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**International Accounting Standards Board**



**INFORMATION FOR OBSERVERS**

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# Chapter 6 Policyholder participation

## Introduction

1. This chapter discusses four categories of contracts for which the payments to policyholders depend partly on the performance of the portfolio of which the contract forms a part, the assets backing that portfolio or the entity that issued the contract:

   (a) participating contracts (paragraphs 2-32)

   (b) universal life contracts (paragraphs 33-39)

   (c) unit-linked contracts (paragraphs 40-57)

   (d) index-linked contracts (paragraphs 58 and 59)

**Participating contracts**

## Overview

2. This section discusses participating contracts under the following headings:

   (a) Background (paragraphs 3-5)

   (b) How do participating contracts work? (paragraphs 6-12)

   (c) Two views of a participating contract (paragraphs 13-15)

   (d) Definition of a liability (paragraphs 16-22)

   (e) Arguments for a unitary view (paragraph 23)

   (f) Arguments for a two-components view (paragraphs 24-27)

   (g) Measurement of participating contracts (paragraphs 28 and 29)

   (h) Preliminary views (paragraphs 30-32)

## Background

3. Some insurance contracts, and some investment contracts sold by insurers, give the policyholder both guaranteed benefits (eg a death benefit) and a right to participate in favourable performance of the relevant class of contracts, related assets or both. The insurer has some discretion over the amount or timing of the resulting distributions to policyholders, but there are often constraints over that discretion. In this respect, participating contracts differ from unit-linked contracts, for which such discretion does not exist. This paper describes a policyholder's right to participate in favourable contract performance as a policyholder participation right, and a contract that contains such a right as a participating contract. Other terms, such as with profits contract, are sometimes used to refer to such a contract.

4. For convenience, this paper uses these generic terms rather than the more formal and specific term 'discretionary participation feature' (DPF) introduced by IFRS 4. This paper does not discuss whether phase II should amend the definition of a DPF. The Board will review that definition later in this project. IFRS 4 defines a

DPF as a 'contractual right to receive, as a supplement to guaranteed benefits,[1] 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.

5. As the definition of a DPF highlights, policyholder participation rights give the insurer some discretion, but also constrain that discretion. The combination of discretion with constraint makes it difficult to determine whether such rights create a liability for the insurer. Paragraphs 6-32 discuss 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 obligation to stand ready to provide guaranteed benefits).

## How do participating contracts work?

6. For a participating contract, the insurer charges a larger premium than it expects to need. If the actual experience is in line with the insurer's expectations, the insurer refunds part or all of the excess premium to policyholders. To illustrate, suppose that an insurer issues 1,000 non-participating contracts for which the

[1] IFRS 4 defines guaranteed benefits as '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'.

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.

7. Consider now what would happen if the contracts are participating contracts. The insurer might charge, say, CU 100 per contract. If the actual claims and benefits equal the previously estimated expected value of CU 80 per contract, the insurer will pay a dividend of, say, CU 13 to each policyholder.[3] This will leave a margin of CU 7 per contract for the insurer. If the actual claims and losses are lower than CU 80 per contract, the insurer will pay a larger dividend. If actual claims and losses are higher than CU 80 per contract, it will pay a smaller dividend. Unless average claims exceed CU 93, the insurer can always achieve its target margin of CU 7 per contract. The insurer (and, ultimately, the insurer's owners) bears the risk that claims exceed CU 93; below that level, the participating policyholders bear the risks. For that reason, the target margin for the participating version of this contract is lower than the target margin for the non-participating version.

8. In this example, both the participating and non-participating versions of this contract protect policyholders against financial consequences of insured events by pooling the experience of all policyholders. However, the non-participating contract also protects the policyholder against the risk that aggregate losses of all policyholders as a class are worse than expected, whereas the participating contract does not protect policyholders against that risk. Thus, participating contracts limit the aggregate risk borne by the insurer.

9. Participating contracts vary greatly in the mechanisms used to share favourable performance with policyholders. Typically, these mechanisms involve the following three steps, which may occur in the same accounting periods or in different periods:

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

[3] As noted before, this entire example ignores the time value of money.

(a) Step 1: Determine the amount available for distribution (described below as the distributable amount). Typically, participating contracts (or the surrounding legal and regulatory environment) specify the basis for determining the distributable amount. In some instances, the distributable amount is the profit, as determined for general purpose financial reporting, arising from a defined pool of contracts. In other instances, the profit is computed using a different formula (for example, a formula that includes all realised investment gains but excludes unrealised investment gains). In some cases, the distributable amount is the profit for the current period. In other cases, it is the cumulative undistributed profit since the inception of the pool of contracts.

(b) Step 2: Allocate part, or all, of the distributable amount to policyholders as a class. In some instances, the contract, law or regulation require the insurer to allocate at least some of the distributable amount to policyholders. For example, the insurer may be required to allocate at least 90% of the distributable amount to policyholders. In other instances, no minimum allocation is specified. In many instances, insurers allocate more than the required minimum, and there is often a market expectation that they will do so. In some systems, no minimum allocation is required, but if any allocation is made to the owners of the insurer, the insurer must allocate at least a specified amount to policyholders at that time. For convenience, this paper uses the term 'policyholder surplus' to describe the cumulative amount allocated to policyholders as a class but not yet distributed to individual policyholders.

