



# Report to HM Treasury

## Financial Reporting for Life Assurance

June 2005

### Summary

- A *The ASB was requested by the Financial Secretary to the Treasury to review the accounting for with-profits business by life insurers. As a response Financial Reporting Standard 27 “Life Assurance” (FRS 27) was published in December 2004.*
- B *The ASB believes that FRS 27 will cause substantial improvements in life assurance financial reporting in the UK. But FRS 27 does not address all the contentious issues in this area of financial reporting.*
- C *There are three principal users of a life assurer’s financial statements: investors, policy holders and regulators. They all require information to help them understand the overall financial position of the assurer, including its regulatory capital position, and its financial performance.*
- D *Policyholders also require information on the financial situation, including the exposure to risk, and the performance of their policy and the fund to which it belongs.*

- E Regulators have similar information needs to investors; although they often require more detailed and specific information than that available in general purpose financial statements, they are able to request this from the companies in the form of special purpose reports.*
- F Financial reporting for life assurance business – and with-profits business in particular – is inherently difficult: the business is generally long term (with the potential for major changes in conditions during the life of the policy); there is a wide variety of different product types; and the business can be subject to changing regulatory requirements. A more fundamental point is that many aspects of the determination and allocation of the profits of the life assurer’s business are at the discretion of the management of the company.*
- G FRS 27 concentrated on improving the reporting of capital, risk analysis and financial position rather than financial performance. Particular areas addressed were:*
- The capital position of the entity – a new statement, accompanied by narrative explanation, is required setting out the total capital, how that capital has been allocated, the relevant regulatory requirements and the extent to which capital in one part of the business is available to other parts of the business.*
  - Liabilities measurement – a new measurement regime (also required by the regulator), is required for larger UK life funds which recognises constructive obligations to pay future bonuses and uses modelling techniques to value options and guarantees.*
  - Valuation assumptions and their sensitivity to change – new disclosures are required.*
  - Embedded values – where these are recognised, future investment risk margins are not allowed to be included in their measurement.*
- H The ASB, in developing FRS 27, was constrained by the necessity to act in a timely manner, to be pragmatic in asking the preparers to make major changes in a short timeframe and to try not to get too far apart from the regulatory regime or the likely direction of IASB’s project on insurance. Consequently, it was decided that some key requirements of FRS 27 should only apply to larger UK life assurance entities and that many other areas which ideally would have been addressed would be left for longer term action.*

- I *The ASB would like to see FRS 27 applied to the balance of UK life-  
assurance entities but feels this would best be achieved when and if the  
regulator extends the realistic liabilities regime to these entities.  
However, if the regulator does not propose to do this, the ASB may  
consider consulting on extending the scope of FRS 27.*
- J *Although FRS 27 addressed important aspects of life assurance  
accounting, there remain more complex issues that the ASB was not  
able to address in the timescale. Matters which still require fuller  
consideration include:*
- liability measurement and the role of management discretion*
  - the best basis of recognition of profit for these long term contracts*
  - the liability/equity distinction for those surpluses not yet allocated*
  - the role of embedded value information in the financial reports.*
- The detailed discussion in Part III of the report sets out further analysis  
of the issues involved.*
- K *The International Accounting Standards Board is currently carrying  
out a comprehensive project on insurance accounting; the ASB supports  
this project and will actively participate in it, and considers that the  
development of an international solution to insurance accounting is  
preferable to attempts to develop and improve FRS 27.*

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## Part I - Overview

### **1 Introduction**

1.1 In March 2004, the Right Honourable Lord Penrose's Report of the Equitable Life Inquiry (the Penrose Report) was published. The then Financial Secretary to the Treasury subsequently wrote to the Accounting Standards Board (the ASB) to request it to initiate an urgent study into the accounting for with-profits business by life insurers.<sup>1</sup>

1.2 Although the request referred just to accounting for with-profits business, the ASB took the view that the subject was best considered in the context of life assurance accounting as a whole. It therefore undertook a project that considered ways of improving the quality and transparency of reporting by life insurers having regard to the points raised by Lord Penrose in his report and other issues.

1.3 The main result of the work undertaken by the ASB in response to the Treasury request was Financial Reporting Standard 27 'Life Assurance' (FRS 27), which was published in December 2004<sup>2</sup>.

1.4 FRS 27 applies to accounting periods ending on or after 23 December 2005, and as a result is not mandatory for those entities reporting under international accounting standards. However, major insurance and bancassurance groups, with the support of the ABI, entered into a Memorandum of Understanding with the ASB under which they undertook to include in a separate section of their annual reports for 2004 much of the information that would be required under FRS 27. They also agreed that, in their financial statements from 2005 onwards, prepared under International Accounting Standards, they would adopt the requirements of FRS 27; this would be an acceptable basis of accounting for life assurance under the provisions of the relevant International Standard, IFRS 4 'Insurance Contracts'.

1.5 As a result of this agreement to adopt FRS 27, the ASB believes that substantial improvements are being made to life assurance reporting in the UK. However, it does not regard the issue of the standard as resolving all the contentious issues in financial reporting for life assurance businesses; further improvements will require a longer-term process, and the ASB sets out in this report its analysis of the steps that could be taken, by itself and others, to achieve the long-term goal of improved reporting for this type of business.

1.6 This report starts by summarising the information needs of different classes of user of the financial statements of life assurance entities, and the extent to which these needs have been addressed by FRS 27. It then considers areas where

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<sup>1</sup> The letter from the Financial Secretary to the Treasury is reproduced in the appendix to this report.

<sup>2</sup> The FRS followed proposals issued for public comment as Financial Reporting Exposure Draft 34 'Life Assurance Accounting' in July 2004.

further action is needed, and the Board's views on the direction of future development of life assurance accounting.

## **2 Information needs of users of life assurance financial statements**

2.1 There are three principal groups of users of a life assurer's financial statements: investors (and other providers of finance), policyholders (and their advisers, who in turn will often use the services of rating agencies) and regulators. Although each has different interests, there is also much common ground.

### *Investors*

2.2 Investors in a proprietary life assurance company, and other providers of finance to life assurance companies, have the same overall objectives as investors in other types of business. They need information that helps them to assess how effectively management has fulfilled its role of putting the entities resources to a proper, efficient and profitable use; and information about the reporting entity's performance and financial position that is useful to them in evaluating the entity's ability to generate cash (including the timing and certainty of its generation) and in assessing the entity's financial adaptability.

2.3 However, the long-term nature of most life assurance business, and the regulatory requirements relating to that business, mean that certain types of information are more relevant for investors in those entities.

2.4 The nature of a life assurance contract (and especially in the case of a with-profits contract) is that of a long term promise—the life assurer is undertaking to provide financial compensation in the event of specified events that might occur (or will occur in the case of mortality) many years in the future, and, in respect of some products, to provide an attractive return on the investment made by the customer. There is a clear potential conflict between risk and return in this proposition and, for those life funds with shareholder interest, there is also a potential conflict between policyholders' and shareholders' interests. The management of this balance between risk and reward is of interest to investors (as well as other users). It is reflected in the financial security of the entity (in particular its ability to withstand adverse changes in market conditions) and in its financial performance (in particular its achieved and potential investment performance but also its administrative efficiency, its distribution policy, the terms on which it is writing new business and its use of surplus). Thus in addition to information on the assets, liabilities and equity of a life assurer, it is of great importance to be able to gain an understanding of the risks and uncertainties that it faces.

