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International Accounting Standards Board

INFORMATION FOR OBSERVERS

Board Meeting: **25 January 2007, London**

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

Subject: **Letter from the European CFO Forum, the Group of North American Insurance Enterprises and four major Japanese life insurers (Agenda paper 10C)**

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 is attached.

The European Insurance CFO Forum
Group of North American Insurance Enterprises
Nippon Life Insurance Company
Dai-ichi Life Insurance Company
Sumitomo Life Insurance Company
Meiji Yasuda Life Insurance Company

Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
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21 December 2006

Dear Sir David

IASB consideration of Insurance Contracts Phase II: Unconditional obligation requirements in relation to the accounting for future participating benefits

The CFO Forum, GNAIE, and the Four Japanese Life Insurers have been considering the IASB's proposal that the measurement of liabilities in relation to insurance (and investment) contracts with discretionary participation features (DPF) should only include future benefits expected to be payable under contracts when the insurer has an unconditional obligation that compels the insurer to transfer economic benefits to policyholders, current or future. Additionally, Peter Clark has asked for our views in this area and has specifically requested us to comment on:

1. whether insurers have enforceable obligations to pay bonuses under such contracts and whether the determination of enforceability would present practical problems; and
2. whether different treatment should apply to mutuals as compared with proprietary insurers.

We have considered the various contracts that exist in different jurisdictions represented by our groups and the local legal and regulatory constraints around those contracts. We have further considered the exposure draft of proposed amendments to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* and the related subsequent discussions in this area (together referred to in this letter as "the IAS 37 ED") in our analysis of these issues.

We have concluded that:

- an unconditional obligation is created by these contracts once the contract is signed and issued. This obligation is to declare bonuses[1] to policyholders over the term of the contract rather than being an obligation created by the declaration of individual bonuses;
- in accordance with the nature of participating contracts, insurers' discretion is over the timing and amount of future benefits, rather than to avoid settling it, and this should be appropriately allowed for in the measurement basis;
- it would be extremely difficult to universally demonstrate that this obligation is based around legal or regulatory enforceability and such an approach could lead to inconsistent and less relevant and reliable financial statements;

[1] In this letter, the term "bonus" should be interpreted to include all discretionary payments on participating policies whether called bonus, dividend or by any other term.

- since it is very difficult to determine legal or regulatory enforceability we believe that, in practice, classification as equity of amounts for policyholders would be common in certain jurisdictions and not in others;
- in the absence of legal enforceability, the IAS 37 ED indicates that the presence of a constructive obligation will fulfil the definition of a liability and we believe that the unconditional obligation to declare bonuses meets the definition of a constructive obligation;
- the structure of participating funds varies by jurisdiction, but will, in some countries, identify a proportion of a specific fund that can only ever be distributed to policyholders, current or future. It would be misleading to account for these amounts as equity if they can never be distributed to shareholders;
- measurement should therefore be on a portfolio basis taking into account all expected payments to current and future policyholders arising from participating contracts (or funds), where applicable, held at the financial reporting date; and
- the recognition and measurement of discretionary participation features could apply for mutuals in the same way as for shareholder owned entities.

The obligating event

We believe the first question to consider is what the obligating event is under participating contracts – is it the point at which the bonus declaration is made or is it the point at which the DPF contract is signed? Our reading of the tentative conclusions is that the IASB has concluded that it is when the bonus is declared rather than on the inception of the contract. This would lead to very large amounts in, what we regard as, liabilities to policyholders being treated as equity even though the shareholders have no access to these funds and never will have any access to them.

In our view the obligating event is the commitment by the insurer to declare bonuses to policyholders at the stage of entering into the contract. At this point the company is committing itself to paying out the substantial majority of the available surplus based on the participation arrangements. While the contract often does not specify the exact timing or the amount of bonuses to be paid, the very clear expectation that the great majority of available surplus based on the participation arrangements will be paid to policyholders is established. This expectation is evidenced in the construction of the participating fund (if there is one), in local regulation and in the way that these contracts are marketed. Indeed, in some countries the concept of "policyholders' reasonable expectations" or similar principles are enshrined in insurance law.

Enforceable Obligation

We have carried out research into the concept that the obligation to declare bonuses in a participating contract is legally (or from a regulatory standpoint) enforceable. This is a complex issue and is likely to be extremely difficult to categorically prove given the range of jurisdictions and regulatory frameworks in place. An application of the enforceability concept would be open to significant interpretation in jurisdictions that have among them a wide range of legal and regulatory environments.

