Project	**Insurance contracts**
Topic	**Participation features – topic overview**

Purpose of paper

1. This paper is an introduction to a group of papers that discuss measurement of contracts containing participation features ('participating contracts'). It provides background information on the nature of these contracts and an overview of the proposals in the IASB exposure draft and FASB discussion paper. No decisions are requested in this paper.

Overview

Participating insurance contracts

2. Some insurance contracts give policyholders the right to share in the experience of a portfolio of insurance contracts, specified assets, or both. The insurer can have contractual discretion over the amount or timing of distributions to policyholders, although that discretion is usually subject to some contractual constraints (including related legal and regulatory constraints) and competitive constraints. At the inception of the contract, both the insurer and the policyholder typically expect that distributions will be made unless the performance of the underlying portfolio is significantly worse than expected. Such constrained discretion can make it difficult to judge whether and to what extent the participation rights constitute a present obligation for the issuer.

3. For this reason, and others, the IASB exposure draft and FASB discussion paper proposed that the measurement of an insurance contract liability should include all

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expected payments that will be generated by existing contracts and will flow to current and future policyholders as a result of contractual participation features. In other words, the insurer would *not* seek to identify and recognise only those future outflows for which it judged it had a legal or constructive obligation at the reporting date.

Financial instruments with discretionary participation features

4. Some insurers that issue participating insurance contracts also issue investment contracts that do not transfer significant insurance risk to the issuer but do contain participation features similar to those found in participating insurance contracts. The IASB's exposure draft used the term 'discretionary participation features' to describe such features contained within an investment contract. (The exposure draft did not attach a label to similar features contained within an insurance contract because a precise definition was not needed in that context.)

5. The FASB and IASB proposed different requirements for investment contracts that do not transfer insurance risk but do contain discretionary participation features:

   (a) the IASB exposure draft proposed that the contracts should be within the scope of the insurance contracts standard. The effect would be that insurers would apply the insurance contract measurement model to such contracts, with the measurement of the liability including the expected cash flows arising from the discretionary participation features.

   (b) in contrast, the FASB discussion paper proposed that the contracts should not be included in the scope of the insurance contracts standard. The effect would be that the contracts would instead be within the scope of the financial instruments standards, and hence subject to quite different measurement requirements.

Issues arising in feedback to proposals

6. The Board has received feedback on several aspects of the proposals for measuring participating contracts. The main matters that the boards will be asked to discuss are:

   (a) a potential mismatch between the measurement of participating contracts and the measurement of the assets in whose performance the contracts participate;

   (b) whether the expected cash flows should include those that will be generated by existing contracts but are expected to be paid to future policyholders;

   (c) whether investment contracts that do not transfer insurance risk but do contain discretionary participation features should be within the scope of the insurance standard, and if so:

      (i) how a 'discretionary participation feature' should be defined; and

      (ii) how the measurement requirements in the insurance contracts standard should be modified for contracts that do not transfer insurance risk.

Papers for this meeting

7. Agenda Paper 1B (FASB memo 66B) for this meeting discusses the potential mismatch between the measurement of participating insurance and the measurement of the assets in whose performance the contracts participate. The other matters listed above will be discussed in a future meeting.

8. As background information for all of the papers, the appendix to this paper provides more information on contracts with participation features: why they exist and how the features can vary.

APPENDIX— FURTHER INFORMATION ABOUT PARTICIPATING CONTRACTS

Insurance and/or investment contracts

A1. Participating contracts, known in some countries as 'with profits' contracts, enable policyholders to share in the experience of a portfolio of insurance contracts, specified assets, or both. The contracts can be insurance contracts or investment contacts. Participating investment contacts may or may not include a life insurance component.

A2. Participating contracts generally contain a guaranteed element as well as a participating feature. The participating feature gives rise to payments to the policyholder, paid out from a distinct share of surpluses, after providing the guaranteed benefits. The insurer usually has at least some discretion over the amount and/ or timing of these extra distributions to the policyholders.

