



Project **Insurance Contracts**

Topic **Participating contracts**

Purpose

1. This paper discusses participating insurance contracts. These are contracts in which part of the benefits paid to policyholders depends on the performance of an underlying pool of insurance contracts (and sometimes related investments). This paper concentrates on the treatment of that part of the benefits.
2. This paper does not address the following issues, which we will consider separately:
 - (a) Various measurement issues for participating insurance contracts, such as the discount rate and the treatment of embedded guarantees and options.
 - (b) Presentation and disclosure issues for participating contracts.
 - (c) Participating investment contracts (ie those financial liabilities that contain participation features similar to those in participating insurance contracts).
 - (d) Universal life contracts, where a policyholder has substantial freedom to vary the amount and timing of premiums.
 - (e) Unit-linked contracts (known in some countries as variable contracts), where some or all 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).

Summary of the staff's recommendation

3. A majority of the staff recommends treating cash flows arising from a participating feature in an insurance contract in the same way as all other cash flows arising from the contract; thus those cash flows should be included in the measurement of an insurance liability on an expected present value basis. This view means that a participating feature in an insurance contract is regarded as integral to that contract rather than being considered for recognition, classification and measurement separately. Other staff members believe that the participating feature needs to be considered for recognition, classification and measurement separately.
4. We are still investigating how this view would apply to mutuals. If our additional work on mutuals identifies any new issues, we will inform the boards of these issues.
5. When we address disclosure, we will consider whether the boards should require disclosures (a) to help users assess the loss-absorbing nature of the participating contracts and (b) to show the insurer's estimates applied in determining the liability.

Structure of the paper

6. The rest of this paper is divided into the following sections:
 - (a) Characteristics of a participating contract (paragraphs 7-12)
 - (b) Does a participating feature give rise to a liability? (paragraphs 13-17)
 - (c) Two views for approaching participating features (paragraphs 18-26)
 - (d) Arguments for view 1 (paragraph 27)
 - (e) Arguments for view 2 (paragraphs 28-30)
 - (f) Other Project: Financial instruments with characteristics of equity (paragraphs 31-34)
 - (g) Staff's recommendation and questions for the boards (paragraphs 35-37)
 - (h) Appendix A: Examples of participating contracts
 - (i) Appendix B: Case studies of participating contracts

Characteristics of a participating contract

7. In general, an individual decides to buy insurance for protection against the risk that it suffers losses exceeding the average losses suffered by all policyholders participating in the same pool of contracts. The insurer pools the risks transferred to it by the individual policyholders and charges a premium that reflects the aggregate risk of this pool.

A simple case

8. As an example we could think of a portfolio of 1,000 identical non-participating contracts (or policyholders) covering identical risks and with an aggregate expected loss of CU¹100,000 (including claims handling costs). The insurer will want to set a premium to cover the expected losses (CU100 per contract) plus its acquisition costs (say, CU10 per contract) and a margin (say CU 17) to compensate it for bearing the risk that aggregate losses exceed CU100 per contract. Thus, the insurer will seek to set a premium of at least CU127. Accordingly, each policyholder pays a known amount of CU127. In exchange, it is protected against the risk that its own individual losses exceed CU127.
9. Let us consider now a participating version of the same contract. Suppose the 1,000 policyholders form a mutual. To keep the example simple, we will assume that the mutual issues one year contracts on 1 January and is liquidated once all claims have been resolved. Each policyholder pays a premium of, say, CU140. If actual claims exactly equal the expected claims, the insurer will pay out CU110,000 in total (claims of CU100,000 plus acquisition costs of CU10,000). (For simplicity, we ignore investment income.) Thus, CU30,000 will become available to repay policyholders (CU30 per contract) in the form of a policyholder dividend. Conversely, if actual claims are CU125,000 (25,000 more than expected) only CU5,000 is available for repayment to policyholders (premium received CU 140,000 minus the sum of claims of CU 125,000 and acquisition costs of 10,000).
10. It is instructive to compare the two examples:

¹ CU = currency units

- (a) In the non-participating example, each policyholder is protected against two risks:
 - (i) The risk that the policyholder's actual loss exceeds the average loss.
 - (ii) The risk that the aggregate loss of the whole pool exceeds the expected amount.
- (b) In the participating example, each policyholder is protected against
 - (i) the risk that the policyholder's actual loss exceeds the average loss. However, policyholders collectively retain (ii) the risk that the aggregate loss of the whole pool exceeds the expected amount. The policyholder benefits if losses do not exceed the expected amount, which can be effected through a retrospective adjustment of the premium or an additional benefits payment.