A clear indication of the existence of an enforceable obligation would be available where the policyholder can seek a legal ruling that a bonus should be paid. There is an absence of legal case history to evidence whether a contractual promise to pay discretionary benefits is enforceable or not. Legal or regulatory enforceability of performance related bonuses, if tested, would be likely to vary by jurisdiction and depend on current and anticipated future economic circumstances.

As is evidenced by the appendix to this letter, which sets out details of the nature of participating contracts in various countries covered by our groups, contract structures and

regulatory requirements vary by jurisdiction. However, the substance of these contracts is common with the substantial majority of available surplus based on the participation arrangements being paid to the policyholder rather than being attributable to the shareholder.

If enforceability of expected bonus declarations at contract inception can not be demonstrated then this could be reflected in significantly different liability values and profit recognition profiles for contracts with similar economic values. For instance, in some countries the liability would only reflect realised gains whilst in others unrealised and realised gains would be included. Further the liability value of future benefits would vary by jurisdiction, notably it would be at least 20% for Japanese mutual insurers, 70% in China, 85% in France, at least 90% in Germany but zero in most of the United States, for Japanese stock companies, and for the Netherlands, Belgium and South Africa where there is no prescribed minimum. This will make financial statements of insurers considerably less comparable than they would be if all expected payments to policyholders were included.

Users of financial statements will be misled by a financial reporting presentation that includes in equity material amounts that management will either pay to policyholders or, in certain jurisdictions, are subject to restrictions on distribution to shareholders. Companies will be recognising profits in an accounting period that are not attributable to shareholders and will then need to recognise losses at a future date when benefits are allocated to individual policyholders or when a portfolio is transferred. In our view this would misrepresent the results of the business and would make financial statements considerably less relevant from an economic standpoint. Furthermore, it would materially understate what are the true liabilities in respect of contracts with a DPF element and include within shareholders' equity amounts that will never fall to shareholders.

As a related point, we believe that there are likely to be a number of consequences resulting from the exclusion of expected future payments from accounting liability values. One example relates to lapse assumptions used in modelling liabilities. If companies were to stop paying bonuses this would undoubtedly lead to a significant increase in the level of policy lapses. If the determination of the liabilities assumes that there will be no further payments unless there is a legal or regulatory obligation this should be taken into account when determining the lapse assumptions used for the modelling of the DPF contract liabilities. The resulting valuation will not be consistent with market economic conditions at the financial reporting date.

Constructive obligation

In our view it is not appropriate, with respect to discretionary participation contracts, to restrict the recognition of an unconditional obligation to legal or regulatory enforceability. We believe that the discretionary participation feature is a constructive obligation under the IAS 37 ED, which states that a liability can be recognised for an obligation that is not legally enforceable provided the criteria relating to there being little, if any, discretion to avoid settling a constructive obligation, as specified in sub-paragraphs 15(a)-(c), are achieved. We believe that these criteria are met as follows:

a) the insurer has indicated to policyholders that it will declare bonuses over the contract term. This is clear in contract and marketing literature examined;
b) policyholders purchase these contracts, which usually bear higher premiums than fixed benefit policies offering the same guaranteed benefits, in anticipation of a share in the underlying performance through future additional benefits; and
c) the additional benefits will clearly benefit the policyholder.

In our view the discretion associated with these contracts is not around the commitment to declare bonuses but is around the timing and amount of benefits that are awarded to policyholders. Insurers' commit to pay additional future benefits depending on general or

specified performance criterion. As indicated below this discretion will be built into the measurement of the liability.

Measurement of the liability value

The IAS 37 ED indicate that the valuation of liabilities can be based on the present value of expected future cash flows including the effect of risk and uncertainty and taking into account management's judgement of future outcomes and financial effects. This measurement approach is consistent with the proposals of the CFO Forum, GNAIE and the Four Life Insurers of Japan for the measurement of discretionary participation features. The IAS 37 ED measurement basis requires development to consider the specific features of insurance contracts as already considered by the IASB in developing its Phase II proposals.