(c) Step 3: Distribute to individual policyholders part, or all, of the policyholder surplus determined in step 2. In some cases, distribution policies are intended to distribute the profit generated by a generation of contracts to that generation of policyholders, but this is not always intended (and may not always be feasible). The distributions may 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. For ease of discussion the following paragraphs use the term 'policyholder dividend' throughout.

10. In most cases, insurers have some discretion over steps 2 or 3, or both. However, that discretion is usually subject to some constraints (contractual, legal, supervisory or market). In some cases, insurers have some implicit discretion over stage 1. For example, if the distributable amount includes realised gains, but not unrealised gains, the insurer can change the time when the distributable amount arises by changing the time when it sells investments.

11. In some cases, allocations to policyholder surplus are irrevocable. In other cases, the allocation may be revoked in specified circumstances (eg to avoid insolvency). Similar, policyholder dividends are often irrevocable, but in some cases the insurer can revoke them in specified circumstances.

12. In some cases, policyholder dividends are paid to all policyholders in a specified class whose contracts are then in force. In those cases, part of the profit generated by one generation of policyholders is distributed to future generations of policyholders. A change in the timing of a distribution means that a different generation of policyholders will benefit (though typically the generations overlap). In other cases, insurers are required (or choose) to allocate policyholder surplus among policyholders in a way that reflects the relative contributions from each contract to that surplus (the 'contribution principle').

### Two views of a participating contract

13. The Board has considered two views of participating contracts. One view sees a participating contract as a unitary contract that generates a single set of cash flows to policyholders. Because the contract contains one element which is clearly a liability (the unconditional obligation to stand ready to pay the guaranteed benefits), the insurer treats the whole contract as a liability.

14. The other view sees a participating contract as made up of two components: a guaranteed component and a participating component. The insurer has an unconditional obligation to stand ready to pay the benefits specified by the guaranteed component. Thus, an insurer would recognise the guaranteed component as a liability. The insurer would also recognise the participating component as a liability, to the extent that it meets the definition of a liability in the IASB's *Framework for the Preparation and Presentation of Financial Statements*. If any part of the participating component does not meet that

definition of a liability, the insurer would include that part in equity. If policyholders have a prior claim on that component of equity, the insurer would disclose that component separately within equity to highlight the fact that other equity-holders have little, or restricted, access to it.

15. The following discussion considers first whether the participating component meets the definition of a liability (paragraphs 6-22) and then whether the unitary view or the two component view is more appropriate (paragraphs 23-27). When the participating component meets the definition of a liability, the two-component view and the unitary view lead to the same result, namely that the entire contract is classified as a liability.

## Definition of a liability

16. 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'. For the participating component, the critical question is whether the insurer has a present obligation to pay policyholder dividends. In this regard, it is worth considering the precedent set by IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. IAS 37 identifies two categories of obligations: legal obligations and constructive obligations. IAS 37 defines a legal obligation as an obligation that derives from a contract (through its explicit or implicit terms), legislation or other operation of law. IAS 37 defines a constructive obligation as 'an obligation that derives from an entity's actions where:

    (a) by an established pattern of past practice, published policies or a sufficiently specific current statement, the entity has indicated to other parties that it will accept certain responsibilities; and

    (b) as a result, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities.'

17. In June 2005, the Board issued an Exposure Draft proposing changes to IAS 37, including a new definition of a constructive obligation as: 'a present obligation that arises from an entity's past actions when:

(a) by an established pattern of past practice, published policies or a sufficiently specific current statement, the entity has indicated to other parties that it will accept particular responsibilities; and

(b) as a result, the entity has created a valid expectation in those parties that they can reasonably rely on it to discharge those responsibilities.'

18. Some jurisdictions use terms such as 'policyholders' reasonable expectations' in a sense similar to the notion of a constructive obligation. Policyholders expectations might arise from various sources, include marketing literature, other public statements and past practice. In some cases, a regulator or the courts might act to enforce policyholders' reasonable expectations. In other cases, insurers might often apply such notions, but if the insurer fails to satisfy policyholders' expectations, there may be no mechanism for policyholders, regulators or others to enforce them.

19. Some argue that the participating component always meets the definition of a liability. They offer the following arguments:

(a) The policyholder pays more for a participating contract. This creates at least a constructive obligation, and in some cases a legal obligation. Although there may be some circumstances in which the policyholder receives no dividend, that possibility should be factored into the measurement of the participating component and should not preclude its recognition as a liability.

(b) In practice, an insurer cannot retain indefinitely surplus that policyholders expect to be distributed to them. If an insurer does not, without good reason, pay any policyholder dividends, 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.

