that it should not require insurers to unbundle deposit and service components of insurance contracts for the purpose of recognition and measurement. The Board directed the staff to investigate whether unbundling should be prohibited in some or all cases. This paper investigates that question.

Summary of recommendations

2. The staff recommends that the Board should not prohibit unbundling.

Previous discussion

3. The question of unbundling would arise if either:

   (a) Insurance premiums received are reported as revenue rather than as deposit receipts. The Board discussed in July whether an insurer should present all premiums as revenue, all premiums as deposit receipts, or some premiums as revenue and some premiums as deposit receipts. The Board also discussed whether an insurer should split premiums for some or all insurance contracts into a revenue component and a deposit component. The Board decided that the discussion paper should review the alternatives but not express a preliminary view on this topic. Therefore, this paper does not discuss that further.

   (b) The measurement attribute for insurance liabilities differs from the measurement attribute used for financial liabilities, or for performance obligations arising under service contracts. The rest of this paper considers the three cases that might arise:

      (i) Financial liabilities carried at fair value through profit or loss

      (ii) Financial liabilities carried at amortised cost

      (iii) Performance obligations

Financial liabilities carried at fair value through profit or loss

4. If a separately measured deposit component would be carried at fair value through profit or loss, there would be little point in unbundling it from an insurance contract measured at current exit value.

Financial liabilities carried at amortised cost

5. If a separately measured deposit component would be carried at amortised cost, there might be some merit in prohibiting its unbundling, in order to achieve a measurement (at current exit value) that the Board views as more relevant and reliable than amortised cost. However, insurers and actuaries have repeatedly emphasised to us that unbundling would be arbitrary, artificial and burdensome in most cases. Also, unbundling may make it harder to avoid accounting mismatches. Therefore, it seems unlikely that insurers would choose to unbundle a deposit component in most cases.

Performance obligations

6. Performance obligations would typically be measured under IAS 18 at the unearned portion of the consideration received. This may differ from current exit value if circumstances have changed significantly since inception. However, in many components, the service components and insurance components may be intertwined in a way that makes unbundling difficult, arbitrary and artificial. Again, it seems unlikely that insurer would typically elect to unbundle service components.

Components that are readily separable

7. Paragraphs 5 and 6 argue that unbundling a deposit or service component would be burdensome and possibly arbitrary in many cases, so that an insurer would not generally choose to unbundle them. Should the Board prohibit unbundling if an insurance contract contains components that are easily separable? In the staff's view, that would achieve little. If the components are easily separable, an insurer could probably avoid any prohibition by issuing two (or more) separate contracts.

Staff recommendation

8. The staff recommends that the Board should not prohibit unbundling.

AGENDA PAPER 12F POLICYHOLDER PARTICIPATION RIGHTS

Purpose of this paper

1. The purpose of this paper is to seek clarification of one aspect of the Board's decision in March. An earlier version of this paper was presented at the May IASB meeting as agenda paper 4H, but the Board did not discuss it. The only change since then is the inclusion of paragraph 14 giving the staff's summary of feedback received from the Insurance Working Group in June.

Summary of recommendations

2. This paper recommends the following:

   (a) the face of the balance sheet should distinguish equity attributable to policyholders from equity attributable to shareholders.

   (b) the face of the income statement should distinguish profit or loss attributable to policyholders from profit or loss attributable to shareholders.

3. The paper also asks the Board to confirm whether the notion of an enforceable constructive obligation is the most appropriate test to determine whether an insurer should recognise a liability relating to expected dividends to participating policyholders.

Background

4. In March, the Board decided the following (emphasis added to highlight the points discussed in this paper):

   (a) Policyholder participation rights do not create a liability until the insurer has an unconditional obligation that compels the insurer to transfer economic benefits to policyholders, current or future. More specifically:

      (i) If participating policyholders have a prior claim on distributions of economic benefits generated by a pool of contracts and related assets, that fact does not, by itself, oblige the insurer to transfer those benefits to policyholders. Therefore, an insurer should not recognise that prior claim as a liability, unless some other factor creates an obligation.