The value of the DPF liability will depend on current economic conditions and other performance factors. The valuation of the liability should consider an entity's obligation to policyholders in policy wording, marketing literature or other statements that give rise to policyholder expectations of management's future actions under different economic scenarios, in addition to the legal and regulatory environment. An economic approach is consistent with the IASB's ongoing deliberations in relation to liabilities under the IAS Framework and with other tentative conclusions reached around valuation of insurance contracts.

The IAS 37 ED indicate that a valuation basis reflecting amounts that would be paid to transfer a liability to a third party can be used. It should be noted that, in transferring portfolios of DPF contracts between companies the market always takes into account undeclared bonuses. This reflects the fact that the market knows that the bulk of available surplus, whether declared or not, will ultimately be paid to policyholders rather than shareholders. If these undeclared bonuses are not included in the valuation of the liability then, were a company to transfer a block of such contracts to another company, it would have to recognise a significant loss in its financial statements reflecting the release of equity to finance the price demanded by the acquirer.

In some countries insurers' discretion gives rise to funds that have not been allocated to individual policyholders but to which shareholders have no access. Indeed in some jurisdictions shareholders have no right to any of the funds allocated to pay future discretionary bonuses until a bonus declaration is made. Where these situations apply such funds arise from the constructive obligation to pay future discretionary benefits to current and, in some cases, future, policyholders and should be included in the measurement of DPF liabilities. These liabilities may include:

- funds available to pay future policyholder bonuses but not yet allocated to individual policies; and
- unrealised gains in investments that will contribute to policyholder bonuses.

For the reasons set out above it would be misleading to the users of financial statements to present any of these funds as equity.

Mutual insurers

We believe that the proposals set out in the CFO Forum's Elaborated Principles and GNAIE and the Four Japanese Life Insurers' Life Principles that liabilities for participating contracts should include all anticipated future payments to policyholders, could apply for mutuals in the same way as for shareholder owned entities.

The CFO Forum, GNAIE, and the Four Japanese Life Insurers represent mutual and stockholder companies. We can see no rationale for different measurement of liabilities for participating contracts due to the nature of the organisation of the issuing entity.

Conclusion
The enforceability of the obligation to pay bonuses under participating contracts is extremely difficult to apply and demonstrate on a consistent basis. However, we believe that a constructive obligation to declare bonuses is established on signing such a contract in accordance with the definitions in the IASB's IAS 37 project.

To ensure financial statements are relevant to users, and provide consistency of measurement of economically similar contracts, an economic basis of valuation for DPF contracts is required. Such an approach should be on a portfolio basis and take into account all expected payments to policyholders including those that have not yet been allocated to individual policyholders.

We can see no rationale for mutual insurers to adopt different practices from shareholder-owned companies in the financial reporting of discretionary participation features.

Further response
If you have any queries or questions that you would like to raise, please feel free to contact us.

Yours sincerely

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APPENDIX

The nature of contracts with discretionary participating features

As for most insurance business, the structure of DPF contracts varies widely throughout the world. Much of this has been driven by local regulation or practice. We have considered some of the major countries represented by members of our three groups.

Germany
The allocation of benefits to policyholders of participating contracts is governed by legal, contractual and supervisory rules as well as by management's discretion to distribute additional benefits. Each year the insurer is obliged by law to allocate at a minimum 90% of net investment income and an additional part of gains from insuring risk of the individual insurer (not the group accounts).The benefits to policyholders are allocated either to the technical provision or to the policyholders' bonus fund (*Rückstellung für Beitragsrückerstattung, RfB*) which are both part of the insurance liabilities to policyholders. While the technical provisions are based on guaranteed allocations of individual policyholders by contract with the insurer, the RfB belongs to the portfolio of policyholders and can only be reduced by transfer of benefits to individual policyholders. These allocations are determined by the insurer by annually setting individual profit rates for the contracts based on guaranteed interest rates, insurance results and realised capital gains. Usually management allocates, in addition to the legal minimum, additional surplus amounts which are at their discretion. The total amount of surplus allocated to policyholders is agreed each year with the local regulator.

France
Local regulations require that a minimum of 85% of investment income and realised capital gains be paid to policyholders. Even if the company can determine the timing at which unrealised capital gains are realised, ultimately however, all investment returns will be split at least 85:15 in favour of the policyholder. It should also be noted that traditionally French companies pay out more than the required minimum 85% of gains and that the difference between the 85% and the amount actually paid is material in the context of the shareholders' equity. The benefits to policyholders are allocated either to the technical provision or to the policyholders' bonus fund (PPE which must be allocated to individual policyholders within 8-year period) which are both part of the insurance liabilities to policyholders.