(c) Although a participating component may be similar in some respects to non-controlling interest in a subsidiary (minority interest) or preference shares (preferred stock), which are classified as equity under IFRSs, it differs from them in the following respects:

(i) If an insurer stops paying policyholder dividends, it will be unable to attract new business. In contrast, if an entity does not pay dividends to shareholders, its share price may go down but it may still be able to attract new business.

(ii) Policyholder participation rights expire with the host contract. In contrast, the rights conferred by irredeemable preference shares typically do not expire (though a portion of those rights may expire if the dividends are non-cumulative). Similarly, a non-controlling interest in a subsidiary typically has an indefinite life (unless it is redeemable, in which case it is classified as a liability).

(iii) Some policyholder participation rights might rank ahead of some non-policyholder liabilities in a liquidation. In contrast, preference shares typically rank behind liabilities.

(iv) The participating component is embedded in a larger contract, whereas a non-controlling interest in a subsidiary is typically a stand-alone instrument.

20. The Board agrees that a present obligation exists if someone, such as the policyholder or an insurance supervisor, can enforce the obligation by compelling the insurer to pay policyholder dividends. However, in the Board's preliminary view, no present obligation exists if no-one can enforce payment, even if there is an expectation that the insurer will pay. For example, the insurer may feel economically compelled to pay policyholder dividends to maintain its market position, but such economic compulsion is not enough to create a present obligation. Many entities may feel just as much economical compulsion to pay dividends on preference shares (preferred stock) or ordinary shares (common stock), but they have no obligation to do so and so entities do not recognise a liability in respect of future dividends on shares.

21. Similarly, although policyholders may have a prior claim on a definable portion of results from a group of contracts, that prior claim does not create a present obligation towards those policyholders. An insurer could simply retain the surplus indefinitely without distributing dividends to policyholders. If such prior claims

did create such an obligation, entities would need to classify preference shares (preferred stock) and minority interests as a liability.

22. The Board notes two other factors indicating that policyholder surplus functions to some extent like equity:

    (a) Policyholder surplus bears some of the risks relating to the relevant class of contracts. In paying for a participation right, the policyholder is supplying capital that is available to bear risks. In that respect, a policyholder participation right is rather like a non-controlling interest in a subsidiary (minority interest), which is typically classified in equity.

    (b) In a mutual insurer, the policyholder participation right is the only source of capital. If it is classified as a liability, a mutual insurer will report no equity. Mutuals intend to retain part of their surplus indefinitely and view that part as equity.

### Arguments for a unitary view

23. For the following reasons, some argue that the measurement of an insurance liability should include all cash flows that are expected to go ultimately to current or future policyholders:

    (a) At inception, if the initial measurement of the insurance liability does not include expected policyholder dividends, the insurer will report a large profit (unless the measurement is calibrated initially to the premium, resulting in a large implicit margin). This would be misleading because equity would include amounts that the insurer expects (and feels compelled) to return to policyholders, and because large losses will follow in later periods when the insurer distributes policyholder dividends.

    (b) As discussed above, the two-components view relies on determining whether an enforceable obligation exists. It may be difficult to make this determination. In some instances, the conclusion could be extremely sensitive to estimates of the likely effect of litigation and regulatory intervention, with little or no case law precedent. Moreover, some insurers might conclude that part of the expected policyholder dividends gives rise to an enforceable obligation and part does not. That split could change from period to period.

(c) Equity analysts are interested in the split between policyholder interests and shareholder interests. They are less interested in a split between enforceable payments and unenforceable payments.

(d) 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).

(e) Paragraph BC22 of the Basis for Conclusions on IAS 32 *Financial Instruments: Presentation* 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.' 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. Moreover, the two components of convertible debt are not inversely related in the same direct way as the guaranteed and participating components of a participating contract.

(f) Treating expected policyholder distributions as equity would be inconsistent with the Board's preliminary views on other aspects of this project:

(i) Chapter 4 states that the measurement of an insurance liability should include expected future policyholder premiums meeting specified criteria. It is inconsistent to exclude expected policyholder dividends arising from those premiums.

(ii) The current exit value of the whole contract reflects future policyholder dividends, whether or not they are enforceable.

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

(g) Failure to pay policyholder dividends would lead to massive lapse. However, using lapse estimates that reflect no policyholder dividends would not result in useful information.

(h) Excluding expected policyholder dividends from the liability measurement would imply that the guaranteed component should be measured as if it were a separate non-participating contract. However, the risk margin for a non-participating contract does not give useful information about a participating contract because it implies that the insurer faces risks that actually fall on policyholders. To avoid this result, the margin for the actual participating contract could be used, but then the amount recognised as a liability would combine the cash flows for a non-participating contract (the guaranteed component) with the risk margin for a participating contract; this combination does not provide a faithful representation of any economic phenomenon in the real world.

### Arguments for the two-components view

24. In the Board's preliminary view, the two-component view is more appropriate. The guaranteed component and the participating component have different economic characteristics and should be considered separately. 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 to classify it in equity if no obligation exists.