More realistic cases

11. The above simple example illustrates the basic idea behind policyholder participation, but more realistic cases have additional features. The following list provides examples of insurer's discretion, but is not meant to be exhaustive:
- (a) The basic model makes the policyholder participate in the aggregate insurance risk. Quite often the policyholders participate in investment risk as well. Sometimes the policyholder shares only in investment risk and not in the aggregate insurance risk.
 - (b) Some participating contracts are not pre-funded (a higher premium is paid to be able to benefit from possible future adjustments), but are post-funded. Post-funded means that the policyholder will have the obligation to pay an additional premium if the aggregate losses were higher than previously anticipated.
 - (c) In most realistic examples, the pool of contracts is not liquidated after a single generation of contracts. At any one time, the pool contains overlapping generations. In some cases, but not all, insurers are required to distribute any surplus arising within the pool to those

policyholders who are members of the pool at the time of the distribution.

- (d) Often, insurers aim (or are required) to distribute surplus to policyholders in a way that treats each policyholder equitably. For example, some insurers are required to adopt the ‘contribution principle’. This requires the insurer to make allocations to policyholders in proportion to their contribution to the surplus. However, in many cases, there is no formula for achieving this. Instead, the insurer uses its discretion within the constraints of the overall objective.
- (e) In some constructions, if some of the surplus is not distributed to policyholders, it becomes unrestricted and could be used, for example, to pay dividends to shareholders.
- (f) In other constructions, undistributed surplus remains ring-fenced in a separate fund until it is distributed. In some of these constructions, if any distribution is made to shareholders, a specified multiple must be paid to policyholders. For example, a common construction in some countries requires that at least 90% of any distribution goes to policyholders and no more than 10% goes to shareholders.
- (g) In some cases the amount distributable to the group of policyholders is specifically defined, e.g. by using a specific rate on investment returns, but the allocation of that surplus to the individual policyholders not.
- (h) The surpluses available for distribution are often calculated according to statutory requirements or local GAAP, which means that often only realised gains are included. This gives rise to temporary differences between the statutory measurements and the measurements used for general purpose financial reporting. These temporary differences are analogous to those that generate deferred tax liabilities and deferred tax assets. When these temporary differences reverse, they become part of the surplus available for distribution.

- (i) Because the participation feature bears some of the risks arising from a pool of contracts, in some cases and some scenarios, the participating feature reduces the insurer's net cash outflows. An example of this is when unrealised investment losses cause a deficit in a participating fund but future premiums for existing contracts will reduce that deficit.
12. The staff seeks a general principle that can be applied to participating features in insurance contracts. Participating features are found in a wide variety and may differ greatly from jurisdiction to jurisdiction and can even differ significantly within a jurisdiction. This paper does not analyse every feature that might exist in participating contracts worldwide. The Appendix A provides some examples of from various jurisdictions over the world.

Does a participating feature give rise to a liability?

13. The payout from a participating feature is calculated in three main steps. These steps are:
- (a) Determination of the amount available for distribution. This may for example depend on statutory profits arising from a defined pool of contracts. Different formulas may apply. For convenience, we call this amount "distributable surplus" in this paper.
 - (b) Allocation of part, or all, of the distributable amount to policyholders as a group (in contrast to amounts attributable to shareholders). This amount was called "policyholder surplus" in the discussion paper *Preliminary Views on Insurance Contracts*.
 - (c) Distribution to individual policyholders of part or the entire surplus determined for the group of policyholders. The discussion paper used the term "policyholder dividend" for these amounts.
14. The insurer has usually some (constrained) discretion over the amount or timing of distributions to policyholders. The insurers' discretion on the calculation of surpluses attributable to the policyholders as a group and/ or payments to individual policyholders may result in some or all of the following elements,

which generally reverse in future periods, though not necessarily in the short term [the case studies in Appendix B illustrate some of these elements]:

- (a) accumulated temporary differences that will reverse ultimately into distributable surplus
- (b) accumulated distributable surplus not yet allocated between policyholders (collectively) and shareholders
- (c) accumulated distributable surplus allocated to policyholders (collectively) but not yet allocated to specific policyholders
- (d) amounts included in the expected present value of future premiums that exceed the amount needed to pay for the expected present value of additional net cash outflows resulting from those future premiums.