2.5 A key feature of financial information on the performance of life assurers is that, in preparing it, assumptions have to be made about future outcomes. This is necessary because of the long-term nature of the business, and because the final

outcome of a with-profits contract is very dependent on future events. These future events include investment returns and investment policy, the receipt of renewal premium (lapse and surrender assumptions), the use of the surplus in the fund (the application of the estate), the sort of new business written over the lifetime of the policies, mortality and longevity of policyholders, expense levels, and the impact of policyholder options and guarantees. All these factors, and the dynamics and interplay of the different risks, will influence the eventual outcome for both investors and policyholders. These users also need information that helps them to assess the validity and significance of the assumptions. A feature that is common to many of these considerations is that an analysis of developments up to the balance sheet date may not provide much by way of meaningful indication of the future. This is especially relevant in recent years where investment market changes have both eroded the financial strength of many life assurers and made projections of future performance much more problematic. In this situation, historic bonus levels and the performance of policies maturing at the current time can be very poor indicators of the future performance of policies currently in force.

2.6 Investors also need information on the main causes of the changes in the financial position during the year and the sensitivity of the entity's financial performance to those causes.

2.7 Information is also needed about financial position. One aspect of this that is of particular significance to shareholders in life assurance entities is the effect of the entity's capital structure on the generation of 'shareholder capital'. In the case of many with-profits businesses, shareholders are entitled to up to 10% of the declared bonuses. Investors are therefore interested in the level of declared bonuses and the extent to which appropriate and adequate capital resources are available to cover those bonuses.

2.8 This reference to 'appropriate and adequate capital resources' is important. Although the capital structures of some life assurers are quite straight-forward, others can be complex with different elements of the capital being subject to differing regulatory restrictions as to their use and distributability—in other words, different degrees of fungibility. Investors need to understand the sources and disposition of the existing capital resources if they are to be able to make assessments about the financial strength of the life assurer. Without such information, investors are less able to assess the need for further capital, may not fully understand the ability of the fund to withstand market price shocks or the extent of the surplus in a fund that might enable it to provide enhanced returns.

2.9 A final aspect of a life assurer's financial position that the investor needs is an analysis of the entity's projected future cash flows. A life assurer's book of policies in force at the balance sheet date will typically represent a set of contracts with commitments and cash flows that will continue for many years – up to 50 years in the case of a pensions contract. There is significant inherent uncertainty as to the future performance of these policies. This uncertainty is attributable to the dependence of the cash flows on investment markets, mortality and morbidity

experience, as well as management and policyholder actions. Any analysis of the risks and uncertainties relating to the accounts of a life assurer should include an analysis of the assumptions made in respect of the future cash flows and provide an indication of the range of potential outcomes (and the consequences respectively for shareholders and policyholders). An understanding of changes that are made in assumptions is also essential.

2.10 There are different ways of viewing both the financial performance and the financial position of a life assurance entity and, as the turmoil in the financial markets over the last few years has served to highlight, the appropriate basis will vary with circumstances. During the prolonged equity bull market, the primary focus of investors in life assurance entities tended to be the contribution to the growth made by the new business sold in the year and the potential for surplus being released from the life fund to flow to the shareholders. However, following significant investment market and interest rate movements and increases in regulatory supervision and requirements, there has been an increased focus on solvency and on the source and disposition of capital (ie financial strength). The financial statements need to provide information on both the future cash flow and the financial strength.

#### *Policyholders*

2.11 Life assurance policyholders need to receive information on the future benefits they can expect from their own policy; but also on the security of those benefits and, if that policy involves a participatory interest, the potential return. Because these returns and their security will depend in part on the policy terms, in part on the financial position of the overall fund and (where relevant) in part on the overall group financial position, this means that policyholders need information on the financial performance and financial position of the particular life fund, and on the life assurance entity as a whole.

2.12 There are a number of features of life assurance contracts that influence the nature and extent of the interest by policy holders in the performance of their life fund and the entity as a whole:

- Contracts that are with profits (participating) – where the policyholder has a direct interest in the overall performance of the fund as a whole throughout the contract period.
- The non-transferability of life policies – although there is a limited market in traded endowment policies, for the vast majority of life policies, the policyholder (and life assurer) are restricted as to their ability to transfer ownership of the policy. Traditionally, low surrender values have been set to enable the life assurer to recover initial costs, and these also have the effect of encouraging the retention of the policy for its full term (and also as a reflection of the long term investment approach adopted by the fund).



- Related to the non-transferability of policies is the fact that for most life policies the terms (such as the premiums charged) are agreed on inception and are not subsequently changed. This means, for example, that as a policyholder ages, the mortality risk borne by the life assurer under the policy increases without a commensurate increase in premiums paid; there is an increasing incentive to maintain the life policy on the part of the policyholder, who would lose continuing insurability on these terms were they to surrender the policy.
- For with profits policies, the return to policyholders is provided by way of reversionary and terminal bonuses. Once declared a bonus is guaranteed, so there is an understandable tendency with life funds to defer the declaration of bonuses until there is confidence that the liability so created can be met. This is particularly the case with policies where premiums are invested in equities and other volatile asset categories. Whilst the investment policy is valid for the long term returns being sought, it may be inappropriate to base annual bonuses on the market value of the underlying assets given that there is an exposure to subsequent declines in value. A consequence of this approach is that a surplus of assets over declared bonuses will tend to build up over the lifetime of the policy with a large proportion of the eventual total return being included in the terminal bonus (at which point there is no mismatch risk between the asset value and the total policy proceeds). The existence and development of this surplus is clearly of interest to the policyholder. (Note that the realistic liabilities regime discussed below seeks to look through this position and attribute the undeclared bonuses to policyholders).

Each of these features leads to the policyholder having an interest in the overall performance of the life fund.

2.13 Policyholders also need information on the financial performance and financial position of the entity as a whole, because all life assurance products are essentially underpinned by the assumption that the life assurer is going to remain in a financially viable state and accordingly able to meet its obligations. This needs to be assessed at an overall level as well as at the individual fund level.

2.14 The balance of a policyholder's interest between their fund and the life assurer as a whole will depend in part on the way in which the operation is run (for example, whether strict ring-fencing of each fund is applied or whether the operation emphasises the benefits of group-wide diversification of risk and therefore the ability of one fund to provide finance to another). However, even in those situations where ring-fencing is applied, it can still be of relevance for policyholders to assess how other parts of the group are performing (for example to assess the likelihood of finance being needed for expansion in other parts of the Group, which might lead to the distribution of surplus from their part).

