Project **Insurance Contracts**

Topic **Participating contracts – Appendix B**

Appendix B: Cases

B1. This appendix illustrates treatment of insurance contracts with participating features. The examples in this appendix focus on the treatment of that participating feature; less focus is put on the guaranteed benefit (ie the non-participating element of the contract).

B2. In agenda paper 10A, staff described two views for dealing with participating features in insurance contracts:

(a) View 1: the payments to the policyholders arising from participating features in insurance contracts are cash flows from the contract like any other cash flows from the contract.

(b) View 2: the components of a participating contract will be split into i) a guaranteed benefit and ii) a participating feature. In a next step, the participating feature will be classified as liability or equity, either as a whole or by splitting it into two components.

B3. The examples in this paper illustrate the treatment of the participating feature under view 1. In addition, we explain how the treatment under view 2 might differ from view 1; we note that in agenda paper 10A staff identified three possible approaches for view 2:

(a) Classify it always as equity.

(b) Classify it as a liability to the extent a legal or constructive obligation exists; the remaining part would be classified as equity (bifurcate the

participating feature into a liability component and an equity component).

(c) Classify it as liability or equity depending on the predominant characteristic of the feature (classify case by case depending on an overall analysis of contractual terms, legislation or regulatory regime).

B4. The examples included in this paper are:

(a) Case 1 (Base case): 90% of profit required to be paid out to policyholders

(b) Case 2: 90% of profit required to be paid out to policyholders, statutory measurement requires a higher liability

(c) Case 3: minimum 90% of profit required to be paid out to policyholders, with discretion over the remaining 10%

(d) Case 4: 90% of profit required to be paid out to policyholders, but discretion over timing

(e) Case 5: minimum 20% of profit required to be paid out to policyholders, with discretion over the remaining 80%

General comments on the examples

B5. The examples use the term 'guaranteed benefit' to describe the policyholder benefits that do not depend on the participation feature.

B6. The benefits received by policyholders behave in some respects in the same manner as an option for the policyholder to put some of the insurer's assets. We capture this factor in the examples by including an option written by the equityholders to the policyholders. The amount we have included is arbitary, and is included for illustrative purposes only. Moreover, to aid comparison, we have included the option at the same amount in each example. In more realistic examples, the option value would depend on the fact pattern in each case.

B7. The examples ignore taxes.

Case 1 – Base case: 90% of profit required to be paid out to policyholders

Fact pattern

B8. The insurer has assets with a carrying amount of CU11,000. The guaranteed benefits have a carrying amount of CU 10,000. The insurer's distributable profit (under IFRS for the financial year (01.01.00 to 31.12.00) is CU 1,000, before considering the effect of the participation feature. Under the terms of the insurance contract, the insurer is required to pay out to the policyholders a dividend equal to 90% of the profit for the financial year shortly after the period end; the remaining 10% will become available to shareholders at the same time. Dividends are declared in February 01.

B9. We presume that policies in force at the end of year 00 are also in place in February 01, However, at the end of year 01 significant changes in the portfolio may take place (lapses, terminations, new contracts).

B10. In this case the effect of time value of money can be regarded as not material.

Application of the fact pattern

B11. Under view 1, the expected value of the distribution to policyholder will be included in the measurement of the liability. Because the insurer is required to pay out 90%, the insurer would in this case only have one scenario to consider; a payout of CU900 with a probability of 100%. The estimated distribution to policyholders included in the measurement of the liability at the end of year 00 would therefore be CU900.

View 1

	CU		*CU*
Assets		**Insurance liability**	
Investments	11,000	Guaranteed benefits	10,000
		Expected present value of policyholder dividends	900
		Put option	25
			10,925
		Shareholders' equity	
		Retained earnings	100
		Written put option	(25)
			75
Total assets	11,000	Total liabilities and equity	11,000

B12. Treatment of the participating feature under view 2:

Classify it always as equity.	Will differ significantly from outcome of view 1 because the whole distributable amount (CU1,000) will be classified as equity. The CU900 distributable to policyholders would have to be shown under an equity line item such as "policyholders' equity".
Classify it as a liability to the extent a legal or constructive obligation exists	The same outcome as from view 1.
Classify it as liability or equity depending on the predominant characteristic of the feature	The same outcome as from view 1.

