

Extract from the joint CEA-CFO Forum letter of 30 November 2007 on the Discussion Paper Phase II Insurance Contracts

### **Participating Contracts**

To ensure financial statements are relevant to users, and provide consistency of measurement of economically similar contracts, an economic basis of valuation for participating contracts is required. Such an approach should be on a portfolio basis and take into account all expected payments to policyholders including those that have not yet been allocated to individual policyholders. This is consistent with our view that it is inappropriate to split the contract into its underlying rights and obligations for the purpose of recognition.

We believe that a constructive obligation to declare bonuses is established upon inception of a participating contract and this constructive obligation should be recognised when measuring an insurance liability. This is consistent with any economic measurement basis including the exit value model being applied by the IASB where such expected cash outflows would be taken into account by a transferee. The recognition of an obligation to pay bonuses under participating contracts based on legal enforceability is extremely difficult to apply and demonstrate on a consistent basis and is inconsistent with the economic reality of the contract. Given that a variety of fund and contract structures are used around the globe such a definition is likely to lead to some companies treating such participating features as equity and others as liabilities. We do not believe that this will lead to relevant and reliable accounting.

The Discussion paper asks whether the guidance in IAS 37 is sufficient to establish whether a constructive obligation exists. Whilst we believe that the guidance quoted in the Discussion paper from the IAS 37 exposure draft will prove sufficient, we are concerned about the on-going debate in this area regarding the definition of the constructive obligation. We would oppose any narrowing of this definition. The IFRS definition of a constructive obligation must allow for such obligations to be included in the value of an insurance liability. This should be made clear in IAS 37 and the revised insurance contracts standard.

We believe that it is important that all participating contracts, whether classified as insurance or investment, should be accounted for consistently under the new Phase II accounting standard and this issue should be addressed in setting the scope of the standard.

We can see no rationale for mutual insurers to adopt different practices from shareholder-owned companies in the financial reporting of discretionary participation features.<sup>1</sup>

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<sup>1</sup> The Swedish mutual market has separately raised this issue with the IASB

Extract from the Appendix to the joint CEA-CFO Forum letter of 30 November 2007 on the Discussion Paper Phase II Insurance Contracts

**Question 16**

*(a) For participating contracts, should the cash flows for each scenario incorporate an unbiased estimate of the policyholder dividends payable in that scenario to satisfy a legal or constructive obligation that exists at the reporting date? Why or why not?*

*(b) An exposure draft of June 2005 proposed amendments to IAS 37 (see paragraphs 247-253 of this paper). Do those proposals give enough guidance for an insurer to determine when a participating contract gives rise to a legal or constructive obligation to pay policyholder dividends?*

a) We support the assertion that, for participating contracts, cash flows for each scenario should incorporate an unbiased estimate of the policyholder dividends payable to satisfy a legal or constructive obligation that exists at the reporting date. In the same way that all expected future premiums should be included in the valuation of an insurance contract in order to reflect the true economic value, as discussed above, all expected future payments to participating policyholders should be taken into account in arriving at an economic valuation. Such cash flows would be taken into account in market transactions.

The arguments supporting our views were expressed in the CFO Forum letter to the IASB in December 2006. This letter was included in the IASB observer papers for January 2007 and is included as Appendix B to this letter.

An unconditional obligation is created by these contracts upon inception. This obligation is to declare bonuses<sup>1</sup> to policyholders over the term of the contract rather than being an obligation

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<sup>1</sup> Bonus should be interpreted to include all discretionary payments on participating policies whether called bonus, dividend or by any other term.

created by the declaration of individual bonuses. The nature of participating contracts is such that insurers have discretion over the timing and amount of future benefits, rather than the ability to avoid settling them and hence we believe this unconditional obligation to declare bonuses meets the definition of a constructive obligation.

It is extremely difficult to universally demonstrate that this obligation is based around just legal or regulatory enforceability given the differing structures of participating funds around the world. A definition based purely on legal or regulatory enforceability would, in our view, lead to classification as equity of amounts for policyholders in some jurisdictions and not in others. This will result in inconsistent and hence less relevant financial statements.

The classification as equity in some countries could be misleading, for example in those countries where a proportion of a specific fund is identified which can only be distributed to policyholders, current or future. These amounts will never be available to shareholders which is inconsistent with their inclusion in equity.

Measurement of liabilities for discretionary participation features should be on a portfolio basis. This should take into account all expected payments to current and future policyholders arising from participating contracts (or funds) held at the financial reporting date.

In terms of measurement there are a number of specific jurisdictional issues that must be addressed in the final insurance standard, given the differing contract and fund structures around the globe. We have previously referred to many of these within our Elaborated Principles and the CFO Forum letter in December 2006.

For example in certain markets, for many participating contracts the benefits under those contracts are based on accounts not prepared in accordance with IFRS, such as local GAAP accounts or regulatory accounts. To the extent that there are differences in valuation of assets and liabilities between IFRS accounts and such accounts, the portion of this difference that would be attributable to the policyholders should be included in the measurement of the insurance liability on a portfolio basis. The uncertainty over the amount and timing of future bonuses will be reflected in the measurement of the obligation through the use of probability-weighted cash-flow scenarios in common with all other expected cash flows associated with the contract.

We support the Board's preliminary view that the accounting for participating contracts should be consistent across shareholder-owned insurers and mutuals.<sup>2</sup>

b) The accounting for participating contracts is a significant matter for insurers and many of the underlying issues are unique to the insurance industry. We believe all cash flows relating to the contract should be included in the measurement of that contract as stated above. The proposed amendments to IAS 37 as included in the Discussion paper would, in our view, provide sufficient guidance to enable all expected bonus payments under participating contracts to be reflected in the contract valuation. Our concern is, however, that as the definition of a constructive obligation is still being discussed by the IASB, this may not be the case if this proposed definition is narrowed in final revisions to IAS 37. We would oppose such a narrowing. The IFRS definition of a constructive obligation must allow for such obligations to be included in the value of an insurance liability. This should be made clear in IAS 37 and the revised insurance contracts standard.

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<sup>2</sup> The Swedish mutual market has separately raised this issue with the IASB.