## *Regulators*

2.15 Regulators have their own information needs to enable them to carry out their duties of prudential supervision, and are able to require more detailed and specific information about a life assurance entity than would be appropriate for disclosure in the financial statements or policyholder information. However, many of a regulator's information needs will be similar to those of both policyholders and investors – they are interested in determining the current financial strength of the entity, and the way this might change as a result of improving or deteriorating overall financial performance

2.16 Financial information prepared for regulators on a different basis from that used for the financial statements results in additional complexity and can cause confusion. Where specific information is needed for regulatory purposes, this should wherever possible be determined on a basis that is supplementary to the financial statements, rather than adopting a different reporting basis for regulatory information.

2.17 In the UK, the Financial Services Authority (FSA) is, in adopting its realistic regime for life assurance, making changes that bring the regulatory basis for life assurance reporting closer to a basis that would be consistent with general principles for financial reporting. In particular, the new approach moves away from incorporating prudential margins in the measurement of liabilities, and restrictions on the value of assets, and instead requires best estimates and market-based values. The resultant net asset position is then 'stress-tested' by assessing the effect of changes in variables and assumptions to verify the adequacy of the capital position.

2.18 This new approach is welcome. Because of its emphasis on the general principles that underlie financial statements as the starting point for the regulatory returns, the approach has reduced some of the complexity in life assurance reporting by moving two aspects—financial statements and prudential returns—onto essentially the same basis and made it easier to introduce some financial reporting improvements in FRS 27.

## **3 Needs addressed by FRS 27 'Life Assurance'**

3.1 The improvements to life assurance financial reporting made in FRS 27 focused mainly on improving reporting on financial position rather than financial performance.

3.2 FRS 27 requires additional information in relation to:

- the capital position of the entity – a new disclosure is required, the capital statement, showing the disposition of shareholders' funds and other components of capital across the entity. This must be supported by narrative explanation of the regulatory requirements for the various life

assurance businesses of the entity, the capital held to meet them, and the extent to which capital in one part of the entity's insurance business is available to meet risks and requirements in other parts of that business;

- liabilities – a change is required in the measurement of life assurance liabilities – large UK life funds will have to value their with-profits policyholder liabilities in accordance with the 'realistic balance sheet' provisions of the FSA's new prudential regime; this 'realistic' calculation recognises constructive obligations to pay future bonuses and uses stochastic modelling techniques to value options and guarantees, where the value of each option or guarantee is calculated as the average outcome under a large number of potential future scenarios reflecting possible changes in market values;
- valuations – disclosures are required on assumptions made in valuations and their sensitivity to changes;
- embedded value – for bancassurers and other entities that currently recognise the embedded value of life assurance business, a change in the measurement of embedded value has been made through a restriction excluding future investment risk margins from the measurement.

3.3 The ASB will continue to review the application of FRS 27, both in voluntary information given under the Memorandum of Understanding in respect of December 2004 year ends, and full implementation for December 2005 year ends, and consider if any amendments to the requirements should be proposed.

#### *Fund-level information for policyholders*

3.4 Although FRS 27 introduces new disclosure requirements for the financial statements of life assurance companies, the financial statements of the total entity will not necessarily be able to provide policyholders with information on their particular policy or fund. Most of this information will be provided by the pre-sales product disclosures and by the post-sales periodic policy holder information.

3.5 The form and content of those disclosures and information are a concern for life assurers and their regulator, the FSA, rather than the ASB. The FSA, in developing requirements for disclosures to policyholders, considers whether sufficient information on the financial performance and financial strength of the fund is included. The format of the capital statement required by FRS 27 may provide a starting point for such disaggregated information.

#### *Further development*

3.6 FRS 27 addressed a number of important issues in life assurance accounting; but the scope of its requirements relating to the measurement of liabilities, including options and guarantees, was limited, by time constraints and practicalities, to building on the FSA realistic liability regime. This regime applies

only to larger UK with-profits entities. Extension of the scope of FRS 27 to cover smaller with-profits funds, overseas with-profits funds and a wide range of other funds and types of business that remain on the modified statutory basis is a matter that remains to be considered.

3.7 Further, it was felt by the ASB that, given the circumstances, they needed to introduce FRS 27 as quickly as due process would allow. It was therefore decided not to tackle some of the other more complex issues and thereby attempt a more fundamental revision of financial reporting of life assurance, as this could well take a number of years.

3.8 A key issue that would need to be addressed in a fundamental revision is the basis of profit and revenue recognition for life assurance business. The modified statutory solvency basis for reporting involves the use of statutory transfers from the with-profits fund and profit smoothing techniques such as the amortisation of deferred acquisition costs in line with margin earned. This still forms the basis of profit recognition under FRS 27. This is a very different profit recognition regime from the asset/liability framework that now underpins most developments in financial reporting outside insurance. Further, another profit and revenue recognition basis, used by bancassurers (and also by life assurers in supplementary statements), bases profit on changes in the embedded value of in-force business. This is also allowed under FRS 27 and is quite different from the general concepts of revenue recognition.

3.9 In addition to profit recognition, certain other major issues were not fully addressed by FRS 27.

- Although FRS 27 adopted the FSA realistic liability framework as being closer to general accounting principles for liabilities than the previous modified statutory basis, it is not clear that this is wholly in line with the conceptual definition of a liability (and in particular the concept of a constructive liability); the introduction of Principles and Practices of Financial Management statements (PPFM)<sup>3</sup> and greater clarity in the regulatory obligations for life assurers to treat customers fairly means that there is less discretion, but it would still seem to be the case that, for example, a management decision to distribute part of the estate over future years, and therefore intending to declare enhanced bonuses in the future could be reversed and therefore might not meet the criteria for a constructive obligation.
- The FSA realistic regime permits both a prospective and a retrospective approach to measuring the liability to policyholders (this is explained more fully in section 7 in Part III of this report); it is not clear to what extent these achieve the same objective or to what extent it is possible to adopt a solely retrospective basis.

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<sup>3</sup> The PPFM is a document that the FSA requires life funds to make available to their policyholders, setting out the fund's investment management and bonus distribution policies.

- The appropriate treatment of the Fund For Future Appropriations (FFA)<sup>4</sup>, including the issue of its balance sheet classification, remains unresolved.
- Existing financial reporting provides no information on prospective cash flows.

3.10 At present, users rely heavily on the supplementary embedded value information (that is outside the financial statements themselves, and usually not part of the Operating and Financial Review (OFR), but forming a separate part of the annual report) provided as additional information to the financial statements. Consideration should be given to the extent to which that information should be incorporated into the financial statements.

#### **4 Further development of FRS 27**

4.1 A major factor in the ASB being able to make rapid progress on implementing FRS 27 was the fact that the FSA was already introducing its realistic liabilities regime for large UK with-profits funds. As a result, the ASB did not need to develop detailed principles for measurement of liabilities but could refer directly to the methods for measuring liabilities set out in the FSA regulations.

4.2 However, because FRS 27 was using the FSA methods, the ASB felt it could only require them from those entities that the FSA required to apply them, ie larger UK with-profits entities. Smaller entities and overseas business carried out by a UK life assurance entity are excluded from the scope of the FSA realistic balance sheet regime.