A3. Participating *investment* contracts are issued predominantly by life insurers as general investment / savings vehicles to enable contract holders to participate in the performance of designated assets held by the insurer. Sometimes, assets for both participating insurance and investment contracts are held in the same with-profits fund and both types of contracts share in the profits of the fund.

Key characteristics

A4. In practice participating contracts vary widely in terms of structure and complexity due to legal or regulatory requirements. They share, however, the following key characteristics:

(a) the amounts paid to contract holders are contractually linked to the performance of a pool of underlying insurance contracts or assets (such as equities, bonds or property) and comprise guaranteed benefits (as specified at contract inception) and additional benefits.

(b) the issuer has some discretion over the amount and/or timing of additional benefits to contract holders, and over how that amount is allocated to particular generations of contract holders, although that discretion may be subject to contractual constraints (including legal or regulatory constraints that flow from the contract).

(c) although the issuer has contractual discretion over the distribution of additional benefits, it is common practice that current or future contract holders will ultimately receive some part of the accumulated surplus available at the reporting date for distribution to contract holders.

(d) If the actual investment returns are below the guaranteed benefits, the shortfall results in a loss to the insurer.

A5. In some cases, once additional benefits are allocated to the community of policyholders as a class, the insurer has some discretion over when and how to allocate those amounts to particular policyholders within that class.

A6. Policyholders may share in the performance of insurance contracts through a retrospective premium adjustment clause. In some of these contracts, the policyholder initially pays a higher premium and receives a repayment at a later date if claims experience is better than expected. In other contracts, the policyholder initially pays a lower premium (or even no premium) and then is required to pay an additional amount at a later date. Examples of the latter include the protection and indemnity (PI) clubs run by ship-owners. If a ship is damaged, the ship-owners in the club have to contribute a share of the losses.

A7. Typically investment contracts with discretionary participation features also have a demand feature—the policyholder can cancel the contract at any time and receive the distributions allocated to the policyholder by the date of cancellation.

A8. It can be useful to think of a participating contract as containing a combination of several elements, for example:

(a) an interest in a portion of the underlying assets

(b) a share in assets producing cash flows equal in all scenarios to the guaranteed benefits

(c) an option, written by the issuer, permitting the policyholder to put the interest in the underlying assets to the issuer for a fixed strike price equal to the guaranteed benefits

(d) other options, such as surrender options, conversion options, and options to make the contract paid up (ie to stop paying premiums but still receive some benefits).

Why do investment contracts with discretionary participation features exist?

A9. Investment contracts with discretionary participation features enable contract holders to share in the performance of a pool of assets in a manner that smoothes the investment return over time so that contract holders are not exposed to volatility as directly as they are in unit-linked (variable) contracts. No precise formula dictates how the smoothing mechanism operates and the issuer generally has some discretion over it. The extent of the discretion, and of the constraints on it, varies geographically and to a degree also from case to case.

What types of discretion exist?

A10. There are many different types of discretion. For example:

(a) the distributable surplus may be based on net income that includes realized gains on assets, but not unrealized gains. Because the distributable surplus does not include unrealized gains, discretion arises mainly from the ability to determine when to sell investments. At least a specified portion of the distributable surplus (eg 90%) must be allocated to contract holders each year (or within a specified period, eg 5-8 years). In some cases, insurers have a practice of paying considerably more than the required minimum. In some cases, the required minimum is 0%, but the insurer has a practice of paying a significant portion of the distributable surplus each year.

(b) the distributable surplus may remain in a ring-fenced fund indefinitely until the insurer distributes it. At least a specified proportion (eg 90%) of any distribution must go to policyholders. The rest of the distribution becomes available to the shareholders of the insurer. Sometimes, if fund balances have grown over many years, there may be uncertainty about whether a portion that originated many years ago ‘belongs’ ultimately to contract holders or to shareholders. This is sometimes known as the ‘orphan estate’.

(c) the insurer may set distribution scales periodically. These remain in force until changed and are designed in a way intended to distribute surpluses to each generation of policyholders in an equitable manner that reflects that generation’s contribution to the surplus.

A11. Some jurisdictions may have few specific regulations so management will have discretion regarding the amount and timing of the allocations. Accordingly, the amount of any profit share is contingent on management decisions, the terms of the contract, the local regulatory requirements, and the legal rights that result from those sources.

