



**Michael Monahan**  
Director, Accounting Policy  
(202) 624-2324 t (202) 572-4746 f  
mikemonahan@acli.com

November 16, 2009

Sir David Tweedie, Chair  
International Accounting Standards Board  
30 Cannon Street  
London EC4M 6XH, United Kingdom

Mr. Robert H. Herz, Chair  
Financial Accounting Standards Board  
401 Merrit 7  
Norwalk, CT 06856-5116

Re: Insurance Contracts – Discretionary participation features in insurance contracts

Dear Sir David and Bob Herz:

The American Council of Life Insurers (ACLI)<sup>1</sup> is pleased to share with you our views regarding the issues related to discretionary participation features in insurance contracts, which is expected to be a topic of discussion at the upcoming IASB meeting and the joint meeting of the IASB and FASB. Prior to the November meetings, there has been limited discussion on this topic since the release of the Discussion Paper, *Preliminary Views on Insurance Contracts* (DP). As a result, we strongly encourage the Boards to review the responses to the DP especially with respect to Question 16, which addressed this topic.

The purpose of this letter is to highlight critical factors that the Boards should take into account when discussing this topic. Insurance contracts containing discretionary participation features (DPFs) are of strategic importance to the insurance industry. Participating dividends and other non-guaranteed elements serve as a risk reduction mechanism. When the value of guaranteed benefits increases, the value of future dividends and other non-guaranteed elements generally decrease as a direct and related consequence. The measurement of insurance contract liabilities containing DPFs must recognize the economic nature of the contract. Whether the Boards ultimately decide on the modified IAS 37 approach or the fulfillment approach as the measurement basis, both approaches require the current measurement of the liability, which means that the measurement must take into account all current inputs. There should be no exclusion or limitation placed on DPFs. To do so would result in a measurement that is not a faithful representation of the liability and would provide users with misleading information. It is essential that the measurement take into account all components of the whole contract, i.e., all expected cash flows with no artificial constraints.

In our response to Question 16 of the DP we stated:

“With respect to 16a, we agree that participating contract cash flows should incorporate an unbiased estimate of policyholder dividends associated with each scenario being measured. However, the estimate should be based on reasonable expectations of policyholder behavior and should not be constrained by other criteria (e.g. legal or

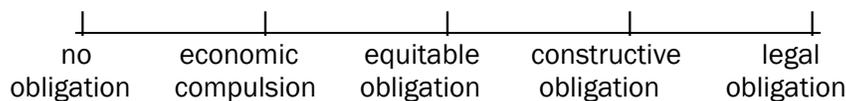
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<sup>1</sup> The American Council of Life Insurers represents 340 member companies operating in the United States, of which 332 are legal reserve life insurance companies, and 8 are fraternal benefit societies. These member companies account for 93% of total life insurance company assets, 94% of the life insurance premiums, and 94% of annuity considerations in the United States.

constructive obligation, economic compulsion).

The determination and payment of dividends is a key contractual obligation created in a participating contract, and as such should be included as a cash flow when measuring the insurance liability. If the insurer were to transfer the contracts to a third party the price would include the expectation of paying future dividends. Excluding all or a portion of expected dividends creates an inaccurate picture of a company's financial position and operating results. For example, other assumptions (e.g. lapse) would need to be adjusted to reflect the non-payment of dividends; otherwise the resulting liability would not be consistent with current economic reality. Additionally, in a period of changing economic conditions reported earnings and surplus would be distorted if dividends were not fully reflected in the measurement. For example, in a period of rising interest rates, both projected interest spreads and dividend expectations would increase. Finally, excluding dividends is inconsistent with the preliminary views requiring all cash flows to be included in the liability as described in paragraph 116, requiring 'current estimates of contractual cash flows' as well as the inclusion of future premiums (paragraph 173)."

In developing our response to this question, we reviewed existing accounting guidance in forming our response. We noted that the IFRS Framework states that an essential characteristic of a liability is that the entity has a present obligation. That obligation may be legally enforceable or arise from normal business practice, custom or desire to maintain good business relation or act in an equitable manner. US GAAP, FASB Concept Statement No. 6, contains a similar description of a liability—"Obligations in the definition is broader than *legal obligations*. It includes equitable and constructive obligations as well as legal obligations." There are a number of examples, such as pension accounting, and accounting for certain employee benefits, that meet the accounting definition of a liability that do not rise to a legal obligation. There is a spectrum of possibilities—ranging from no obligation to a legal obligation (see chart below).



Note: Illustration is not intended to be proportional, e.g., equitable obligation ≠ 50%

While future dividends may not meet the definition of a legal obligation it would appear to meet the definition of constructive or equitable obligation criteria. More importantly, we believe that an unconditional obligation is created once the contract is signed and issued. This obligation is to declare bonuses/dividends to policyholders over the term of the contract rather than an obligation created by the declaration of individual bonuses. In accordance with the nature of participating contracts, insurers' discretion is over the timing and amount of future benefits. This benefit should be taken into account in the measurement of the contract.

IFRS 4 defines discretionary participation feature as a contractual right to receive, as a supplement to guaranteed benefits, additional benefits that are likely to be significant; whose amount or timing is at the discretion of the issuer and performance based. We believe this definition is a reasonable depiction of DPFs and consistent with our views expressed above. While the definition is clear, it is unclear how the definition will be applied in the measurement of insurance contract liabilities.

The IASB staff paper-10A (FASB 31A) describes the issues to be deliberated at the November Board meetings. The Paper asks the question—does a participating feature give rise to a liability offering two views for the Boards' consideration. The details continue to focus on the same issue described in the DP—whether all, none or part of distributable surplus is a liability.

View 1, which is the staff recommendation, articulates a position that payments to policyholders arising from participation features would be cash flows from the contract and therefore consistent with the tentative decision that the measurement of an insurance contract includes expected (probability-weighted) cash flows. View 2 presents an alternative that would require bifurcating the contract and determining if the participation feature is a liability or equity.

We strongly support View 1 as the approach for DPFs. 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. We believe that View 1 would also apply for long-duration contracts, i.e., all cash flows must be taken into account. To exclude any part of the cash flows would serve to be an artificial constraint with the potential to cause a significant gain at issue followed by losses that would not reflect the nature of the business.

View 2, in our opinion, should not be selected for two reasons. First, view 2 argues that a liability will be recognized only to the extent a participating feature results in a present obligation, which is inconsistent with the nature of the contract and takes a narrow interpretation of the characteristics of a liability contained in the IFRS Framework. Second, requiring bifurcation (unbundling) would not only add complexity to the measurement but fails to recognize the interdependence of the contract features. Our recent letter to you on unbundling provides additional commentary on this point.

We encourage the Boards to consider our comments contained in this letter along with responses to the DP as they deliberate issues related to discretionary participation features and other components of the measurement of insurance contract liabilities. We welcome the opportunity to discuss these points in further detail.

Sincerely,



Michael Monahan  
Director, Accounting Policy

cc: Peter Clark, IASB staff  
Hans van der Veen, IASB staff  
Jeffrey Cropsey, FASB staff  
Mark Trench, FASB staff