4.3 Furthermore, the realistic liability approach does not extend to liabilities other than with-profits liabilities – it does not apply to obligations in respect of non-participating business or unit-linked business, which are still reported on the modified statutory solvency basis; in the case of non-participating business, this includes the measurement of liabilities on what, in normal financial reporting terms, would be regarded as an excessively prudent basis. As a result, the financial reporting of life assurance business still has many issues which need further exploration.

4.4 The ASB believes that extending the application of the requirements of FRS 27 relating to measurement of with-profits liabilities beyond the large UK with-profits funds would result in significant improvements in insurance financial reporting, including:

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<sup>4</sup> The FFA represents the surplus on a life fund that has not yet been allocated between policyholders and shareholders; it does not, therefore, clearly meet the definition of either a liability or equity.

- improved measurement of options and guarantees, reflecting the cost of potential liabilities under these and not just the obligations currently payable;
- improved measurement of other life assurance liabilities, taking into account future bonuses and other discretionary payments and not just those which have already been declared.

4.5 The scope of these measurement requirements of FRS 27 could be extended to cover with-profits business of smaller UK life funds. It may be preferable to do this if and when the FSA extends its realistic liabilities regime.

4.6 Extending the realistic liabilities approach to non-participating business would require the development of new regulations by the FSA, as the existing regulations, and the expertise developed in interpreting them, could not be applied directly to these different classes of business. Although the principles of realistic liabilities could be applied, detailed requirements and guidance would need to be developed. Both the development of new regulations and their implementation would demand significant resources from both the FSA and the life assurance entities.

4.7 Similarly, the overseas business of UK life funds could not easily be included within the existing realistic liabilities regulations, and effort would be required to address the wider variety of products used world-wide.

## **5 Developing a framework for life assurance financial reporting**

5.1 The IASB is currently carrying out a comprehensive project on insurance accounting. This project includes a fundamental review of all major aspects of insurance accounting, and it is seeking to develop an international consensus on the issues, drawing on expertise of a wide range of people. The ASB will continue to monitor this project closely and to work with the IASB and others to do all it can to ensure that a high quality standard is issued and implemented as a matter of priority.

5.2 The implementation of the IAS Regulation<sup>5</sup> on the application of international accounting standards also means that the ASB no longer has the authority to introduce improvements in the accounting policies adopted by many of the biggest UK life insurers. The Board is still the standard-setter for those UK entities not required (and choosing not) to prepare their financial statements in accordance with EU-adopted IFRS, but it has to tread carefully in fulfilling that role because it would not usually be appropriate to have different standards for (the generally smaller) UK entities that apply UK standards than for the (generally bigger) UK entities that apply international standards.

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<sup>5</sup> (EC) No. 1606/2002

5.3 The ASB is therefore of the view that it would not be appropriate for it to work on the development of its own approach to life assurance liability measurement, but should concentrate on assisting IASB in its wider project.

5.4 As a start to this assistance we have set out some views on some of the complex issues involved in to sections 7 to 10 in Part III of this report.

5.5 Section 7 discusses a fundamental issue for life assurance accounting, the basis of measurement of liabilities. General accounting principles adopt the concept of a 'best estimate' measurement of both contractual and constructive obligations at the balance sheet date. However, translating this concept into a practical measurement basis for life assurance business is complex. The FSA realistic liabilities approach adopted in FRS 27 is much closer to this concept than the modified statutory basis of measurement, which incorporates prudent over-estimates of contractual liabilities but does not take full account of bonuses not yet declared and obligations under guarantees and options.

5.6 Section 7 also analyses in more detail the alternative prospective and retrospective approaches to liability measurement for life assurance. It concludes that, whilst no single approach is wholly satisfactory, the nature of many types of life assurance policy is such that, at least to some extent, a prospective approach is necessary.

5.7 Section 8 discusses profit recognition and the way this is derived from liability measurement. Under the asset/liability model of the IASB Framework, profit is determined from changes in assets and liabilities.

5.8 However, in the context of life assurance the liability measurement basis may depend to some extent on assumptions about the appropriate timing of recognition of income. Thus there is a circularity problem – profit recognition is defined by the measurement of liabilities, yet the liability measurement needs to make assumptions as to the allocation of income to different periods.

5.9 In section 8 it is noted that retrospective valuation methods may sometimes be more conceptually sound as a basis for profit recognition where they are less reliant on deciding first how income should be allocated to future periods. However, the section concludes that no single approach is entirely satisfactory.

5.10 Section 9 discusses the distinction between shareholders' funds, other equity and liabilities in a life assurance business. The IASB Framework treats all credit amounts that are not liabilities as equity. In the case of a with-profits life assurance business, the 'estate', excluding any constructive obligations, represents an amount that is not a liability, but is largely attributable to current and future generations of policyholders, as well as shareholders. Accounting for this as equity would possibly not recognise the economic substance of the item.

5.11 Section 10 analyses an alternative approach to life assurance accounting, the use of embedded value methodologies such as those used by many large life assurers as the basis for supplementary reporting and by bancassurers as the basis

for consolidating life assurance businesses into their group financial statements. This approach seeks to value the in-force assurance business, using an approach that has many similarities to the prospective valuation method for measuring liabilities, and determines profit as the change in this value. It also provides a means of allocating the estate between the interests of policyholders and the interests of shareholders. As such, it provides an additional perspective on the life assurance business. However, in a number of respects this approach is not consistent with general accounting practice or the IASB Framework, and it may be better restricted to the provision of supplementary information than as a basis for the main financial statements themselves.

5.12 One piece of information that users of life assurance entity accounts would potentially find useful is an indication of the timing of the future cash flows from the life fund. Neither realistic liability measurement nor embedded value methods provide this information – the latter calculates a single net present value of future cash flows from in-force business, but these are not necessarily a smooth stream and some types of business can give rise sharply fluctuating cash flows over the life of the policies. Some additional disclosure of this information would therefore be useful.



## Part II - Conclusions

### **6 Conclusions on future directions of life assurance accounting**

6.1 The ASB has addressed above some of the more significant issues that have been identified from its work on life assurance. In summary:

- (a) the present basis of life assurance accounting in the UK remains in need of improvement despite the progress made by FRS 27;
- (b) in the short term, further progress in extending FRS 27 to more entities and more transactions would be facilitated by the extension of the FSA realistic liability approach to all life funds and all types of business;
- (c) other than pursuing that possibility, the ASB should support the IASB in its comprehensive project on insurance accounting.

6.2 Major issues relating to life assurance accounting that will need to be addressed by the IASB arise in the following areas:

- (a) measurement of liabilities –
  - (i) whether undeclared discretionary future bonuses on with-profits policies always fall within the definition of constructive obligations consistent with other liability recognition principles;
  - (ii) the subjectivity of liability valuation, whether based on prospective or retrospective approaches, and the fact that it takes account of future management intentions in relation to action that could be taken in certain circumstances to reduce liabilities to policyholders or reallocate benefits between different groups of policyholders;
  - (iii) the consistency of a stochastic modelling approach to valuation of options and guarantees with a fair value measurement principle;
- (b) profit recognition – whether profit recognition based on changes in assets and liabilities is able to resolve the many complex issues that arise, given that the measurement of liabilities incorporates many subjective and discretionary elements and in some circumstances assumes a particular basis for recognising income;
- (c) equity versus liability classification – whether the existing Framework distinction between liabilities and equity fits well with the residual rights of policyholders and shareholders to the estate in a life assurance business;
- (d) embedded value methodology and disclosures –

- (i) whether there is a conflict between an embedded value approach and the IASB conceptual framework;
- (ii) whether the embedded value approach could provide useful supplementary information;
- (iii) whether embedded value disclosures can be developed to provide information indicating the timing of cash flows from the life fund.