25. The two-component view is consistent with IAS 32. Under IAS 32, the issuer of convertible debt classifies the liability component as a liability (similar to straight debt) and the equity component (the embedded conversion option) in equity.

26. If IAS 32's split accounting model for convertible debt were applied in full to participating contracts, it would be necessary to split the proceeds received from the policyholder (ie the premium) into the proceeds for the liability component (recognised in the income statement) and the proceeds for the equity component (not recognised in the income statement). Making that split could be problematic 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

could be inconsistent with a measurement model that reflects future cash flows. However, it would be impracticable to reperform the split when each premium is received. Accordingly, in the Board's preliminary view, the treatment of participating contracts should differ in two respects from split accounting under IAS 32:

(a) An insurer would recognise the entire premium in the income statement.

(b) Similarly, an insurer would recognise policyholder dividends as an expense when the insurer concludes that it has an enforceable obligation to pay them.

27. Examples 6.1-6.5 [in the appendix to this paper] illustrate how the notion of an enforceable obligation might apply for a participating component if the two-components view is adopted. In examples 6.1-6.3, the unitary view and the two-components view lead to the same answer. In examples 6.4 and 6.5, the two views lead to different results if the insurer concludes that the participating component does not give rise to a present obligation.

## Measurement of participating contracts

28. The above discussion concentrates on the classification of participation features. Brief mention is made below of two measurement issues: the approach to embedded options and guarantees and determining the discount rate. Participating contracts create an asymmetric payoff that resembles an embedded option or guarantee. For example, consider a contract for which policyholders receive back this original investment plus 90% of any related investment return. The insurer bears the loss if the investment return is negative. The payment to policyholders equals the sum of the following three components:

(a) 90% of the fair value of the assets, plus

(b) 10% of the original amount invested, plus

(c) the pay-off from an option to put 90% of the assets for 90% of the original amount invested. To measure the contract at current exit value, the insurer would need to measure this third component using option-pricing techniques that capture both the intrinsic value of that option and its time value on a market-consistent basis.

29. The second, related, aspect of measurement relates to the discount rate. Chapter 3 reports the Board's preliminary view that the discount rate should depend on the characteristics of the liability, not the characteristics of the assets held to back those liabilities. For a participating liability, some cash flows from the liability may depend contractually on the cash flows from the underlying assets. An insurer would need to measure those asset-dependent cash flows on a basis consistent with the measurement of the underlying assets. If the asset-dependent liability cash flows equal the asset cash flows in all scenarios, the current exit value of the asset-dependent cash flows equals the current exit value of the assets. In more realistic cases, the liability cash flows depend asymmetrically on the asset cash flows because of guarantees or options. In those cases, more sophisticated techniques are needed to reflect the asymmetry on a market-consistent basis.

## Preliminary views on participating contracts

30. In the Board's preliminary view, policyholder participation rights create a liability when the insurer has an unconditional obligation to transfer economic benefits to policyholders, current or future. More specifically:

    (a) A policyholder participation right creates a liability to the extent that it legally or equivalently compels potential outflows of cash or other economic resources. An obligation may be enforceable in various ways, including legal action by a policyholder or intervention by a regulator.

    (b) An insurer may feel economically compelled to pay policyholder dividends for competitive reasons. However, mere economic compulsion does not create a liability.

    (c) If policyholders have an individual or collective prior claim on part of an insurer's equity, that prior claim does not, in itself, create an obligation. If part of an insurer's equity is subject to such prior claims, an insurer should disclose that fact.

    (d) If no unconditional obligation exists, an insurer should not recognise a liability for expected policyholder dividends. If an unconditional obligation arises later, the insurer should recognise the resulting liability and an expense then.

(e) Policyholder participation rights should not be regarded as the equity component of a hybrid contract (similar to convertible debt). Accordingly, none of the premium should be regarded as proceeds received for issuing an equity instrument.

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

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

31. Example 6.6 illustrates how an insurer's financial statements would look if a participating component is classified in equity. [That example will be based on the example in agenda paper 10B]

32. The Board and the FASB will consider in their joint project on the conceptual framework whether to retain, modify or abandon the distinction between liabilities and equity instruments. If they modify or abandon it, the Board will revisit the preliminary views expressed in this chapter.

**Universal life contracts**

33. The American Council of Life Insurers defines universal life insurance as 'A type of permanent life insurance that allows you, after your initial payment, to pay premiums at any time, in virtually any amount, subject to certain minimums and maximums. This policy also permits you to reduce or increase the death benefit more easily than under a traditional whole life policy. To increase your death benefit, the insurance company usually requires you to furnish satisfactory evidence of your continued good health.'[4]

34. A universal life contract typically operates as follows:

(a) Premiums are added to a policyholder account.

(b) The contract permits the policyholder to vary premiums, within specified limits.

[4] http://www.acli.org/ACLI/Consumer/Glossary/Default.htm

(c) The contract provides mortality coverage as long as funds remain in the policyholder account to pay the mortality and other charges. Some contracts contain 'secondary guarantees' that permit mortality coverage to continue even if the policyholder account is exhausted.