15. Does a participating feature give rise to a liability and, if so, to what extent does the insurer have a liability? Under the IASB's *Framework* and the FASB's Concepts Statement No. 6 *Elements of Financial Statements*, the boards' liability definitions share the following characteristics:

- (a) There exists a present obligation for the entity.
- (b) It arises out of a past event.
- (c) The obligation is expected to result in an outflow of economic benefits.

16. A number of factors are relevant for assessing i) whether and ii) to what extent the insurer has a liability from participating features:

- (a) The insurer is constrained by legislation, regulation or contract features in its discretion over distributions to policyholders. These constraints may vary:
 - (i) from jurisdiction to jurisdiction
 - (ii) within a jurisdiction, from company to company
 - (iii) within a company, from type of contract to type of contract
 - (iv) over time.

- (b) When an insurer has decided to allocate part, or all, of the distributable surplus to policyholders as a group but has not yet distributed part or the entire surplus determined for the group of policyholders to individual policyholders, the amount allocated to policyholders is determined for the policyholders as a group rather than to individual policyholders. (This surplus determined for the group of policyholders will be allocated to individual policyholders in a later period.)
 - (c) Distributions from participating contracts are typically made to policyholders whose policy is in force at the time when the distribution is made. However, discretion over the timing of payments to the individual policyholders could also mean that future generations of policyholders benefit from the policyholder surplus (and, accordingly, some of the existing policyholders miss out on that surplus). The group of policyholders that a participating feature relates to, therefore, may contain both existing and future policyholders.
 - (d) Local regulatory requirements and unwritten (regulatory) rules, the expected regulator's behaviour and even market practices significantly affect the payments arising from the participating features in practice.
17. The number and complexity of factors involved make that answering the question i) whether and ii) to what extent the insurer has a liability from participating features will not be straight-forward in many cases. Often a participating feature has a part that would be a present obligation (eg because insurer is required to pay policyholder dividends) and a part that may not necessarily meet the definition of a present obligation, but:
- (a) those parts may not be identifiable easily, and
 - (b) the boundary between those parts may be gradual rather than clear-cut; in other words, there may be a 'grey area'.

Two views for approaching participating features

18. Insurance contracts that contain a participating feature can be analysed into:

- (a) A guaranteed benefit: a payment or other benefit to which a particular policyholder has an unconditional right that is not subject to the contractual discretion of the insurer.
 - (b) A participating feature: a right to participate in favourable and non-favourable performance of the relevant class of contracts, related assets or both. The insurer has usually some (constrained) discretion over the amount or timing of the distributions to the policyholders. However, over time the participating feature generates some benefits that become eventually guaranteed.
19. This paper presents two views on accounting for insurance contracts with participating features:
- (a) **View 1:** The boards tentatively decided that the measurement of an insurance contract includes expected (ie probability-weighted) cash flows. For this purpose, the payments to the policyholders arising from participating features in insurance contracts would be cash flows from the contract like any other cash flows from the contract.
 - (b) **View 2:** Based on the view that the components of a participating contract have to be bifurcated, the 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. In a final step, those cash flows from those participating features that result from a liability (if any) will be included in the measurement of that liability on the basis of expected cash flows.

View 1: Using the expected cash flow approach

20. In February 2009, the boards decided tentatively that the measurement of insurance contracts should include the expected (i.e. probability-weighted) cash flows. Such cash flows are future premiums that are considered to be part of an existing contract and other cash flows resulting from those premiums, eg benefits and claims. [The FASB plans to discuss the issue of future premiums at a future meeting.]