6.3 The IASB should also consider the development of disclosures explaining the risks and uncertainties faced by the life assurer and the role played by the various categories of a life assurer's capital in relation to those risks, along the lines of the quantitative and narrative disclosures relating to capital position required by FRS 27.

## Part III – Detailed analysis of key issues

### **7 Liability recognition and measurement**

#### ***Constructive obligations***

7.1 The liability recognition and measurement principles that apply to most entities are those set out in FRS 12 (which does not apply to insurance contracts). Liabilities are required to be recognised when:

- (a) an entity has a present obligation (legal or constructive) as a result of a past event;
- (b) it is probable that a transfer of economic benefits will be required to settle the obligation; and
- (c) the amount of the obligation can be estimated reliably.

Thus, under these general principles the liability is not restricted to legal obligations—constructive obligations are taken into account as well.

7.2 The application of this definition of liability to life assurance business – and in particular with-profits life assurance – is complex. For example, it is clear that for with-profits policies declared bonuses are liabilities, but it is not easy to decide to what extent other obligations to policyholders meet the definition of a constructive liability. Estimated future bonuses may reflect the reasonable expectations of policyholders, but these are not normally communicated to policyholders, nor are they entitled to rely on them, and they are to a significant extent within the discretion of management and subject to change, for example if future investment returns are below expectations. This is particularly the case in relation to planned enhancements to future bonuses (for example, to distribute part of the estate) that management may intend but which they have given no commitment to make.

7.3 Under FRS 12 such an intention would create a constructive obligation only where:

- (a) by an established pattern of past practice, published policies or a sufficiently specific current statement, the entity has indicated to other parties that it will accept certain responsibilities; and
- (b) as a result, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities.

## **Measurement**

7.4 Fundamental issues in the development of a framework for life assurance reporting arise in relation to the objectives and methodology for valuing policyholder liabilities. However, life assurance (and in particular with-profits life assurance) gives rise to particular difficulties in this area.

7.5 Historically, the measurement of liabilities relating to with-profits life assurance has been based on the amount of bonuses declared, without taking account of the potential for future bonuses (both reversionary and terminal) to policyholders. This approach forms the basis of the modified statutory solvency basis of reporting. In addition, prudential margins were built into the measurement of liabilities, in excess of the amounts representing the best estimate of the eventual outcome. Under FRS 12, liabilities are to be measured at the best estimate of the amount required to settle the present obligation at the balance sheet date, rather than including additional excessive margins for prudence.

7.6 The realistic liability measurement basis recently introduced by the FSA moves towards a best estimate basis for measurement, with the need to take account of uncertainty in the eventual outcome being addressed in the tests for the adequacy of capital. It also seeks to measure both the contractual and constructive obligations to with-profits policyholders as at the balance sheet date. However, it is not easy to determine the extent of the constructive obligations that have arisen at the balance sheet date – particularly where policies include options and guarantees. Two general approaches can be adopted:

- (a) a prospective valuation, which forecasts the expected future payments to policyholders and then adjusts for future events to arrive at a valuation at the balance sheet date; or
- (b) a retrospective valuation, that builds up the amount of the liability at the balance sheet date from the past events.

7.7 The retrospective and prospective approaches are, in broad terms, seeking to achieve the same measurement objective, and in theory should come to the same answer. However, the practical application of these approaches can result in differences arising, as discussed further below.

### *Prospective valuation for with-profits business*

7.8 With profits (or participating) business is the type where the differences in the practical application of the prospective and retrospective approaches are most significant. This reflects the fact that not only is the liability uncertain in amount and timing, but it is also to a greater or lesser extent determined at the discretion of management, operating within defined guidelines.

7.9 A prospective valuation attempts to forecast the actual future payments to policyholders, and then by deducting future premium that is expected to be received and adjusting for other future events (such as expenses expected to be incurred and investment return expected to be earned) arrives at a net liability reflecting the position at the valuation date. In making this assessment, the likelihood of policyholders continuing to pay premiums is taken into account, even though there is no contractual obligation on policyholders to continue to pay premiums on their policies.

7.10 The prospective valuation of with-profits policies is determined as the net present value of all the future cash flows associated with the policy, including:

- projected benefits payable to policyholders, including both declared and forecast bonuses (as well as surrender payments where there is early termination);
- future premiums;
- future expenses and other charges;
- future investment returns;

together with the value attributed to any options and guarantees forming part of the policy.

7.11 In simple terms, the value of the liability to policyholders at an intermediate date in the life of the policies is determined as the total benefits currently forecast to be paid, less the extent to which these amounts will arise from future receipts of premium (less expenses) and future investment gains.

7.12 In determining the net present value, risk margins or an adjustment to the discount rate are incorporated to reflect the uncertainty inherent in these future cash flows. Considerable subjectivity is involved in the choice of appropriate margins and discount rate, although this subjectivity may reduce as industry practice develops.

7.13 The prospective valuation approach is similar to the way that management, or a potential purchaser, generally values a portfolio of life assurance policies and reflects the value that a rational entity would pay for a third party to assume the obligation under the policy at the balance sheet date. Life policies by definition are long term and many (in particular with profits policies) are designed and priced on the basis of their overall expected outcome rather than their intermediate performance from year to year. As a consequence the valuation of such policies for purposes other than general purpose financial reporting does not usually draw a distinction between historic and prospective events in the life of the policy, other than to apply a risk discount for uncertainty to the future events. In particular this approach entails the recognition of future premium expected to

arise on renewal of policies (after applying a lapse rate assumption). The valuation also reflects the charges that will be made over the whole life of the policy for the cost of mortality risk, investment management fees or other deductions made in determining the eventual calculation of the amount due to the policyholder. Risk margins are incorporated into the projections to reflect the uncertainty inherent in the cash flows, and as a result the benefits to shareholders' interests arising from policy charges and investment management fees are recognised over the life of the policy.

*Retrospective valuation for with-profits business*

7.14 A retrospective approach builds up the policy value by having regard to the policy terms and conditions and the history of the policy up to the balance sheet date. It seeks to determine the value that the policyholder has accumulated at the valuation date reflecting the receipt of premium, expenses incurred and investment return earned up to that date. Such a valuation also needs to take into account any allocation to the policy of investment return relating to the estate, any distribution of the estate, and charges for mortality or the costs of options and guarantees that are to be borne by the policy; determining the appropriate allocation of such elements is subjective and reflects management discretion, and the determination of these allocations at a date part way through the policy life may sometimes be artificial.

