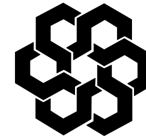

30 Cannon Street, London EC4M 6XH, United Kingdom
Tel: +44 (0)20 7246 6410 Fax: +44 (0)20 7246 6411
Email: iasb@iasb.org Website: www.iasb.org

International Accounting Standards Board

This document is provided as a convenience to observers at IASB meetings, to assist them in following the Board's discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.
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: **25 January 2007, London**

Project: **Insurance contracts (phase II)**

Subject: **Policyholder participation rights (Agenda paper 10)**

Purpose of this paper

1. This paper discusses the final set of issues for which the staff would like Board input before the finalisation of the discussion paper.

2. The staff expects to send the Board a pre-ballot draft of the discussion paper in January, with the aim of bringing any sweep issues to the February Board meeting, and publishing the paper in March.

3. The other papers for this meeting are:

   (a) A working draft of chapter 6 of the discussion paper (agenda paper 10A)

   (b) An example illustrating the Board's tentative decisions on participating contracts (agenda paper 10B)

   (c) A letter received from the European CFO Forum, the Group of North American Insurance Enterprises and four major Japanese life insurers, in response to a request from the staff for information (agenda paper 10C).

Summary of recommendations

4. This paper recommends the following:

   (a) An insurer should classify the whole of a participating contract as a liability. The measurement of the liability would include all cash flows that are expected to go ultimately to current or future policyholders. (paragraphs 5-16)

   (b) If the Board does not accept the recommendation in (a), the face of the balance sheet should distinguish equity attributable to policyholders from equity attributable to shareholders, and the face of the income statement should distinguish profit or loss attributable to policyholders from profit or loss attributable to shareholders. (paragraph 17)

   (c) In measuring a universal life contract, each cash flow scenario should include interest credited at the rate that the insurer estimates will apply in that scenario, rather than the absolute minimum that can be contractually required. (paragraphs 18-21)

   (d) As stated in the papers for the September meeting, the staff intends to carry out further research on the operationality and relevance of the guaranteed insurability test for universal life contracts, but believes that the Board does not need to resolve this issue before publishing a discussion paper. (paragraph 22)

Previous discussion

5. The Board previously discussed participating contracts in March and September 2006. Appendix A summarises the Board's decisions. In summary, an insurer should classify the participating component of a participating contract as a liability only to the extent that the insurer has an enforceable obligation.

6. Paragraphs 2-32 in the working draft of chapter 6 (agenda paper 10A) explains the background to the Board's tentative conclusions and the arguments for and against them.

7. Agenda paper 10B contains an example of four approaches for policyholder participation rights:

(a) The Board's tentative conclusions: Include in the measurement of the liability those payments for which the insurer has enforceable obligation. Include in equity those payments for which an enforceable obligation exists, even if the insurer expects to pay them to policyholders.

(b) As in the Board's tentative conclusions, but also:

(i) on the face of the balance sheet, distinguish equity attributable to policyholders from equity attributable to shareholders

(ii) on the face of the income statement, distinguish profit or loss attributable to policyholders from profit or loss attributable to shareholders.

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

(d) The treatment recommended in this paper: include in the measurement of the liability all cash flows that are expected to go ultimately to current or future policyholders.

8. Many constituents have commented to the staff on participating contracts and none have been in favour of the Board's tentative conclusions. Many have highlighted this area as their single greatest concern about the direction of the project.

9. Appendix B (repeated from September agenda paper 12F) summarises feedback from the June 2006 meeting of the Insurance Working Group.

Discussion

10. The working draft of chapter 6 presents two views of participating contract: a unitary view and a two-component view. Most constituents, if not all, adopt the unitary view. They would include in the measurement of the liability all cash flows that are expected to go ultimately to current or future policyholders.

11. In the staff's view, the two-component view is conceptually more appropriate. The guaranteed component and the participating component have different characteristics. The participating component has some characteristics of equity: it bears some of the risks (often significant) and gives policyholders access to some

of the rewards. If the participating component could exist as a stand-alone contract, it would be appropriate, in the staff's view, to classify it in equity if no obligation exists.

12. Nevertheless, the participating component is not a stand-alone contract. Of course, IAS 32 provides a precedent for splitting compound financial instruments, such as convertible debt, into a liability component and an equity component. However, for two reasons, the staff finds the arguments for that treatment less compelling for participating contracts:

    (a) Policyholder dividends are just one form of contractual benefit among others, and are an integral part of the contract. If claims are high, dividends will be low, and vice versa. In aggregate, they are inversely related to a large degree (though not necessarily one for one – a change of CU 1 in claims may affect the dividend by more or less than CU 1). This inverse relationship between the components is not present in convertible debt: changes (if any) in the liability cash flows do not directly affect the cash flows from the equity component.