(ii) A dividend scale approved by the regulator creates an obligation. The staff will investigate whether the insurer should measure that obligation using the dividend scale currently in force, or develop estimates of the dividend scale that would apply in each cash flow scenario.

(iii) To the extent that no unconditional obligation exists, an insurer should not recognise a liability in respect of expected transfers of economic benefits to policyholders. If an unconditional obligation comes into existence subsequently, the insurer should recognise the resulting liability and an expense at that time.

(iv) **In assessing whether an insurer has a constructive obligation to pay dividends to participating policyholders, the Board will rely on the definitions being developed in its conceptual framework and IAS 37 projects.** The Board decided in February 2006 that an equitable or constructive obligation can be a liability only if it **legally or equivalently compels** potential outflows of cash or other economic resources.

(v) Policyholder participation rights should not be regarded as the equity component of a hybrid contract (similar to convertible debt). Accordingly, no part of the premium should be regarded as proceeds received for issuing an equity instrument, **dividends to participating policyholders are an expense, not a distribution of profit and the face of the income statement need not distinguish profit or loss attributable to equity holders of the insurer and profit or loss subject to prior claims of policyholders. However, the insurer should disclose the fact that part of its equity is subject to those prior claims.**

(vi) Identical requirements should apply to shareholder-owned insurers and mutuals.

(vii) Participation rights in investment contracts should be treated in the same way as participation rights in insurance contracts.

Example

5. We illustrate with the following example. As always, we have simplified facts to restrict the example to the most relevant features for the question we are considering. As a result, the example is artificial. Insurer A issues participating insurance contracts, with the following features:

   (a) Each policyholder pays a single premium of CU 1,000 on 1 January.

   (b) If the policyholder dies in the next two years, the contract pays a death benefit of CU 20,000.

   (c) The contract ends after two years. If the policyholder survives to the end of the second year, there is no fixed maturity benefit, but the policyholder is eligible to receive a dividend if the insurer declares one. The insurer has typically paid policyholder dividends of around 90% of the surplus attributable to maturing contracts and, at the same time paid a dividend of around 10% of that surplus to shareholders. The insurer expects this practice to continue for the foreseeable future. However, the insurer believes it has no enforceable legal or constructive obligation to pay any benefit whatsoever to policyholders or shareholders.

   (d) The insurer issues 1,000 contracts on each of 1 January x2, 1 January x3 and 1 January x5. On 1 January x4, the insurer issues 1,800 contracts.

   (e) 1% of the original number of policyholders die each year. For example, for contracts that started on 1 January x2, 10 policyholders die in x2 and 10 die in x3. For contracts that started on 1 January x4, 18 policyholders die in x4 and 18 die in x5.

   (f) There are no lapses, acquisition costs, running costs, taxes, or differences between actual experience and previous estimates. Investment returns and risk margins are ignored.

6. The following tables summarise the insurer's balance sheet, income statement and cash flows, applying the staff's understanding of the Board's decisions in March (all figures in CU'000):

Balance sheet

	x3	*x4*	*x5*
Cash	800	1,440	800
Policyholder liabilities	(200)	(360)	(200)
Equity	600	1,080	600

Income statement

	x3	*x4*	*x5*
Revenue	1,000	1,800	1,000
Policyholder benefits	(400)	(720)	(400)
Policyholder dividends	(540)	(540)	(972)
Profit	60	540	(372)

Changes in equity

	x3	*x4*	*x5*
Opening equity	600	600	1,080
Profit	60	540	(372)
Shareholder dividends	(60)	(60)	(108)
Closing equity	600	1,080	600

Cash flow statement

	x3	*x4*	*x5*
Premiums	1,000	1,800	1,000
Death benefits	(400)	(560)	(560)
Policyholder dividends	(540)	(540)	(972)
Shareholder dividends	(60)	(60)	(108)
Net cash inflow (outflow)	0	640	(640)
Opening cash	800	800	1,440
Closing cash	800	1,440	800

7. There are two striking things about this example:

   (a) Insurer A collects premiums in the first year of the contract but expects to pay some of the premiums back to policyholders in the second year. Nevertheless, the insurer does not recognise as a liability the dividends it expects to pay to policyholders.

