Contact(s)	**Sandra Hack**	shack@iasb.org	+44 (0)20 7246 6488
	Hans van der Veen	hvanderveen@iasb.org	+44 (0)20 7246 6464
	Mark Trench	metrench@fasb.org	+1 (0) 203 956 3455

Project **Insurance contracts**

Topic **Participating contracts: follow-up**

Purpose of this paper

1. The staff brings back the issue of participating contracts that was discussed in the Joint Board meeting in November 2009 (agenda paper 10A, FASB Memorandum 31A) to determine whether there is the possibility of a common answer by both boards.

Summary of recommendation

2. Some staff members recommend using view 1, which views payments arising from the participating feature as contractual cash flows as any other.

3. Other staff members recommend using view 2, which recognises the liability up to amount of the legal or constructive obligation and regards the remaining part as equity.

Background

4. Participating contracts can be characterised in a way that each policyholder is protected against the risk that the policyholder's actual loss exceeds the average loss. The policyholders collectively retain the risk that the aggregate loss of the whole pool exceeds the expected amount. The individual policyholders benefit

This paper has been prepared by the technical staff of the FASB and the IASCF for discussion at a public meeting of the FASB or the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the FASB or the IASB.

Comments made in relation to the application of U.S. GAAP or IFRSs do not purport to be acceptable or unacceptable application of U.S. GAAP or IFRSs.

The tentative decisions made by the FASB or the IASB at public meetings are reported in FASB *Action Alert* or in IASB *Update*. Official pronouncements of the FASB or the IASB are published only after each board has completed its full due process, including appropriate public consultation and formal voting procedures.

if losses do not exceed the expected amount, which can be effected through a retrospective adjustment to the premium or an additional benefits payment.

5. In their November Joint Board meeting the boards expressed different initial preferences on how to treat participating contracts.

6. The IASB expressed an initial preference for View 1, which views payments arising from the participating features as contractual cash flows as any other.

7. The FASB expressed an initial preference for View 2, which splits the participating contract into two components: a guaranteed benefit piece and the participating feature. More in particular, that view distinguishes within the participating feature between an equity part and a liability part according to whether the entity has a legal or constructive obligation. Another way to look at this could be to recognise the liability up to amount of the legal or constructive obligation and regard the remaining part as retained earnings.

8. Those Board members who supported view 2 favoured a version we labelled then as view 2B. In the November meeting the staff presented two other modifications of View 2, namely views 2A and 2C. These approaches would classify the participation feature always as equity or classify it according to its predominant characteristics as equity or as a liability. It seemed that neither the IASB nor the FASB were interested in those other options; we therefore do not intend to explore these any further.

9. This paper does not discuss whether participating dividends allocated to policyholders should be presented as a reduction of policyholder premiums or as an expense akin to policyholder benefits. Under either presentation, the issue whether or to what extent the insurer has a liability from participating features in insurance contracts is the same.

10. This paper also includes, in the appendix, examples of participating contract types to illustrate the complexity and variety of participating contracts.

11. This paper does not discuss mutual insurers. We will continue to research issues relating to mutuals. If this work uncovers issues that require attention by the boards, we will address these at a later meeting.

Useful information regarding participating contracts

12. According to the *Framework* and the FASB Statement of Financial Accounting Concepts No. 1 *Objectives of Financial Reporting by Business Enterprises,* the objective of financial statements is to provide information about the financial position, performance and changes in financial position of an entity that is useful to a wide range of users in making economic decisions. The Framework highlights the importance of an evaluation of the entity's ability to generate cash and of the timing and certainty of these cash flows for the economic decisions to be taken by users of financial statements.

13. Staff identified two main points of interest regarding participating contracts for users of financial statements:

    (a) Which cash flows will (ultimately and/or expected) flow to policyholders and which flow to shareholders?

    (b) Which amounts are loss absorbing?