21. Under view 1, the participating feature is not considered separately for recognition and measurement. Hence, the cash flows that arise from a participating feature are integral to measurement of the liability like any other cash flow and should be included in the measurement of the liability on an expected present value basis. A participating contract would in this context be regarded as a contract that, based on the aggregate outcome of the policy portfolio, retrospectively adjusts the premium previously paid by the policyholder (although some might refer to distributions to policyholders as paying out an additional benefit to those policyholders).
22. Because view 1 considers the cash flows from a participating contract, including the participating feature, on an expected value basis, the insurer:
- (a) first recognises an insurance liability that includes (on an expected present value basis) the part of the distributable surplus that will be paid out to policyholders. In determining that expected present value, the insurer takes into account all relevant factors, such as contractual terms, local regulatory requirements and unwritten (regulatory) rules, the expected regulator's behaviour and market practices.²
 - (b) then recognises as equity the remaining part (if any) of the distributable surplus, which is expected to be allocated to shareholders.
23. Some existing accounting models use approaches similar to view 1 for participating contracts. These include US GAAP, see FASB Accounting Standards Codification (ASC) on Financial Services – Insurance 944-50-25 to 99-50-30, and Canadian GAAP, see CICA Handbook, Section 4211 on *Life Insurance Enterprises – Specific Items*.

² We note that for in determining the expected distributions to policyholders, the insurer would not only have to consider policyholder surplus recognised in the financial statements, but also look at amounts that are recognised in the financial statements but will not be included in policyholder surplus until a future period (for example if distributable surplus and policyholder surplus are based on realised gains and exclude gains that are recognised but unrealised).

View 2: Split the participating contract

24. View 2 is based on the reasoning that the insurance contract should be accounted for as two components:
- (a) The guaranteed benefits;
 - (b) A participating feature.
25. Under this view, the guaranteed benefits would be classified as a liability. The classification of the participating feature needs further analysis. We identified three possible treatments for further analysing the participating feature³:
- (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).
26. As mentioned earlier, the cash flows from those participating features that are classified as liability (if any) will be included in the measurement of the insurance liability on the basis of expected cash flows.

Arguments for view 1

27. Arguments for including expected cash flows without analysing the participating feature separately for recognition and measurement are:
- (a) The premium paid for participating insurance contracts significantly exceeds the premium for an otherwise identical non-participating contract. If the participating component, partly or as a whole, were to be classified in equity, one would have to separate the part of the

³ A fourth approach would have been to classify the participating feature always as a liability. However, because the outcome of this approach would probably be similar to view 1, we do not explore it further in this paper.

premium for the participating feature and recognise that part of the premium directly in equity.

- (b) Assessing a participating feature for classification as a liability, equity or a split between both will often be difficult and burdensome because the parts may not be identifiable easily. A classification will therefore not be obvious in many cases and may, in the end, require some arbitrary choices and may also change over time.
- (c) Furthermore, the elements of a participating feature are interlinked and interdependent. For example, policyholder behaviour in practice interacts with the insurer's distribution decisions: if an insurer pays lower dividends to policyholders, more policyholders are likely to cancel their contracts. These interactions may make it challenging to split a participating feature into components. For example, if one splits the participating feature into a liability component and an equity component, one has to decide whether the lapse assumptions for the insurance liability should be based on:
 - (i) the required (minimum) payments to the policyholders, or
 - (ii) the expected payments to policyholders that include the payments from the component of a participating feature recognised in equity.
- (d) Users are interested in knowing which earnings flow to the shareholders and which flow to the policyholder. Treating participating features separately for recognition and classification may lead to a presentation that arguably blurs the position of policyholders and the position of a shareholder in an entity.

Arguments for view 2

28. Arguments for splitting a participating contract into a guaranteed benefit and a participating feature are:

- (a) View 2 regards separate recognition, classification and measurement of components of a contract as resulting in a more faithful representation of the characteristics of the participating feature. Proponents of this

view see it as consistent with IAS 32 *Financial Instruments: Presentation*, which creates a precedent for splitting one type of contract (a compound financial instrument) into separate liability and equity components [paragraphs 31-34 discuss this further].

- (b) As a result of not explicitly addressing the recognition and classification of the participating feature, the measurement of the liability under view 1 may include cash flows that do not result from a present obligation (ie do not meet the definition of a liability). Some believe this is particularly the case for dividends that result from existing (or past) contracts but will be paid to future policyholders. Proponents of view 2 argue that a liability will be recognised only to the extent a participating feature results in a present obligation⁴. [Proponents of view 1 acknowledge that, for example, future policyholders might benefit from a policyholder surplus that is determined on an expected value basis. However, those proponents argue that under view 1 the obligation, even if towards future policyholders, arises from existing (or also past) contracts.]
- (c) A separated equity component would demonstrate the loss absorption capacity provided by a participating feature has through the (constrained) discretion of the insurer over amount and timing of policyholder dividends; information about these loss-absorbing characteristics is important to users.
- (d) An input for determining the expected cash outflows from policyholder dividends is the insurer's expectations of its distribution policy. Such an input might lack verifiability in some cases.