7.15 The retrospective approach to with-profits policy valuation generally adopts a technique known as 'asset share'. This has been developed over the last few years to provide a guide as to the constructive obligation to policyholders at intermediate points in the lifetime of a policy. Essentially the approach builds up an amount representing the accumulated financial value of the policy from inception on a retrospective valuation basis. The main components of the asset share for a policy are as follows:

- Premiums received;
- Investment return achieved on the accumulated asset share each year – this can be calculated as a specific return (where there is direct hypothecation of assets to policies) or a general return for the fund as a whole (or something in-between);
- Expenses – these will include all acquisition and administration costs that the policy terms and conditions permit to be charged to the policy;
- Charges – these will include charges for mortality risk and other benefits provided by the policy;
- Miscellaneous profits or losses – these include surpluses and losses arising on other policies written by the fund. Such profits and losses can

arise from all aspects of the performance of the other policies, including lapses, surrenders, claims, expense performance and investment return;

- Participation in the Estate – the estate represents the surplus held by the fund over the constructive obligations to policyholders. There is generally considerable discretion over the use of the estate. In some cases part of the estate can be applied to increasing the benefits to existing policyholders and where this occurs this will represent an increase in the policies' asset share.

7.16 Whilst the asset share provides a useful indication of the accumulated constructive obligation in respect of a with profits policy, the management of the life assurance entity have considerable discretion as to the application of almost all the component elements of the calculation; asset share is not therefore an objective measurement of the liability. Discretionary judgement, although constrained as discussed in the following paragraph, applies not only to the distribution of any surplus or loss arising in the period as between policyholders and shareholders but also to the distribution of such items between cohorts of policies, and applies to the allocation of investment return, expenses, charges, the miscellaneous profits and losses from other policies and the sharing of the estate.

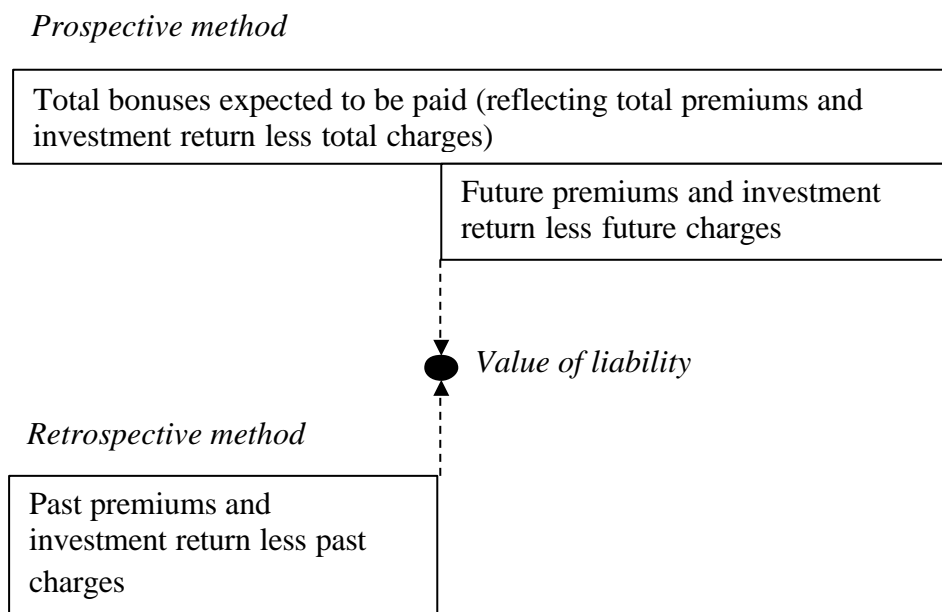
7.17 Some limitation on the discretion in respect of the asset share is provided by the requirement to ensure that policyholders are treated fairly and that the policy benefits are calculated in accordance with the fund's Principles and Practices of Financial Management (PPFM) document as required by the FSA. Despite these requirements, the very nature of a participating policy means that there is going to be subjectivity and discretion applied to the determination of the policy benefit and that this will change over time. A key feature (and historic strength) of with profits policies has been that the discretion afforded to the fund's management during the lifetime of the policy has enabled a very long term view of investment and other issues to be taken. This reflects the fact that the majority of policies are held for the long term. The corollary of the advantages of a with profits policy has been that the value of the policy at any intermediate point of time is indeterminate. This lack of transparency represents a significant disadvantage of with-profits policies.

7.18 It should therefore be emphasised that the determination of the asset share at an intermediate point in a policy life does not represent a measure of the actual obligation to a policyholder if the policy were to be terminated at that date. A large proportion of policies will generally continue through to maturity (it normally being in both the policyholder's and insurer's interest for this to happen) and as a consequence the actual financial arrangements that apply in the relatively small number of cases of surrender or lapse that arise each year should not be assumed to be the same as would apply in the highly unlikely event of all policies terminating in this way at the balance sheet date. This consideration is especially important in respect of policies where there is discretion on the part of the life fund as to the extent of the liability to the policyholder in the event of

surrender or lapse. In these circumstances the liability will be strongly influenced by the overall state of the fund and the circumstances giving rise to the policy's early termination. In many cases life funds reserve the right to apply adjustments to the liability to take account of the circumstances at the time. As an example, a single policy becoming paid up in a with profits fund is likely to be given better terms than if all policies in the fund were to go paid up at the same time. Similarly, a larger deduction for a discretionary market value adjustment may be applied if a large number of policies are expected to be surrendered than if surrenders are relatively few. Future changes in circumstances can also give rise to a major redistribution between policies and as between the policyholders, the shareholders and the estate.

*Comparison of prospective and retrospective approaches*

7.19 The prospective and retrospective methods are, in broad terms, seeking to achieve the same objective. In simplified terms, the asset share at the valuation date relating to a group of policies (as determined under the retrospective method) plus the expected future premiums (less expenses) and investment return equals the projected asset share at maturity, and represents the amount the policyholder might 'reasonably' expect to receive – and thus broadly the same as the forecast benefits payable. Thus the prospective valuation – future benefits less future premiums and future investment gain – might be expected to be the same as the asset share at the valuation date. This is illustrated in the following highly simplified diagram, which contrasts the prospective method based on estimating the eventual liability and deducting the future items, with the retrospective method which builds up the liability from past events only:



7.20 However, several elements of both prospective and retrospective calculations (such as the allocation of investment return to policies, valuation of



options and guarantees, future bonus policy and management's intentions for distributing the accumulated surplus in the fund (the 'estate') and treatment of investment gains on this) are subject to a high degree of management discretion.

7.21 In summary, therefore, although both the prospective approaches and the retrospective asset share methodology can estimate the liability to policyholders, neither can provide an objective basis of measuring the constructive obligation that is unaffected by assumptions about management discretion. In particular the uncertainty as to the usage and consequent ownership of the estate represents an unavoidable complication in the determination of the constructive obligation to policyholders, and applies under both the prospective and retrospective approaches.