   (b) The insurer recognises profits in one period, followed by losses in another period.

8. We can see these effects most clearly by looking at the contracts issued in x4. For these contracts:

   (a) Insurer A collects CU 1,800 at the start of x4, pays benefits of CU 360 in each of x4 and x5 and repays CU 972 to policyholders at the end of x4. This leaves

CU 108 available as a dividend for shareholders. At the end of x4, although insurer A expects to pay policyholders CU 1,332 (death benefits of CU 360 plus dividends of CU 972) it recognises a liability of only CU 360.

(b) In x4, insurer A recognises revenue of CU 1,800 and expenses of CU 720 (actual death benefits of CU 360 for x4 and expected death benefits of CU 360 for x5), leading to a profit of CU 1,080 from these contracts. In x5, insurer A recognises a loss of CU 972 on these contracts. The profit of CU 1,080 in x4 comprises the CU 972 that insurer A expects to return to policyholders in x5 and CU 108 profit for the shareholders.

9. In the staff's view, constituents are likely to have concerns that this method of accounting:

(a) includes in equity amounts that the insurer expects to return to policyholders.

(b) results in profits (potentially large profits) at inception, with predictable losses in later periods when dividends are paid. These effects would balance out in aggregate if the insurer is in a steady state. However, if the insurer is contracting, or expanding, or fluctuating in size, the effects will not balance out.

(c) relies on an insurer's ability to determine whether an enforceable constructive obligation exists. In many cases, this may be highly judgemental and dependent on estimates of the likely effect of litigation and regulatory intervention for which there is little or no case law precedent. Indeed, it is possible that some insurers could conclude that part of the expected policyholder dividends gives rise to an enforceable constructive obligation and part does not. Furthermore, that assessment could change from period to period.

(d) assumes that the insurer could retain indefinitely surplus that policyholders expect to be distributed to them. In practice, if an insurer did not, without good reason, pay any dividends to participating policyholders, the insurer would not attract new business. Moreover, in some cases, although an insurer might not have an enforceable obligation to pay dividends out of a continuing operation, a cessation of new business might trigger an enforceable obligation to pay dividends to the remaining policyholders.

10. The appendix to this paper illustrates how this example would look using three alternative approaches that the Board rejected in March:

    (a) Highlight, on the face of the balance sheet and income statement, the portion of equity and profit that is expected to be returned ultimately to policyholders.

    (b) Use split accounting, similar to IAS 32's treatment of compound instruments, such as convertible debt.

    (c) Include in the measurement of the liability all cash flows that are expected to go ultimately to current or future policyholders.

11. The papers for the March meeting considered the arguments for and against these alternative methods. This paper does not repeat the arguments.

Staff recommendation

12. In the staff's view, it is important to provide transparency about the extent to policyholders have prior claims on amounts recognised in equity. For many insurers issuing participating contracts, the amounts subject to these prior claims are far more material than minority interests and should be subject to at least as much transparency. Therefore:

    (a) the face of the balance sheet should distinguish equity attributable to policyholders from equity attributable to shareholders.

    (b) the face of the income statement should distinguish profit or loss attributable to policyholders from profit or loss attributable to shareholders.

13. The staff has some concern that, in the specific case of participating insurance contracts (and participating investment contracts) it may be particularly difficult to assess whether an insurer has an enforceable constructive obligation to pay dividends, and that attempting to draw this distinction may not result in more useful information for users. The staff asks the Board to confirm whether the notion of an enforceable constructive obligation is the most appropriate test to determine whether an insurer should recognise a liability relating to expected dividends to participating policyholders.