Example

14. We begin with an example. An insurer has issued a portfolio of identical participating insurance contracts for which it estimates that it will pay the following benefits in three different scenarios:

    (a) Scenario 1 (normal, with a probability of 80%): death benefits 1,000, distributions back to participating policyholders 900, total cash outflows 1,900.

    (b) Scenario 2 (seasonal flu epidemic, with a probability of 15%): death benefits 1,600, distribution back to participating policyholders 340, total cash outflows 1,940.

    (c) Scenario 3 (swine flu pandemic, with a probability of 5%): death benefits 5,000, distribution back to participating policyholders nil, total cash outflows 5,000.

15. For simplicity, ignore the time value of money, adjustments for risk and uncertainty and any other contract margins, as well as expenses (other than policyholder benefits) and investment returns.

16. The following table summarises for each scenario the **expected** (present) value of the cash flows (cash flow times probability).

Scenario	Death benefits	Participating benefits	Total cash flows
1 (normal)	800	720	1,520
2 (flu)	90	51	141
3 (swine flu)	250	0	250
Total	1,140	771	1,911

17. We comment as follows on this example:

    (a) The expected present value of payments to policyholders is 1,911.

    (b) These contracts mitigate risk for the insurer, because some of the risk in the contracts is borne by the policyholders through the participation mechanism. This could be shown through disclosing the split of the expected policyholder benefits between death benefits (1,140) and expected participating benefits (771), though this split might not necessarily be the best way of providing information about risk.

    (c) There is an inverse relationship between the death benefits and the participating benefits. When death benefits are higher, the dividends tend to be low, and vice versa.

(d) Of the participating benefits that this insurer expects to pay, at least some part almost certainly results from a legal or constructive obligation.

(e) Quite likely, part of the expected participating benefits does not result from a legal or constructive obligation.

(f) The actual amount of any enforceable obligation is uncertain and – depending on the participating contract type, regulation and circumstances – has a wide range. It would therefore be difficult to make a reasonable estimate of how much would actually be enforceable in the unlikely event that an insurer pushed to the limit an assertion that its discretion is unfettered. Precedent is typically rare in this area.

Application of the views

View 1

18. View 1 regards cash flows arising from a participating feature in an insurance contract in the same way as all other cash flows arising from the contract. This would mean that all those cash flows should be included in the measurement of the insurance liability on an expected present value basis. The participating feature represents an integral part of the contract, rather than an individual item that should be considered separately for recognition and measurement.

19. In the example, applying view 1 the insurer will recognise a liability of **1,911**, which equals the probability-weighted cash flows of all scenarios.

Arguments for View 1

20. Proponents of view 1 see a participating contract as one contract. The payments under this contract are interrelated and depend on each other. The participating feature often has a balancing impact, so that in essence the policyholder benefits form more or less stable payments. Assessing a participating feature to determine which part is a liability and which part is equity (or retained earnings) will often be difficult and burdensome because the parts may not be easily

identifiable and the resulting split may not be particularly useful to users in practice.

21. Applying view 1, the measurement of the insurance liability includes, on an expected value basis, the part of the participating benefits that will be paid out to policyholders. When determining these amounts, the insurer has to consider and determine in its scenario analyses all relevant factors, such as contractual terms, regulatory requirements and rules as well as expected regulator's behaviour and market practices. This is consistent with the overall approach to the model to include cash flows on an expected value basis. In February 2009, the boards decided tentatively that the measurement of insurance contracts should include the expected (i.e. probability-weighted) cash flows. Limiting the participating dividend payments under an insurance contract to those that meet the definition of a legal or constructive obligation is not useful for users to assess the amount, timing and uncertainty of future cash flows because it is based on an uncertain and perhaps difficult estimate of minimum required payments rather than expected payments.

22. To illustrate, in the above example, it may well be that in scenario one, reasonable estimates of the payment that could be compelled could fall in a very wide range, say, between 200 and 771 (the total amount available for payment to policyholders). In other words, of the total expected (present) value of the participating benefit (771):

    (a) A part, maybe at least 200, clearly meets the definition of a liability in the boards' conceptual frameworks.