Case 2: 90% of profit required to be paid out to policyholders, statutory measurement requires a higher liability

B13. In this case everything is assumed to be as in case 1, except that the determination of distributable surplus (used in assessing what is available for distribution) requires the insurer to value the guaranteed benefits at CU11,000, rather than its carrying amount of CU 10,000 in the general purpose financial statements. Thus, the distributable profit is zero and the profit in general purpose financial statements is CU1,000. Thus, there will be no distribution of policyholder dividends in February 01. This effect will reverse in the future in the same manner as a temporary difference between the carrying amount of an asset or liability and its tax base (see IAS 12 *Income Taxes* and FASB Accounting Standards Codification (ASC) Topic *Income Taxes-Overall-Recognition* 740-10-25).[1]

B14. Under view 1, the expected value of the distribution to policyholder will be included in the measurement. For this purpose, the insurer would also consider amounts that are recognised in the financial statements but will not be included in the policyholder surplus until a future period. The insurer estimates a payout of CU900 in the future, derived from the temporary difference that will reverse in future periods. The estimated distribution to policyholders included in the measurement of the liability at the end of year 00 would therefore be CU900.

B15. The amount of CU900 remains in the entity and will generate returns. When discounted at the expected rate of return on that reinvestment, the expected present value of (CU900 plus expected return) equals CU900. (The shape of the distribution of those returns does affect the value of the option written by the shareholders to policyholders. These examples do not address the measurement of that option.)

[1] Another temporary difference can arise if statutory accounting does not recognise unrealised gains.

View 1

	CU		*CU*
Assets		**Insurance liability**	
Investments	11,000	Guaranteed benefits	10,000
		Expected present value of policyholder dividends	900
		Put option	25
			10,925
		Shareholders' equity	
		Retained earnings	100
		Written put option	(25)
			75
Total assets	11,000	Total liabilities and equity	11,000

B16. Treatment of the participating feature under view 2:

Classify it always as equity.	Will differ significantly from outcome of view 1 because the whole distributable amount (CU1,000) will be classified as equity.
Classify it as a liability to the extent a legal or constructive obligation exists	The same outcome as from view 1.
Classify it as liability or equity depending on the predominant characteristic of the feature	The same outcome as from view 1.

Case 3: minimum 90% of profit required to be paid out to policyholders, with discretion over the remaining 10%

B17. Case 3 is based on case 1, except that the contract terms state that the insurer has to allocate to policyholders a minimum of 90% of the realised gains; the insure can, and often does, decide to allocate more to policyholders, up to 100%, but

has discretion over that 10%. The remaining distributable surplus will be available to shareholders.

B18. The insurer's practice for many years has been to pay out an additional 5% on top of the required minimum of 90%.

B19. View 1 would calculate the probability-weighted cash flows. This means that the insurer indentifies different scenarios and probability-weights these scenarios. For each scenario, the insurer determines the cash flows (before participation) and then determines what dividend it would distribute to policyholders in that scenario.

B20. In this case, the distribution to the policyholders is not subject to much uncertainty because the distribution will be in February 01. We therefore expect (with a probability of nearly 100%) a pay-out of CU950.

View 1

	CU		*CU*
Assets		**Insurance liability**	
Investments	11,000	Guaranteed benefits	10,000
		Expected present value of policyholder dividends	950
		Put option	25
			10,975
		Shareholders' equity	
		Retained earnings	50
		Written put option	(25)
			25
Total assets	11,000	Total liabilities and equity	11,000

B21. Treatment of the participating feature under view 2:

Classify it always as equity.	Will differ significantly from outcome of view 1 because the whole distributable amount (CU1,000) will be classified as equity.

Classify it as a liability to the extent a legal or constructive obligation exists	May or may not be the same as view 1. The liability will include at least the required minimum of CU900. But the classification of the remaining CU100 will depend on a number of factors, such as local regulatory requirements and unwritten (regulatory) rules and the regulator's expected behaviour.
Classify it as liability or equity depending on the predominant characteristic of the feature	Will differ somewhat from the outcome of view 1 because the amount distributable to policyholders (CU900) will be classified as liability; when the insurer is required to pay out a minimum of 90% of the distributable amount, it is likely that the participating feature will be a liability based on it predominant characteristics.