Input from the Insurance Working Group

14. The Insurance Working Group discussed the contents of this paper in June. Participants made the following comments:

    (a) Under the Board's tentative conclusions, expected future policyholder premiums are included in the liability if they must be paid to maintain guaranteed insurability, but expected policyholder dividends arising from those premiums are not recognised until their payment is enforceable. That is inconsistent. A Board member noted that, under existing and proposed definitions, expected policyholder dividends do not qualify as a liability until their payment is enforceable (or the equivalent).

    (b) Current exit value reflects the value of future policyholder dividends, whether or not the dividends are enforceable. In response, the staff noted that this depends on whether the objective is to establish the current exit value of the enforceable cash flows alone, or of both the enforceable and discretionary cash flows.

    (c) Excluding expected future policyholder dividends from the measurement of the liability is not a faithful representation of the contract. Policyholder dividends are an integral part of the contract and the insurer has an obligation to the policyholder, although its amount and timing is not defined and the amount could, in some scenarios, be zero. Even if the specific amount and timing of policyholder dividends are not enforceable, corporate governance requirements typically create an enforceable duty for the insurer to act properly.

    (d) The policyholder pays more for a participating contract.

    (e) Policyholder dividends affect policyholder persistency. Cash flow estimates may be internally inconsistent if the estimates include persistency estimates but exclude expected dividends that affect persistency.

    (f) If the insurer has no enforceable obligation to pay policyholder dividends, that fact does not mean that the expected policyholder dividends must be excluded from the measurement of the liability. By analogy, the measurement of the liability would include a risk margin, even though the risk margin will ultimately be released when the insurer is released from risk. A participating liability should not be unbundled into a guaranteed liability component and a

non-guaranteed equity component, just as the Board is not proposing to unbundle other cash flows arising from insurance contracts.

(g) In existing accounting approaches, expected future distributions to shareholders do not increase equity today. Similarly, expected future distributions to policyholders should not increase equity.

(h) If equity includes expected policyholder dividends, users would take them out. Disclosure is needed so that analysts can make adjustments as they want.

(i) The notion of a constructive obligation suits some environments (eg the UK) better than others. A more useful notion is economic compulsion. In some countries (eg France and Belgium), the guaranteed benefits are at a low level and most of the benefits take the form of participation. Users want to know the likely cash outflows if you are in that business. A Board member noted that the Board does not view economic compulsion, by itself, as creating an obligation.

(j) Expected policyholder dividends should be viewed as extra-contractual obligations that are recognisable if the dividends are probable and can be estimated reasonably.

(k) Under the Board's tentative conclusions, a dividend scale established by Board resolution and filed with a regulator creates an obligation. However, there is a fine line between illustrations used in sales proposals and board resolutions. This line may be difficult to draw and contentious.

(l) If the measurement of a participating contract is calibrated initially to the premium, the implicit margin will be huge.

(m) The policyholder is very important and the financial statements should report clearly the whole of the insurer's obligation to the policyholder.

(n) In the expected value approach, each scenario ought to include the dividends appropriate for that scenario.

(o) Whatever treatment is adopted for participating contracts, the same treatment should be used for other insurance contracts for which some of the cash flows are not guaranteed. Examples include universal life and some North American term contracts.

(p) In a ring-fenced participating fund, the shareholder receives dividends only if the policyholder also receives dividends. The fund should be disclosed separately as an indication dividend paying capability.

(q) Although some people see policyholder participation rights as analogous to minority interest or preference shares, there are important differences.

  (i) If the insurer stops paying policyholder dividends, it will soon have no business. In contrast, if an entity does not pay dividends to shareholders, although its share price will go down, it will still have a business.