    (b) A part, perhaps 100, might not be regarded as resulting from a legal or constructive obligation.

    (c) A large part in the middle, as much as 471 (771 less the estimates of 200 in (a) and of 100 in (b)) might or might not result from a legal or constructive obligation.

23. The only parts that flow to equity are those which the insurer expects to allocate to shareholders. This is useful to users because they are interested in knowing

which part of a distributable surplus flow to the shareholders and which to the policyholders. Any distributable surpluses that are expected to be paid to policyholders under the contract (in the example 771) should not be presented in a way that implies it belongs to the shareholders.

24. It is also worth remembering what happens at the inception of a contract if some expected policyholder benefits are not included in the expected present value of the cash flows. Suppose that (a) there is a single premium of 100 at inception, (b) the expected present value of the future guaranteed benefits is 90 and (c) the expected present value of policyholder participation is 7. If the cash flows exclude the policyholder participation, the residual margin will be 10; the 7 relating to policyholder participation will run off as the residual margin runs off. In contrast, if the cash flows include the policyholder participation, the residual margin will be 3; the 7 relating to policyholder participation will run off naturally as the cash flows run off. Because the subsequent run-off of the residual margin is inherently arbitrary, proponents of view 1 believe that it will be more informative and intuitive to include the expected policyholder participation in the cash flows.

25. The boards' frameworks state what a liability is. Clearly, it would not be a faithful representation (in principle) to depict something as a liability without having an obligation. However, in the narrow circumstances of participating contracts, where obligations, guarantees and discretion are intertwined in a complex structure, the staff believes it makes more sense to treat all payments to participating policyholders as arising from an obligation even though there may be some uncertainty in practice as to how much of those payments could be enforced if the insurer attempted. This has, first of all, consequences for the measurement of the liability. These features would be expected cash flows as any other. Disclosures should be able to explain the participation feature included in these contracts (see paragraphs 33 to 35).

View 2

26. Of the IASB and FASB members who preferred view 2, most, if not all, seemed to prefer view 2B. Under view 2B, the insurer would recognise a liability for the participating benefits to the extent that it has a legal or constructive obligation to pay those benefits. In the example, it would recognise a liability of somewhere between 1,140 and 1,911, depending on its assessment of how much of the obligation would be enforced if the insurer attempted to avoid payment.

27. As long as the insurer can be compelled to pay some participating benefits in, for example, scenario 1, it would need to recognise a liability of **more than 1,140** (which represents the probability-weighted expected cash flows of the guaranteed payments).

Arguments for View 2

28. Proponents of view 2 argue that separate recognition, classification and measurement of components of participating contracts (unbundling) could result in a more faithful representation of the characteristics of the participating feature, because the policyholders collectively act as equity holders in respect of the participating feature of their contracts. Even though this may be seen as an exception to general measurement approach for insurance contracts of expected values, this approach results from applying the definition of a present obligation that is provided by the IASB *Framework* and FASB *Concepts Statements*. A measurement based on the expected payment to the policyholder (View 1) might not be a faithful representation of the participation feature in such contracts if the insurer does not have a constructive or legal obligation to pay participation benefits.

29. If part or all of a participation feature is classified in equity because it does not create a liability, that treatment would demonstrate the loss absorption capacity provided by a participating feature, arising from the (constrained) discretion of the insurer over the amount and timing of policyholder dividends; information about these loss-absorbing characteristics is important to users. Under view 1, the loss absorbing nature of some parts of the liability (due to discretion over

timing and amount) cannot be fully shown on the face of the balance sheet. Disclosures are necessary to give users this information.

30. In view 1, one 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 and could cause ambiguity. Furthermore, it adds another variable to the proposed insurance model that depends on subjective assessments by the insurer.