Case 4: 90% of profit required to be paid out to policyholders, but discretion over timing

B22. Case 4 is based on case 1, except that the contract terms state that the insurer can determine when it pays out to individual policyholders the amount allocated to policyholders as a group (policyholder surplus). In other words, the insurer has to allocate 90% of the financial year's profit (CU900) to policyholder surplus, but can decide to distribute that policyholder surplus to individual policyholders after year 01.

B23. Under view 1, the expected value of the distribution to policyholders will be included in the measurement. Because the insurer is required to pay out 90%, the insurer would in this case only have one scenario to consider; a payout of CU900 with a probability of 100%. The estimated policyholder surplus included in the measurement of the liability at the end of year 00 would therefore be CU900.

B24. The insurer has discretion on how much to actually pay out at which point in time. Suppose the insurer expects to pay out CU460 on 01 and the rest of CU440 sometime later. As explained in paragraph B15, the present value of those payments is also CU460 and CU440 respectively.

View 1

	CU		*CU*
Assets		**Insurance liability**	
Investments	11,000	Guaranteed benefits	10,000
		Expected present value of policyholder dividends (to be paid out in 01)	460
		Expected present value of policyholder dividends to be paid out after 01 from surplus existing at 31.12.01	440
		Put option	25
			10,925
		Shareholders' equity	
		Retained earnings	100
		Written put option	(25)
			75
Total assets	11,000	Total liabilities and equity	11,000

B25. Treatment of the participating feature under view 2:

Classify it always as equity.	Will differ significantly from outcome of view 1 because the whole distributable amount (CU1,000) will be classified as equity.
Classify it as a liability to the extent a legal or constructive obligation exists	May or may not differ significantly from view 1. Considering the fact pattern, a significant part of the policies in force at the end of year 00 may not be in place anymore when the policyholder surplus will be paid out to individual policyholders. The classification of the distributable amount allocated to policyholders at the end of year 00 (CU900) will depend on a number of factors, such as local regulatory requirements and unwritten (regulatory) rules and the regulator's expected behaviour.

Classify it as liability or equity depending on the predominant characteristic of the feature	May or may not differ significantly from view 1, depending on whether the dominant characteristics are considered to be liability or equity. This classification will be done on an overall analysis of contractual terms, legislation or regulatory regime.

Case 5: minimum 20% of profit required to be paid out to policyholders, with discretion over the remaining 80%

B26. Case 5 is based on case 1, except that the contract terms state that the insurer has to allocate to policyholders a minimum of 20% of the realised gains. In addition, the insurer can decide to allocate more to policyholders, up to 100%, but has discretion over that 80%. The remaining distributable surplus will be available to shareholders.

B27. The insurer's practice for many years has been to pay out an additional 75% on top of the required minimum of 20%.

B28. View 1 would calculate the probability-weighted cash flows of the different scenarios. In this case, the distribution to the policyholders is not subject to much uncertainty because the distribution will be in February 01. We therefore expect (with a probability of nearly 100%) a pay-out of CU950.

View 1

	CU		*CU*
Assets		**Insurance liability**	
Investments	11,000	Guaranteed benefits	10,000
		Expected present value of policyholder dividends	950
		Put option	25
			10,975
		Shareholders' equity	
		Retained earnings	50
		Written put option	(25)
			25
Total assets	11,000	Total liabilities and equity	11,000

B29. Treatment of the participating feature under view 2:

Classify it always as equity.	Will differ significantly from outcome of view 1 because the whole distributable amount (CU10,000) will be classified as equity.
Classify is as a liability to the extent a legal or constructive obligation exists	May or may not differ significantly from view 1. The liability will include at least the required minimum of CU2,000. The classification of the remaining CU8,000 will depend on a number of factors, such as local regulatory requirements and unwritten (regulatory) rules and the expected regulator's behaviour.
Classify it as liability or equity depending on the predominant characteristic of the feature	May or may not differ significantly from view 1, depending on whether the dominant characteristics are considered to be liability or equity. This classification will be done on an overall analysis of contractual terms, legislation or regulatory regime.