#### *Deposit floor*

7.22 An issue that applies to both prospective and retrospective methods is whether the liability attributable to each individual with-profits policy should be constrained so as always to be no less than the current surrender value of the policy; or whether the overall liability of a portfolio of policies should merely take into account the expected level of surrenders over the whole portfolio. Under an asset share valuation approach, costs incurred by the life assurer in setting up the policy may be deducted from the asset share attributable to that policy, resulting in an asset share that is lower than the surrender value at that time (and in some cases even resulting in a 'negative liability' for that policy); this shortfall is reversed over the later years as further premiums are received on the policy. Under a prospective method, value attributed to future premiums may be included to reduce the liability below the surrender amount. In both approaches, it is assumed that lapse rates will remain low and the initial costs will be recovered out of future premiums, and this is reflected in the measurement of the liability.

#### *Application of prospective and retrospective approaches to non-participating business*

7.23 For non-participating policies the insured value is generally a fixed (or formulaic) amount (such as a specified amount payable on death with a term assurance policy or the annual monetary amount of an annuity once it is in payment). There is no participation on the part of the policyholder in the overall performance of the fund nor in the outcome of other policies written by the fund. The principal uncertainty relates to the occurrence of the insured event – and this often relates to uncertainty over timing as opposed to the event itself.

7.24 For term assurance policies, the liability can be calculated on a prospective basis as the amount payable in the event of death multiplied by the probability of the event occurring during the policy term, discounted back to a present value; a deduction would then be made in respect of the future premiums expected to be received under the policy, less expenses. The probability of death, and hence of a claim being paid, is determined using actuarial mortality tables; applied to large

homogeneous blocks of policies these are generally good predictors of the actual mortality claims, due to the homogeneity of the risks, and the large amount of historical data on which these are based (although there are trends developing that increase uncertainty of future mortality levels, such as medical improvements giving rise to greater longevity).

7.25 For this type of policy, the liability can also be estimated using the retrospective approach, but this appears to require an extension of the normal concept of what constitutes a liability; the liability for claims would reflect only claims incurred before the measurement date, but in addition the life assurer has an obligation to 'stand ready' to make future payments, based on premiums already received. In the case of term assurance, an actual liability arises only on the death of the policyholder; but there is an obligation on the part of the insurer to pay claims if death occurs over the remaining period covered by the premium received; this obligation can be described as a 'stand ready' obligation. For an annuity contract that is in payment, there is an existing obligation to make payments, but for an annuity that is not yet in payment, the obligation is contingent upon a future event (for example, on the policyholder attaining a certain specified age) and until that occurs, the insurer has no more than a 'stand ready' obligation. However, determining the appropriate value for these 'stand ready' obligations is not straightforward, especially for long-term contracts where (as is usually the case) a fixed annual premium is charged, but the risk increases as the policyholder gets older.

7.26 For annuity policies in payment, the liability can be measured as the annual value of the annuity multiplied by an actuarially determined estimate of the number of years the policy will continue. Since no additional premiums are received for an annuity policy that is in payment, the retrospective and prospective methods are the same for this type of policy.

#### *Application to unit-linked business*

7.27 Prima facie the determination of the liability for unit linked business is a straightforward retrospective application, being based on the number of units held by a policy multiplied by the price at the balance sheet date, which is itself determined by a valuation of the matching assets at that date. A separate charge to the value of the units is usually made to cover the costs of mortality claims, and these effectively become a separate non-participating contract, which would be measured as discussed above. Where contracts contain guarantees or options, these also need to be considered, as discussed below. Note that many policies of this type do not meet the definition of insurance contract in IFRS 4 (and FRS 26) and as such are accounted for as investment contracts rather than insurance.

#### *Options and guarantees*

7.28 For all the types of life policy outlined above, the policy terms and conditions can include various forms of option or guarantee. The value of these

will depend on the anticipated outcome over the remaining period of the policy to which they apply. Historically options and guarantees were valued using deterministic principles – the value being derived from the actual circumstances at the balance sheet date without regard to the potential for such circumstances to change in the future.

7.29 It is appropriate to take into account the potential for the options and guarantees included in current policies to become effective at some future date as a result of market or other changes – that is, to move ‘into the money’. The basis of valuation should be the value that a rational entity would pay to remove the liability created by the option or guarantee at the balance sheet date. In the absence of a deep and liquid market for such options and guarantees, this value can be estimated using stochastic valuation techniques which assess the range of potential outcomes and attach probabilities thereto.

7.30 Prima facie this technique can be applied when the policyholder liabilities are being calculated either on a prospective or retrospective basis. There is however a complication for with profits policies that arises as a consequence of the discretionary nature of the liabilities. Subject to ensuring that customers are treated fairly, the liability to non guaranteed policies will vary dependent on whether or not the options and guarantees applying to other policies in the fund become valuable. This can impact the retrospective valuation at the balance sheet date and reflects the discretionary nature of with profits liabilities – with profits policies participate in the overall outcome of all policies written in the fund and it is therefore logical that there will be an interrelationship between all policies. This complication means that the retrospective valuation at the balance sheet date is impacted by a prospective analysis – with the liability to non guaranteed policies being reduced by the current value of the options and guarantees (estimated using the transfer value approach outlined above), provided that such a reduction is in accordance with the policy terms and conditions and is consistent with treating customers fairly.

7.31 A related complication in the case of with-profits policies is the interrelationship between the forecast future bonuses and the effect of options and guarantees, and as a result it will generally not be appropriate simply to add the estimated value of the liability for options and guarantees to the estimated value of the constructive obligation for the policy. In the extreme scenarios – which can often be a significant element of the valuation of options and guarantees, even though they are of very low probability – the life fund’s management has the greatest discretion to alter future bonus declarations (for example, perhaps reducing payouts to a percentage of asset share that is significantly less than 100% in order to maintain the solvency of the fund as a whole). It is therefore necessary to value all elements of the liability on an holistic basis rather than viewing each element in isolation.

## *Conclusion*

7.32 Liability recognition and measurement is key to life assurance reporting and is highly complex. The interpretation of the general concepts of constructive liability are difficult to apply to with-profits liabilities, and may give rise to a conflict with current practice.

7.33 Liabilities may be valued using either a retrospective or prospective approach. Both involve considerable subjectivity, and depend on assumptions about the application of management discretion in the future. The valuation of options and guarantees in particular can only be based on projections of future outcomes, but is also heavily influenced by assumptions about management actions in response to potential changes in investment conditions.

## **8 Profit recognition**

8.1 In an asset/liability accounting model, profit recognition is determined by the recognition and measurement of assets and liabilities. Under the IASB Framework, an increase in assets or decrease in liabilities is a gain, and conversely a decrease in assets or an increase in liabilities is a loss (except where the change results from transactions with owners). From this starting point, the profit of a life assurance business would be determined by changes in liabilities to policyholders, investments and other sundry assets and liabilities, and (for those entities such as bancassurers that recognise it) any value attributable to the in-force business.