Staff recommendation and question for the boards

31. Some staff members conclude that, based on the arguments presented in paragraphs 20 to 25, 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. Those staff members therefore recommend view 1.

32. Other staff members recommend view 2, recognising a liability up to amount of the legal or constructive obligation, for the reasons set out in paragraphs 28 to 30.

Question for the boards
Do you agree with the staff's recommendation (a) in paragraph 31 to view the participating feature as a source of cash flows from the insurance contract like any other (view 1) **or** (b) in paragraph 32 to recognise a liability up to amount of the legal or constructive obligation (view 2)?

Possible disclosure requirements

33. The staff proposes to require specific disclosures to capture the nature of the participating contracts and bridge the gap between the two views discussed above. The staff recommends that the insurer should describe and explain its participating contracts and the conditions impacting amount and timing of

payments. Details should be given regarding in which pool policyholders participate, this may be a specific pool of contracts or assets or the overall performance of the entity.

34. Information about which amounts will eventually flow to shareholders and which to policyholders is important information to users of the financial statements. On the other hand, users will also be interested in any loss-absorbing characteristics of liability components.

35. The staff intends to seek further advice from the Insurance Working Group regarding disclosures for participating contracts. As a starting point, the staff thinks that the disclosures could be based on what the *Guidance on implementing* IFRS 4 *Insurance Contracts* suggests in paragraphs IG32 (g), IG64 (c) and IG65F. In summary, those suggestions cover:

(a) Accounting policies, characteristics of participating contracts and conditions that impact amount and timing of payments:

(i) Actual participation rates and dividend policies

(ii) Sharing rules between policyholder and shareholder

(iii) Underlying source of participation

(iv) Insurer's discretion on amount/ timing and loss absorption potential

(b) Subclassifications of line items in the statement of financial position and in the statement of comprehensive income (or in the notes):

(i) Contractual and discretionary amounts

(ii) Existence of guarantees

(iii) Amounts eligible or designated for profit sharing

(iv) Amounts distributed or allocated to policyholders

(c) Description of the process used to determine assumptions (including uncertainties) for the insurer's policy in making allocations or distributions:

(i) Changes to previous allocation decisions and previous expectations

(ii) Expected increase

(iii) Expected surplus and expected policyholders' share in the surplus

(iv) Participating features for which the amount available for distribution is currently negative

(d) Description of asset risk and risk mitigation through participating contracts

(i) Sensitivity analysis showing the impact of the loss absorption potential and of changes in the allocation rates

(ii) Information about the level at which guarantees given start to have a material effect on the insurer's cash flows.

Question for the boards
Do you agree that these disclosure requirements should be part of the Standard?

Appendix: Examples of participating contracts

A1. This appendix comprises Appendix A for agenda paper 10A/ FASB Memorandum 31A of the November Joint Board meeting and paragraph 16 of that agenda paper. Both excerpts should remind the boards of the variety and complexity of participating contracts in practice.

Appendix A (to agenda paper 10A/ FASB memorandum 31A)

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. In some cases the obligation to pay to the policyholders is restricted, for example, to realised surpluses. This means that although the insurer may decide when to realise surpluses and this may establish a timing difference between the amounts recognised in the financial statements and the corresponding amounts immediately available for distribution to policyholders, the amounts are still only available for policyholders. The insurer usually has, to an extent, discretion over the amount and/ or timing of these extra distributions to the policyholders.

A3. In most countries this discretion is (partially) constrained by legal or regulatory requirements as well as by competitive constrains. 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.

A4. 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 how the staff have summarised the information.

A5. 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.

A6. 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.

A7. 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.

A8. 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

A9. 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.

A10. 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.

A11. 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.

A12. 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.

A13. 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.

A14. 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.

A15. 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.

A16. 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.

A17. 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.

A18. In Germany there 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.

Paragraph 16 of agenda paper 10A/ FASB memorandum 31A

A19. 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.