    (b) The Board's tentative conclusions are only partly consistent with IAS 32's split accounting for compound financial instruments. Under IAS 32, the proceeds for the whole instrument are split into the proceeds for the liability component (treated as a deposit) and the proceeds for the equity component (treated like the proceeds of a share issue). However, under the Board's tentative conclusions, the proceeds for the participating component would be recognised in the income statement even if the participating component is included in equity. Similarly, policyholder dividends would be recognised as an expense, not as an appropriation of profit.

13. Why did the Board decide tentatively not to split out the proceeds of a participating component that is equity? The Board noted that such a split would be particularly problematic for regular premium contracts. Either the split would be made at inception and not updated subsequently (which is arguably inconsistent with a basic measurement model built on current market-consistent estimates of cash flows) or updated at every premium receipt date (which could be onerous). In the staff's view, it is appropriate not to require this split. However, in

consequence, the Board's tentative conclusions are not fully consistent conceptually.

14. The staff has several concerns about the Board's tentative conclusions. In summary:

    (a) The staff is not convinced that the distinction between enforceable and unforceable policyholder participation will provide the most relevant information to users.

    (b) The distinction between enforceable and unforceable policyholder dividends may be very difficult to draw in practice. It would not be helpful to base an important classification decision on this difficult decision. Indeed, 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.

    (c) Arguably, excluding some policyholder dividends from the measurement of an insurance liability is inconsistent with some other aspects of the measurement model.

15. Although it is not very appealing conceptually to report the participating component as equity if the insurer has no enforceable obligation to pay policyholder dividends, the discussion in paragraph 13 shows that a conceptually pure alternative is not available in practice. In the staff's view, the most practicable solution, and the one that best meets the needs of users, is to classify the whole contract as a liability (the unitary view). Therefore, the measurement of the liability would include all cash flows that are expected to go ultimately to current or future policyholders.

16. The working draft of chapter 6 does not implement one aspect of the Board's tentative conclusions. The tentative conclusions state that a dividend scale established by Board resolution and filed with a regulator creates an obligation. For the following reasons, the staff has excluded that conclusion from the working draft:

(a) On further discussion with practitioners, the staff now believes that the situation described is not a very practical real-life example.

(b) The conclusion does not appear consistent with the basic expected value model. A more consistent approach is to include in each scenario an unbiased estimate of the dividend that would apply in that scenario.

Disclosure

17. 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 non-controlling interests in subsidiaries (minority interests) and should be subject to at least as much transparency. Therefore, if the Board rejects the staff's recommendation on classification, and retains the notion of enforceability as the test for classifying a participating component, the staff recommends that:

    (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.

Universal life contracts

18. Universal life contracts permit some flexibility to both policyholders (on the premiums they pay and the cover they buy) and insurers (on insurance charges and crediting rates). The working draft of chapter 6 give more detail on these contracts.

19. In September, among other things, the Board asked the staff to consider whether estimates of cash outflows should include interest credited to policyholder accounts at the minimum rate that can be contractually required, or at the rate that the insurer expects to apply in each scenario. The Board also asked the staff to consider the interaction of crediting rates with estimates of lapses.

20. Although crediting rates for a universal life contract are not contractually linked to the performance of the underlying pool of contracts and related assets,

practitioners often argue that their economic behaviour is very similar in practice. In the staff's view, if the measurement uses the contractual minimum crediting rate, the result will not be relevant to users and will be subject to many of the same practical drawbacks as the two-component view of participating contracts.

21. Accordingly, the staff recommends that, in measuring a universal life contract, each cash flow scenario should include interest credited at the rate that the insurer estimates will apply in that scenario, rather than the absolute minimum that can be contractually required.

22. The Board has tentatively decided to use a guaranteed insurability test to determine the extent to which the measurement of an insurance liability includes future premiums. Universal life contracts give the policyholder considerable freedom to vary the premiums. Therefore, although some of the premiums for those contracts would probably pass the test, others would probably fail. As stated in the papers for the September meeting, the staff intends to carry out further research on the operationality and relevance of the guaranteed insurability test for these contracts, but believes that the Board does not need to resolve this issue before publishing a discussion paper.

Appendix A
Previous Board discussion

23. In March, the Board decided the following:

(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.

(b) In September, the Board:

(i) reaffirmed its prior tentative conclusion (March 2006) that an insurer should recognise a liability relating to expected dividends for participating policyholders if the insurer has an enforceable obligation. The Board noted that an obligation may be enforceable in various ways, including legal action or intervention by a regulator. However, economic compulsion is not sufficient to create an enforceable obligation.

(ii) directed the staff to investigate further the staff's proposal that the face of the balance sheet should distinguish equity attributable to policyholders from equity attributable to shareholders, and the face of the income statement should distinguish profit or loss attributable to policyholders from profit or loss attributable to shareholders.

(iii) continued, from May 2006, its discussion of universal life contracts, focusing on the proposed test for including future premiums (ie guaranteed insurability), the classification (as a liability or as equity) of crediting rates that exceed the minimum that can be contractually required and the interaction of crediting rates with estimates of lapses. The Board directed the staff to investigate these issues further.

Appendix B
Input from the Insurance Working Group

24. The Insurance Working Group discussed participating contracts in June 2006. 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 an 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.