(d) Within specified limits, the contract may permit the policyholder to increase or decrease the amount of life insurance cover without a medical examination.

(e) Deductions are made from the policyholder account for mortality charges and perhaps for other items, such as administration costs or acquisition costs. The contract may limit the level of mortality and/or other charges.

(f) Interest is added to the policyholder account, based on the account balance. Depending on the contract, this may be:

(i) Interest determined using a crediting rate set by the insurer. The crediting rate will reflect factors such as the returns on the assets backing the contract(s), market conditions, competitive considerations, expectations established in marketing literature and regulatory requirements. The contract may specify a minimum crediting rate.

(ii) The return on a specified pool of assets dedicated to a series of contracts. The contract may specify a minimum crediting rate, for example a return of premiums. The contract may permit the insurer to deduct a periodic investment management fee from the pool of assets.

(g) The contract may permit the policyholder to withdraw the account balance. Withdrawals may be subject to surrender charges, and the contract may restrict the timing of withdrawals.

35. The following paragraphs discuss two aspects of universal life contracts: crediting rates and future premiums.

## Crediting rates

36. For some types of participating contract, policyholder benefits reflect returns on a specified pool of assets, although the insurer has some discretion to vary the amount and timing of that participation. The crediting rate mechanism for a universal life contract can have a similar effect in practice, because actual asset

returns can be an important influence on crediting rates, though actual asset returns are not the sole determinant. Therefore, some argue that an insurer should account for interest credits on universal life contracts in the same way as for policyholder dividends arising from participating contracts.

37. Some may take the view that the insurer has no obligation to credit more than the guaranteed minimum and that the liability should be measured on that basis. In that approach, lapse estimates would need to be consistent with a strategy of crediting the contractual minimum and no more.

38. [as recommended in agenda paper 10] However, in the Board's preliminary view, a measurement based solely on the contractually guaranteed minimum crediting rate is unlikely to provide useful information for users. Instead, estimates of crediting rates in each scenario should reflect what the insurer actually expects to do in that scenario, not the absolute minimum that can be contractually required.

## Future cash flows

39. Applying the preliminary view expressed in chapter 4, the measurement of an insurance liability includes premiums that pass a guaranteed insurability test. For many traditional life insurance contracts, all future premiums specified in the contract would pass the guaranteed insurability test. However, because universal life contracts give the policyholder considerable freedom to vary the premiums, some of the premiums for those contracts would probably pass the test but others would probably fail. The Board intends to carry out further research on the operationality and relevance of the guaranteed insurability test for these contracts.

### Unit-linked contracts

40. In some insurance contracts, some or all of the policyholder benefits are contractually determined by the price of units in an internal or external investment fund (ie a designated pool of assets held by the insurer or a third party and operated in a way similar to a mutual fund). This paper describes these contracts as **unit-linked contracts**, the benefits that are determined by the unit prices as **unit-linked benefits**, the pool of assets as **separate account** assets and all of an insurer's other assets as **general account** assets. In some countries, such countries have other names, for example variable contracts.

41. Unit-linked contracts typically have most or all of the following features:

(a) The premium received from the policyholder is used to buy units in a fund, in some cases after the insurer has deducted a front-end fee or a bid-ask spread.

(b) The unit price at any time reflects the fair value of the assets held in the fund, possibly adjusted for a bid-ask spread.

(c) Charges are deducted from the fund (as a whole) for investment management, administrative and other expenses and tax.

(d) Other charges are often made to individual policyholder's account for insurance coverage (eg a fee for mortality protection), and perhaps also for contract administration and as a means of recovering acquisition costs. These charges are typically determined as a monetary amount, with units cancelled to provide that amount (number of units cancelled equals the monetary amount, divided by the unit price). In some cases, the charges are levied by issuing special sub-classes of units that do not pass through all investment performance (eg where 'capital units' are used as a means of recovering acquisition costs)

(e) Depending on the structure and legal setup, the assets in the fund may or may not be insulated from the insurer's other activities. If the assets are not insulated, this may be an important difference from most mutual funds.

(f) A unit-linked contract may provide both unit-linked benefits and other non-unit benefits (eg life coverage). This paper deals only with the unit-linked benefits. The general principles being developed in the rest of this project would apply to the non-unit benefits.

(g) Insurers often provide some guarantees related to the investment performance of unit-linked benefits. There may or may not be a separate explicit fee for the guarantee.

42. Accounting problems may arise in two main areas:

(a) Should the insurer recognise the pool of assets and the related liabilities?

(b) Typically, the underlying assets are measured at fair value and the same measurement is used for the related part of the liability. What happens if the insurer cannot classify some assets at fair value through profit or loss?

43. This chapter does not address the following topics discussed in other chapters:

(a) Revenue recognition relating to charges made to unit-linked policyholders (see discussion of service margin in chapter 4).