A12. The determination of the amount of funds available for distribution is generally based on the local statutory accounts rather than on the financial statements prepared under GAAP (for example the IFRS financial statements). The local statutory accounts basis for recognising, classifying, and measuring the assets from which distributions are made can differ from the accounting principles of IFRS 9/IAS 39. An important example is that, for local statutory accounting purposes, the insurer might measure investments at amortised cost whereas for IFRS reporting purposes, the insurer might measure them at fair value.

A13. In some cases the obligation to pay to the policyholders is restricted, for example, to realised surpluses. This means that the insurer may have the ability to decide when to realise surpluses. This may establish a timing difference between the amounts recognised in the financial statements and the corresponding amounts immediately available for distribution to policyholders. However, the amounts are still available only for policyholders.

Differences between participating contracts and other contracts that are linked to performance

A14. This section explains the differences between participating contracts and other types of contract that are dependent on the performance of assets—namely *universal life* contracts, *index-linked* contracts and *unit-linked/variable* contracts.

Universal life contracts

A15. In universal life contracts, the insurer has discretion to change the amounts of credits and charges and the policyholder has the discretion to vary the amount of premium paid and life insurance coverage.

A16. Unlike contracts with participation features, universal life contracts do not provide a *contractual* linkage to the performance of assets, liabilities or pools. The connection is rather indirect, because the insurer will exercise discretion on the dividends based on the performance but also based on competitive factors.

Index-linked contracts

A17. In index-linked contracts, the amount of the interest credit is based on, for example, a bond or equity index. Unlike for contracts with participation features, the policyholder is not participating in a performance of assets or liabilities, or both but rather in existing or hybrid financial instruments or indices. There is no obligation for the insurer to actually hold the underlying items. If the insurer decides to carry assets as a replication of the index, this should be rather viewed as a hedging strategy.

Unit-linked or variable contracts

A18. In unit-linked or variable contracts, the policyholder's account is invested in a separate managed fund. These contracts are very similar to participating contracts. They are participation contracts with a fixed participation of 100%. The main difference is the lack of discretion for the insurer.

Geographical variations in participation features

A19. This section of the appendix is carried forward from Appendix B for agenda paper 3F/ FASB Memorandum 60F of the March 2011 Joint Board meeting. It should remind the boards of the variety and complexity of participating contracts in practice.

A20. In most countries the insurer's discretion is at least partially constrained by legal or regulatory requirements as well as by competitive constraints. In many countries the "contribution principle" applies. The contribution principle means that the distribution of the aggregate accumulated surplus among the policyholders is in the same proportion as each respective contract (or portfolio of contracts) that has contributed to the accumulated surplus.

A21. The following information on country-specific types of participating contracts is based on an (internal) survey by members of the Insurance Accounting Committee of the International Actuarial Association (IAA). We thank them for providing the information. They are not responsible for the way in which the IASB staff have summarised the information.

A22. **Belgian** participating contracts provide a contractual right to share in surplus, but usually do not give specific guidance on how the policyholder participates in the surplus or which share belongs to the policyholder. The insurer determines annually the policyholders' share of surplus, which is solely based on the insurer's discretion (the insurer is entirely free to pay the policyholder any amount between 0 to 100% of the surplus). After determining the policyholders' share in surplus for the current year, the Belgian regulators require the insurer to pay out 80% of the amounts set aside for allocation to policyholders in the following year. The remaining 20% are to be payable to policyholders in later periods.

A23. **Finnish** participating contracts determine the policyholders' share entirely based on the insurer's discretion. Actual payments are only driven by competitive market pressure. The insurer decides when to realise surpluses, the individual policyholder's share in that surplus and the timing of the actual allocation. The regulator ensures that the insurer does not allocate surpluses if doing so potentially endangers the insurer's financial stability.