UK
Local regulations do not dictate the amount that should be paid to policyholders, but normally the fund structure specifies that the shareholders are entitled to one ninth of any bonus declared by the fund to policyholders. In other words any investment returns in with profits funds, be they realised or unrealised, that have not been declared as bonuses cannot accrue to shareholders since 90% of any payment out of the fund has to be paid to policyholders. Discretion may exist as to the timing at which the bonus declarations are made, and to whom, but the ultimate proportion that shareholders receive is not.

In addition, for some UK life assurance companies there are amounts that are held within participating life funds that are in excess of those required to meet expected policyholder benefits. These amounts provide capital support to the fund, in which policyholders as a class have a 90% interest. However, due to the basis of distribution from the fund being wholly tied to the declaration of policyholder benefits, shareholders have no rights of access to the remaining 10% of unallocated surplus unless attributed by a Court approved arrangement.

Note that in the UK the regulator requires that policyholders' documentation supporting the structure of these contracts and related funds includes the "Principles and Practices of Financial Management", which makes clear the basis of participation, and companies operate under the regulatory principle of "Treating Customers Fairly".

Netherlands, Belgium and South Africa
The regulator does not prescribe any minimum. Life offices have discretion as to the surplus passed on to policyholders. Nevertheless, the vast majority of investment returns on these contracts ultimately get paid to the policyholder rather than staying with the shareholder.

US[2]
In the US, almost all participating business is sold by mutual insurance companies. In addition, certain Universal Life Contracts, while often non-participating in contract form, do have discretionary elements similar to participating contracts and we believe they should be treated similarly to Participating Contracts. Participating Contract language typically requires the company to determine dividends annually and in some cases requires that the distribution of that amount be performed in an equitable manner. There is no requirement concerning a minimum amount of dividend to be paid. There is significant legal precedent that courts will not override the judgement of the Board of Directors in declaring or allocating dividends. Furthermore, it is questionable whether regulators have the authority to overturn Board decisions on this matter.

In general, dividends are paid out of current year earnings. There is no specific participating fund except for the closed block of participating policies of demutualized companies. The company decides, at the end of the year, how much surplus is required to meet its needs and any excess is paid out as a dividend. There is no concept that amounts earned today will be paid out to future policyholders.

There are two states (New York and Massachusetts) that have maximum surplus limits in their laws. In those states, companies would need to pay dividends if their surplus should exceed the maximum limit. In these cases, companies domiciled in those states would have an obligation to pay dividends lest they exceed that maximum surplus.

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[2] While this letter is being submitted by the Tripartite Group, GNAIE wish to acknowledge the research performed by the American Council of Life Insurers (ACLI) in researching and developing the rationale for this document.

ACLI is the principal trade association of life insurance companies, representing 377 member companies that account for 91 percent of total assets, 90 percent of the life insurance premiums and 95 percent of annuity considerations in the United States.

GNAIE consists of Chief Financial Officers of leading insurance companies including life insurers, property and casualty insurers, and reinsurers. GNAIE members include companies who are the largest global providers of insurance and substantial multi-national corporations.

Together, GNAIE and ACLI companies represent a significant population of the total issuers of participating contracts in the United States.

Japan

In Japanese insurance contracts, insurers explain their policies on dividend payments, such as eligible policies, timing and methods for determining them. Because of these contractual statements, together with commercial practices such as statements in policyholders' guides, illustrations of expected payment amounts, explanation about dividend distribution criteria, and sales of par contracts with higher-premium rates than non-par contracts with the same coverage, Japanese insurers have been obliged to pay dividends, and it has created "policyholders' expectation" about dividends. The Insurance Business Law of Japan provides the underlying basis for the above statements or practices. It requires "fair and equitable" distribution of dividends, and in order to make this requirement effective, there are regulatory frameworks that ensure "fair and equitable" distribution of dividends. Those oversights are conducted by appointed actuaries and regulatory authorities. The minimum dividend payout under the law is 20% of the profit for mutuals with no limits for stock insurers. However, as a result of the above constraints, Japanese insurers have paid dividends at substantially higher level than the legal minimum (over 95% of profits for major life insurers in recent years).