(b) Treatment of future premiums, including future premiums that will recover acquisition costs (included in the measurement of the liability to the extent the policyholder would lose guaranteed insurability if the policyholder either stops paying premiums or surrenders the contract).

(c) Measurement of guarantees related to the investment performance of unit-linked benefits. These would be measured at current exit value (for a unit-linked insurance contract) or fair value (for a unit-linked financial instrument)

## Recognition and presentation of separate account assets

44. The Board considered three treatments for separate account assets:

(a) Exclude the separate account assets from the issuer's balance sheet and exclude the related part of the liabilities. The related part of the liabilities is the part that depends directly on the performance of the assets. If the liability includes other parts (eg guarantees of investment performance or additional death benefits), these would still be recognised.

(b) Include the separate account assets in the issuer's balance sheet as a single line item separate from the issuer's general account assets, and include the entire liability as another line item.

(c) Include in the issuer's balance sheet the separate account assets, commingled with the issuer's general account assets, and include the entire liability as another line item.

45. The first approach excludes the separate account assets (and the related portion of the liabilities) from the issuer's balance sheet. Arguments for this approach are as follows:

(a) In substance, the assets are held for policyholders. They derive the direct benefits from the performance of the assets, and bear the investment risk associated with them. The insurer derives only indirect benefits from the assets through investment management fees and through the impact on any performance guarantees given by the insurer.

(b) In some cases, the assets are not available to the insurer for general business purposes.

(c) This treatment is consistent with the way that an asset manager accounts for funds that it manages.

(d) This approach eliminates accounting mismatches that could occur if the unit-linked assets are not measured at fair value through profit or loss (see paragraphs 49-57).

46. The second approach includes the separate account assets as a single line item separate from the issuer's general account assets and includes the entire liability as another line item. Arguments for this approach are as follows:

(a) Arguably, the insurer controls the assets.

(b) Excluding part of the insurer's obligation from the insurer's balance sheet is not appropriate if the insurer must satisfy the entire obligation.

(c) The single-line presentation is helpful for users because it distinguishes assets for which the policyholders bear all the investment risk from the insurer's other assets.

47. The third approach commingles the separate account assets with the issuer's general account assets. Arguments for this approach are as follows:

(a) Arguably, the insurer controls the assets.

(b) Reporting part of the insurer's obligation off balance sheet is not appropriate if the insurer must satisfy the entire obligation.

48. The Board has not yet formed a preliminary view on the recognition and presentation of separate account assets. The Board is discussing related issues in its project on consolidation.

## Accounting mismatches for unit-linked contracts

49. In most countries, insurers measure assets in unit-linked funds at fair value and measure the unit-linked benefits on a similar basis: if the obligation is to pay benefits equal to 100 units, the benefit is measured at 100 times the current unit price. However, accounting mismatches can arise if some or all of the unit-linked assets:

    (a) cannot be recognised. This might occur if the unit-linked assets include shares or financial liabilities of the issuer itself (treasury shares) or goodwill in subsidiaries

    (b) are recognised, but cannot be measured at fair value. This might occur if the assets meet the definition of inventories in IAS 2 ('assets held for sale [..] in the ordinary course of business […]'), in which case they are measured at the lower of cost and net realisable value. (Commodity broker-traders may measure their inventories at fair value less costs to sell)

    (c) are measured at fair value, but changes in their fair value must be recognised outside profit or loss. This might occur if separate account assets include a building that is rented to the insurer for use in its own operations. The building would be an owner-occupied property within the scope of IAS 16 *Property Plant and Equipment*.

50. The Board would prefer to avoid these mismatches, if all else is equal. In relation to the example of treasury shares, the following paragraphs discuss the advantages and disadvantages of two approaches to eliminating these mismatches.

    (a) Change the treatment of some or all separate account assets so that they can be recognised and measured at fair value through profit or loss.

    (b) Adjust the measurement of unit-linked liabilities for differences between the carrying amount of separate account assets and their fair value.

***Recognition and measurement of separate account assets***

51. Changing the treatment of separate account assets could involve some or all of the following exceptions to normal recognition and measurement requirements:

    (a) Extend the fair value option currently in IAS 39 so that it could be used for all unit-linked assets, financial or non-financial. This approach would have the advantage of building on a treatment that already exists. It would seem most relevant for owner-occupied property.

    (b) Permit or require insurers to recognise as an asset all separate account assets, even if they do not normally qualify for recognition as an asset. This issue might arise if the separate account assets include treasury shares (which do not meet the definition of an asset from the perspective of the insurer as a whole) or internally generated goodwill in subsidiaries (which does not qualify for recognition as an asset under existing IFRSs).

    (c) Permitting or requiring insurers to recognise in the income statement changes in the fair value of owner-occupied property.

52. Such exceptions would require the Board to develop a definition of separate account assets. Arguably, they would also conflict with the Board's objective of setting principles-based standards.