A24. **French** life insurers issue participating investment contracts with a guaranteed minimum annual rate of return on premiums paid, a distinct share in investment returns on the entire surplus of the entity. Under French law the insurer can immediately forward shares in realised surplus to individual policyholders. The remaining amount of the overall required share for policyholders is set aside. However, the insurer has some discretion regarding the timing of the allocation to the individual policyholder. The allocation has to be done within 8 years. The amount set aside can be used to cover subsequent losses to some extent and there might be as well a loss carry forward to be recovered by future surplus.

A25. **South African** life insurers have discretion on the policyholders' share in surplus, as well as on the amount and timing of its allocation or distribution to the individual policyholder. The amounts set aside for policyholders can be negative if they are expected to be recovered during the following three years.

A26. In **Germany** virtually all life insurance contracts are participating contracts. There are strict rules determining the share of recognised surplus that has to be set aside for participation of policyholders. Although the subsequent allocation of the amount set aside to individual policyholders is at the discretion of the insurer, the contribution principle is applied. Losses of a period are generally borne by the insurer. Unallocated amounts can be used to cover subsequent losses if otherwise the insurer would be in financial danger. If contracts terminate for any reason, the policyholder receives an appropriate share of unrealised gains allocable to its contract.

A27. In **Italy**, the participation feature is guaranteed by law to be an entity-wide average of 85% of the realised surpluses (unrealised gains and losses excluded). The exact policyholder's share in the surplus is specified in the individual contract as a specific percentage of investment earnings. The individual policyholder receives its share every year according to the results of the previous year.

A28. **Canadian** participating contracts require an annual allocation of amounts to individual policyholders, payable immediately in the following year. Law requires that the directors must adopt a formal dividend policy and adopt methods for allocation, which an appointed actuary must approve. In Canada there is little discretion in determining the amount or timing of the surplus once allocated. The contribution principle is followed, with the Appointed Actuary recommending dividends to the entity's Board.

A29. In **Australia** the policyholders' share in surplus is set aside and allocated to the individual policyholder according to a formula. Legally, the insurer is obliged to set aside 80% of the surplus for policyholders. Some contracts grant an even higher percentage. The amount set aside may become negative and carried forward. If the insurer voluntarily pays more than 80% (or whatever contractually is required), that can be carried forward, thus reducing future amounts to be set aside to pay dividends to future policyholders

A30. Most **Japanese** participating contracts force the insurer to immediately set aside policyholders' contractually specified share in the realised surplus. These amounts are not immediately payable to the individual policyholder, but rather are aggregated over time. The timing of the irrevocable allocation is at the discretion of the insurer, even though the surplus is already realised. The amounts set aside are revocable and loss absorbing, including those referring to future periods of the individual contract.

A31. In the **US**, the types of contracts are diverse, partly due to significantly different state regulations. Some states allow insurers to apply significant discretion in declaring dividend scales; however, overall they are subject to regulatory control. Regulators are expected to intervene in case of inadequate dividend scales, but that remains untested since in the past all insurers acted in accordance with regulatory rules. If stock insurers issue participating contracts, the amounts distributable to stockholders may be limited by some state laws.

A32. In some states in the US, e.g. New York, state law requires that the insurer sets a minimum percentage of surplus aside for ultimate distribution to policyholders each year. At the same time the law grants insurers some discretion regarding its ultimate allocation. The contribution principle is considered in this allocation.

A33. In the **UK**, participating features are contractually and legally established. The sources to determine the surplus need to be specified and may include sources from non-participating contracts. Policyholders' individual share is typically required to be at least nine times of any allocation to shareholders from aggregated unallocated surplus, to be allocated immediately to policyholders when amounts are allocated to shareholders.

A34. In the **Czech Republic** and **Slovakia**, participating contracts determine the policyholder's share as a fixed percentage of the realised surplus. The insurer's only discretion is when to realise the surplus, as there is no discretion on timing of allocation or amount of payment to the individual policyholder.

A35. **Norwegian** law prescribes that the policyholders' share in surpluses has to be two thirds of each annual surplus (partly including unrealised gains). When policies terminate, there is an obligatory payment of 75% of any surpluses (including unrealised gains) determined at that point in time. Insurers can decide when to realise gains (apart from terminating contracts), but there is no further discretion available.