29. If view 2 is selected, one needs to make a choice between the three variations for treating the participating feature:

⁴ Although staff note that this is not necessarily the case if one would apply an approach under view 2 that classifies a participating feature as liability or equity depending on the predominant characteristic of that feature.

- (a) Classifying it always as equity may be quite straight-forward, but it ignores that fact that at least part of the feature may give rise to a present obligation in at least some cases.
 - (b) Bifurcating it into a liability component and an equity component provides the most disaggregated analysis of the feature, but might also be the most challenging and burdensome approach because the distinction between the two components will not always be sufficiently clear.
 - (c) Classifying it as liability or equity depending on the predominant characteristic of the feature avoids the difficulty of actually separating the liability and the equity component, but puts significant pressure on the line between liability and equity.
30. If the boards select view 2, staff will discuss at a future meeting which of the approaches described in paragraph 29 should be applied.

Other Project: Financial instruments with characteristics of equity

31. Because the insurer has some (perhaps limited) discretion on when and how much (and sometimes whether) to pay to an individual policyholder, some think of the participating feature (or a part of that feature) as an equity component embedded in the insurance contract (view 2, see paragraph 28(a)). The participating feature, in effect, absorbs an unexpected aggregate loss in the portfolio (or, in some cases, losses in the whole entity). Paragraph 28 of IAS 32 requires that the liability component and the equity component of a compound instrument should be classified separately.
32. IAS 32 states that a financial liability exists when an entity does not have an unconditional right to avoid delivering cash (or another financial asset) to another party (see IAS 32, paragraphs 19 and 25).⁵ In our view, the factors mentioned in paragraph 16 of this paper are also relevant to assessing whether the insurer has an unconditional right to avoid delivering cash. As a result of

⁵ An exception applies to puttable instruments described in paragraphs 16A and 16B of IAS 32.

this diversity in participating features, there will in our view often not be straight-forward to determine whether a participating feature gives the insurer such a right or not. [The US GAAP requirements following from the FASB Accounting Standards Codification (ASC) Topic 480 Distinguishing Liabilities from Equity (480-10-25-5 to 480-10-25-7) do require analysing whether the financial instrument is mandatorily redeemable. If it is, it would be classified as a liability.]

33. The boards are looking at the treatment of financial instruments with the characteristics of equity in their current project on Financial instruments with characteristics of equity. Under the boards' proposals in that project, an insurer should decide whether the policyholder has a claim from the participating feature; the policyholder would have a claim if it could require the insurer to make the payments (ie the insurer cannot avoid those payments):
- (a) If, and to the extent that, the policyholder has a claim, the insurer would recognise distributions to policyholders from a participating feature as a liability. [Such a claim could be classified as equity if a payment is made only if the insurer is liquidating or the policyholder is withdrawing from participating in the activities of the insurer. However, we have not been able to identify such a case in the context of insurance so far].
 - (b) If, and to the extent that, the policyholder has not a claim, for example because the insurer has unconstrained discretion over distributions to policyholders, the insurer would not recognise a liability; such distributions to policyholders are recognised as a liability when made (or when promised, if that occurs earlier than the payment date).
34. Again, the factors mentioned in paragraph 16 of this paper are relevant to assessing whether the policyholder has a claim from the participating feature against the insurer; this diversity in participating features will in our view not result in a straight-forward answer in general to the question of whether such a feature gives rise to a claim.

Staff's recommendation and question for the boards

35. A majority of staff concludes that, based on the arguments presented in paragraph 27, cash flows arising from a participating feature in an insurance contract should be considered cash flows like any other; those cash flows should be included on an expected present value basis. The majority of staff therefore recommends applying view 1.
36. Other staff members believe that, for reasons stated on paragraph 28, the participating feature needs to be considered separately for recognition, classification and measurement separately (view 2).
37. When we address disclosure, we will consider whether the boards should require disclosures to (a) to help users assess the loss-absorbing nature of the participating contracts and (b) to show the insurer's estimates applied in determining the liability.

Question for the boards

Do you agree with the staff's recommendation in paragraph 35 to view the participating feature as a source of cash flows from the insurance contract like any other (view 1)?