***Measurement of unit-linked liability***

53. If the separate account assets cannot (even using all available accounting options) be recognised and measured at fair value, an alternative approach would be to adjust the carrying amount of the liabilities to exclude the portion of the benefit that depends directly on the difference between the carrying amount of the assets and their fair value. Some believe that such adjustments would be an ad hoc and rule-based over-ride of a general measurement principle (current exit value).

54. Others view such adjustments as an application of the current exit value principle, rather than a modification of it. Because the pay-outs on the unit-linked liability are directly linked to the fair value of the assets, it is inconceivable that a transfer of the liability could occur without a transfer of the linked assets.

55. For example, consider separate account assets that include treasury shares (ie the insurer's own shares) with a fair value of CU 50 and other financial instruments with a fair value (and carrying amount) of CU 950. For simplicity, assume that the contracts carry no investment guarantees and that the current exit value of the remaining contractual rights and obligations is negligible. A hypothetical transfer of the unit-linked liabilities would involve a transfer of both the assets and the liabilities for a net price of zero. Put differently, the insurer would pay for the transfer of the liabilities by delivering treasury shares with a carrying amount of zero and other assets with a fair value of CU 950. Arguably, the amount that most faithfully represents the current exit value of the insurer's obligation is CU 950. The obligation to deliver the treasury shares could never cause a loss to the insurer. Indeed, if the treasury shares were sold immediately before the transfer, and the proceeds were reinvested in other assets, the insurer would still have to deliver a pool of assets with the same fair value (but a different composition); however, although that pool of assets would now have a carrying amount of CU 1,000, the insurer would not have suffered any economic loss.

56. Adjustments to the measurement of unit-linked contracts would not eliminate the accounting mismatch for owner-occupied property. That mismatch arises not from different measurements but from different treatments of changes in carrying amount.

***Preliminary view***

57. The Board would prefer to eliminate accounting mismatches that could arise when separate account assets are not recognised or are not measured at fair value through profit or loss. However, eliminating all of them would create several inconsistencies with other requirements of IFRSs. This would conflict with the Board's objective of setting principles-based standards. Accordingly, the Board has not yet formed a view on whether it would be acceptable to create such inconsistencies with other requirements of IFRSs. The Board would welcome comments from respondents on this issue.

**Index-linked contracts**

58. In some cases, an insurance liability or financial liability is linked to an index, but the insurer (or other issuer) is not contractually required to hold the underlying

assets, though it may choose to do so to hedge the liability. There is an effect on profit or loss if the issuer holds the underlying assets and does not measure them at fair value through profit or loss. Some argue that the Board should either permit the issuer to measure the underlying assets at fair value through profit or loss, or adjust the measurement of the index-linked liability to reflect the measurement of the assets.

59. The Board does not intend to pursue that approach. In this case, the insurer is not compelled to hold the underlying assets and it could transfer the liability without a simultaneous transfer of the assets. (In this respect, index-linked contracts differ from unit-linked contracts.) Therefore, the carrying amount of the underlying assets (if held) is irrelevant in determining the current exit value of the liability. Moreover, introducing exceptions to normal recognition and measurement criteria for the underlying assets (if held) would create a need for definitions, criteria and perhaps even a new form of hedge accounting.

**Questions for respondents**

60. **Question 6.1 Is it appropriate to view a participating contract as:**

    (a) **a unitary contract, or**

    (b) **a compound contract containing a participating component that would be classified as equity to the extent that the insurer has no enforceable obligation to provide distributions to policyholders? If you do not favour using the notion of an enforceable obligation to determine the treatment of the participation feature, what approach do you propose, and why?**

61. **Question 6.2 Should the Board do some or all of the following to eliminate accounting mismatches that could arise for unit-linked contracts? Why, or why not?**

    (a) **Permit or require insurers to recognise treasury shares if they are held to back a unit-linked liability.**

(b) **Permit or require insurers to recognise internally generated goodwill of a subsidiary if the investment in that subsidiary is held to back a unit-linked liability.**

(c) **Permit or require insurers to measure assets at fair value through profit or loss if they are held to back a unit-linked liability.**

(d) **Exclude from the fair value of a unit-linked liability and differences between the carrying amount of the assets held to back that liability and their fair value.**

**Appendix**
**Examples**

Examples 6.1-6.5 illustrate how the notion of an enforceable obligation might apply for a participating component if the two-components view is adopted. For simplicity, all the case studies ignore the time value of money and margins.

**Example 6.1 Undistributed policyholder surplus**

*Background*

At the end of each year, insurer A must allocate to policyholder surplus 90% of the year's profit arising from participating insurance contracts. The contracts require insurer A to distribute that policyholder surplus as policyholder dividends within three years, unless later losses have eroded that surplus. At 1 January X1, the cumulative undistributed policyholder surplus was CU 900.

*Application of preliminary views*

Insurer A has an unconditional obligation to stand ready to distribute that surplus as policyholder dividends if subsequent losses have not eroded the surplus. Therefore, the insurer recognises the cumulative undistributed policyholder surplus of CU 900 as a liability. In addition, insurer A has given an embedded guarantee, resulting from the asymmetry in pay-offs between future scenarios. The measurement of the liability needs to include a market-consistent measurement of that embedded guarantee.