  (ii) A preference share creates permanent capital, but the policyholder expects a return of the invested capital.

  (iii) Policyholder participation rights permit policyholders to share in assets that already exist. That differs from the right of a shareholder to participate in expected future profits.

(r) There are various types of participation. For example, in the US: (1) a stock company can only withdraw a annual fee, subject to a maximum, from the segregated fund. Everything else ultimately goes to policyholders. (2) In a mutual, the surplus legally belongs to policyholders. (3) For closed block created in a demutualization, the insurer negotiates a glide path with the regulator so that the assets of the closed block are distributed over the life of the block.

(s) We do not recognise expected future shareholder dividends as a liability, even if the issuer has established a scale of expected dividend rates. This suggests that we should not recognise expected future policyholder dividends as a liability unless there is an enforceable obligation.

(t) Some participating contracts are opaque. Including expected policyholder dividends in the liability might create scope for profit smoothing.

(u) It is necessary to address measurement issues for participating contracts, such as deciding what discount rate to use.

Appendix

Example – other methods

Alternative method 1: highlight policyholder equity

Balance sheet

	x3	*x4*	*x5*
Cash	800	1,440	800
Policyholder liabilities	(200)	(360)	(200)
Equity	600	1,080	600

Analysis of equity on the face

Policyholder equity	540	972	540
Shareholder equity	60	108	60
Total equity	600	1,080	600

Income statement

	x3	*x4*	*x5*
Revenue	1,000	1,800	1,000
Policyholder benefits	(400)	(720)	(400)
Policyholder dividends	(540)	(540)	(972)
Profit	60	540	(372)

Analysis of profit on the face

Policyholder profit	-	432	(432)
Shareholder profit	60	108	60
Total profit	60	540	(372)

Notes:

1. Policyholder profit in x4 is the policyholder equity at the end of x4 (CU 972), less the policyholder dividend of CU 540.

2. Shareholder profit is higher in x4 than in x3 and x5 because more contracts were issued. (In this example, risk margins were excluded for simplicity, and the time value of money was ignored. As a result, in this artificial example, all shareholder profit is recognised in the first year.)

Changes in equity

	x3	*x4*	*x5*
Opening equity	600	600	1,080
Profit	60	540	(372)
Shareholder dividends	(60)	(60)	(108)
Closing equity	600	1,080	600

Alternative method 2: classify expected policyholders dividends as a liability

Balance sheet

	x3	*x4*	*x5*
Cash	800	1,440	800
Policyholder liabilities: guaranteed benefits	(200)	(360)	(200)
Policyholder liabilities: participation benefits	(540)	(972)	(540)
Equity	60	108	60

Income statement

	x3	*x4*	*x5*
Revenue	1,000	1,800	1,000
Policyholder benefits	(400)	(720)	(400)
Policyholder participation	(540)	(972)	(540)
Profit	60	108	60

Changes in equity

	x3	*x4*	*x5*
Opening equity	60	60	108
Profit	60	108	60
Shareholder dividends	(60)	(60)	(108)
Closing equity	60	108	60

Alternative method 3: split accounting

Balance sheet

	x3	*x4*	*x5*
Cash	800	1,440	800
Policyholder liabilities	(200)	(360)	(200)
Equity	600	1,080	600

Analysis of equity

Policyholder equity	540	972	540
Shareholder equity	60	108	60
Total equity	600	1,080	600

Income statement

	x3	*x4*	*x5*
Revenue	460	828	460
Policyholder benefits	(400)	(720)	(400)
Profit	60	108	60

Changes in policyholder equity

	x3	*x4*	*x5*
Opening	540	540	972
Proceeds of new contracts	540	972	540
Policyholder dividends	(60)	(540)	(972)
Closing	540	972	540

Changes in shareholder equity

	x3	*x4*	*x5*
Opening	60	60	108

Profit	60	108	60
Shareholder dividends	(60)	(60)	(108)
Closing	60	108	60