**Example 6.2 Policyholder surplus from future premiums**

*Background*

As in example 6.1, insurer B must allocate to policyholder surplus at the end of each year 90% of that year's profit arising from participating insurance contracts; the contracts require insurer B to distribute that policyholder surplus as policyholder dividends within three years, unless later losses have eroded that surplus. At 1 January X1, the measurement of insurer B's participating insurance liabilities includes future premium receipts of CU 5,000 and additional guaranteed benefit payments of CU 4,000 resulting from those premiums. The inclusion of those receipts and payments decreases the measurement of those liabilities by CU 1,000.

*Application of preliminary views*

Insurer B has an unconditional obligation to stand ready to pay 90% of that reduction back to policyholders unless subsequent losses erode that reduction. Thus, the measurement of the liability includes CU 900. In summary, future premiums decrease the measurement of the liability by CU 100 (premiums of CU 5,000 less guaranteed benefits of CU 4,000 less policyholder dividends of CU 900). Also, as in example 6.1, the measurement of the liability needs to include a market-consistent measurement of the embedded guarantee given by insurer B.

**Example 6.3 Timing differences between policyholder surplus and equity**

*Background*

At the end of each year, insurer C must allocate to policyholder surplus 90% of the year's statutory profit arising from participating insurance contracts. The contracts require insurer C to distribute that policyholder surplus as policyholder dividends within three years, unless later losses have eroded that surplus. Statutory profit includes realised (but not unrealised gains) and measures insurance liabilities more conservatively than the basis used for general purpose financial statements. At 1 January X1, the current exit value of the guaranteed benefits 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 aggregate difference between the carrying amounts in general purpose financial statements and the equivalent statutory measurements was CU 1,000 (CU 700 plus CU 300).

*Application of preliminary views*

When that difference reverses in later years, policyholder surplus will increase by CU 900 (90% of CU 1,000). In other words, insurer C has an unconditional obligation to stand ready to pay 90% of that reversal to policyholders. Therefore, insurer C classifies CU 900 as a liability. Also, as in example 6.1, the measurement of the liability needs to include a market-consistent measurement of the embedded guarantee given by insurer C.

**Example 6.4 90-10 fund**

*Background*

The contracts require insurer D to keep premiums received in 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. If the assets in the fund are insufficient, insurer D must use its other assets to pay the guaranteed benefits. Each year, insurer D may declare a dividend out of the accumulated profit of the fund. 90% of each dividend must be distributed to policyholders. At the same time, 10% of the total dividend becomes available for insurer D's general operations (and may, for example, be distributed to shareholders). Shareholders (and the insurer's general creditors) can gain no other access to the assets of the fund. Insurer D expects to pay dividends, and feels economically compelled to do so because declared dividend rates are an important marketing feature. However, insurer D has concluded that it has no legal or other enforceable obligation to declare any dividend at all.

*Application of preliminary views*

Insurer D classifies the following in equity:

(e) 100% of the surplus in the fund (assets less guaranteed benefits)

(f) 100% of the future premiums (less resulting additional guaranteed benefits) that are included in the liability measurement because they meet the guaranteed insurability test described in chapter 4. Therefore, insurer D recognises a gain at inception that will reverse in later periods when insurer D pays (or becomes obliged to pay) policyholder dividends.

Because insurer D has no enforceable obligation, it could retain the surplus indefinitely without distributing dividends to policyholders. Insurer D discloses the fact that policyholders have a prior claim on 90% of the surplus described in (a)(i) and (ii).

As in example 6.1 A, the measurement of the liability needs to include a market-consistent measurement of the embedded guarantee given by insurer D.

**Example 6.5 Policyholder dividends typically exceed the minimum**

*Background*

As in examples 6.1 and 5.2, the contracts require insurer E to allocate to policyholder surplus each year at least 90% of the year's profit arising from participating insurance contracts. In practice, insurer E has generally allocated to policyholder surplus between 95% and 97% of each year's profit. Although insurer E expects to continue making allocations on a similar basis and feels economically compelled to do so because declared dividend rates are an important marketing feature, insurer E has concluded that it has no legal or other enforceable obligation to allocate more than 90% of any year's profit.

*Application of preliminary views*

Insurer E includes in the measurement of the liability its unconditional obligation to stand ready to distribute 90% of each year's profit as policyholder dividends.

Insurer E includes in equity an amount relating to the fact that insurer E need not distribute 10% of each year's profit as policyholder dividends. When insurer ultimately distributes 5-7% of that profit, it will recognise that distribution as an expense.

As in example 6.1, the measurement of the liability also needs to include a market-consistent measurement of the embedded guarantee given by insurer E.

In cases A-C, the unitary view and the two-components view lead to the same answer. However, in cases D and E, the two views lead to different results if the insurer concludes that the participating component does not give rise to a present obligation.