8.2 Applying this approach to life assurance gives rise to a number of difficulties. It is straightforward to measure the assets representing the investments of the life fund at fair value, and this has been common practice in the UK for some years. However, the measurement of liabilities, as discussed in section 7 above, is much more complex, as a result of the high degree of subjectivity involved and the extent to which management has discretion over the actual obligations to policyholders (for example, in the way the estate, and investment return arising on this, is allocated in determining bonuses). Where a prospective basis of valuation is used, it is necessary to make assumptions about lapse rates and hence the level of future premiums that will in fact be received, the need to forecast investment return and expenses, and the inclusion of appropriate risk margins in discount rates used to calculate net present value. However, in making these assumptions an assessment of the appropriate return for the risk that is borne over the future life of the policies is made; hence the process of determining profit is circular – profit recognition is driven by the measurement of liabilities, but the measurement of liabilities depends on the choice of profit recognition profile.

8.3 Retrospective methods of liability measurement do not involve the projection of expected cash flows and therefore do not involve the same degree of judgement about the level of profit that should be recognised over the remainder

of the policy life. However, it is still necessary to make judgements about the allocation of investment returns, expenses and other policy charges, and the circularity problem still arises.

8.4 These concerns lead some commentators to question whether a different approach should be developed for this type of business, under which profit should be seen as being earned as services are provided and risks are borne (ie as the life assurer completes its performance obligations). For example, for a simple unit-linked contract, fees are earned as investment management services are provided over the contract, and the amount charged to the policyholder to reflect the cost to the insurer of providing mortality cover should be recognised as this mortality risk is borne, matching the charge with the cost of claims in each period. For a more complicated with-profits policy, the insurer provides investment management services, administrative services and mortality cover, and the profit expected over the term of the policy would be allocated to each period as these services were provided.

*Non-participating business*

8.5 For straightforward non-participating business, such as term assurance or annuity contracts, the liability to the policyholder will be measured on an actuarial basis, based on expected mortality levels which determine the likely amount and timing of claims or, in the case of annuities, the likely period for which the annuity will be paid.

8.6 A prospective valuation of this liability takes into account the extent to which future premium will be received; this requires a subjective assessment of the allocation of premium to risk borne over the life of the policy. The alternative approach, a retrospective valuation, also requires a subjective assessment of the extent to which premiums already received relate to future risks. In each case, measurement of the liability depends to some extent on a profit recognition assumption.

*With-profits business*

8.7 The obligation to with-profits policyholders comprises declared bonuses, a projection of future bonuses, and any additional liability representing potential obligations under option and guarantee features of the policies.

8.8 A prospective measurement of this liability, as discussed in section 7 above, requires a projection of all future cash flows relating to the policies, including future premium, future expenses and investment income, as well as future claims, and for these cash flows to be discounted to determine a net present value.

8.9 The main concerns of a prospective approach are:

- that by taking into account future events (and in particular the expectation of future premium), it is potentially reducing the value of the current obligations by the benefit of future profits on the policies;

- the approach necessarily takes into account assumptions over future management actions and therefore reflects management's current intentions as to how it will exercise its discretion in future, which could subsequently be changed.

8.10 This approach can also lead to results that some regard as distorting the profitability of the business:

- discounting expected claims at a risk-free interest rate may not be considered appropriate as it results in the risk of incurred claims being settled at an amount higher than the initial best estimate of the claim being borne by future years without deferring a corresponding element of profit to compensate for this risk. Use of best estimates in this way can result in liabilities being stated below the value at which the liability could be transferred to a third party at the balance sheet date;
- recognising future investment gains at a risk-free rate of return understates the investment performance assumed by the insurer in pricing the contracts, and as a result can lead to lower profits (or losses) at the beginning of the contract, offset by higher profits (if an actual investment return is earned above the risk-free rate) in later years;
- on the other hand, using expected rates of return effectively capitalises the value of these returns at the inception of the contract, and can give rise to a gain on inception representing these future gains, with a loss in future years if actual gains are less than forecast.

Although these perceived distortions can be rectified by incorporating risk margins in the discount rates used, adjustments to forecast cash flows for adverse deviation and projecting higher investment returns, such adjustments are perceived as moving away from the principle of 'best estimate' measurement set out in FRS 12 and the objective of recognising gains and losses as they arise. Furthermore, any such adjustments are generally arbitrary – for example, there is little statistical evidence to support any particular level of risk margin to be incorporated into discount rates. On the other hand, it can be argued that, were a third party offering to assume the obligations of the life assurer, they would include such margins in their valuation, and this would therefore be closer to a true fair value based on an exit transaction.

8.11 A retrospective valuation approach such as an asset share model appears more conceptually sound, although the allocation of particular income and charges to individual asset shares is subjective. A retrospective approach might seem to avoid most of the 'circularity' concerns discussed in 8.2 above as the measurement of the liability is less influenced by an assessment of an allocation of profit over the life of the policy; however, it is still necessary to determine allocation of premiums between past and future (for example, a single-premium policy will incur costs over the life of the policy and therefore the obligation at the balance sheet date must take account of these future costs in some way). Future

projections also remain an essential element of the valuation of options and guarantees.

8.12 A further complication for profit recognition in relation to with-profits policies is that not all the change in value of assets and liabilities items is attributable to shareholders; a proportion (usually 90%) is attributable to present or future policyholders. Treating the full amount of an increase in net assets as a gain and including it in equity would be a fundamental change in the presentation of policyholders' interests in the life assurance business. This is addressed in more detail in section 9 below.

*Investment management fees*

8.13 For some types of with-profits and unit-linked business, a significant element of the insurer's profit arises from investment management fees charged to the policyholder over the lifetime of the contract, and the extent to which these exceed the insurer's costs of administrative and investment management costs incurred. The insurer will also have incurred 'acquisition costs' – initial costs associated with the policy (such as commission and set-up costs) and pre-contract costs such as marketing.

8.14 As premium is received, it is invested in units in the fund; deductions are made from the fund, and hence the value of the units, for the investment management charges due to the insurer. The liability to the policyholder at any time is the value of the units held, representing the share of the investments held in the fund, together with investment income, gains and losses, and after deducting management charges. Under an asset and liability approach, the assets representing the investments of the fund and the liabilities to policyholders will be equal. The insurer will also have assets representing the management charge deducted from the value of the units, and until the corresponding costs are incurred this will be offset by a corresponding obligation to provide services; if this obligation is measured at an amount that includes a profit risk margin, the insurer will recognise income and profit over the period of the policy. However, the acquisition costs can result in a loss being recognised at the inception of the contract unless these are deferred or an asset recognised for the value of the policy, representing the future benefit to the insurer of the investment management charges it expects to receive over the life of the policy.

*Profit or loss on inception*

8.15 Unless the asset and liability that are recognised at inception of a contract are equal, a gain or loss arises on inception. Some commentators argue that no service has been provided at this point, and in an arm's length transaction with a customer no gain or loss should arise.

8.16 For many types of policy the insurer incurs significant costs at inception – both internal set-up costs, and external costs such as commission paid to intermediaries. A loss on inception can arise if the premium received less costs

incurred is less than the liability recognised at inception (which might reflect the customer's right to a full refund of premium paid), unless either costs are deferred as an asset or the liability is measured at an amount less than the surrender value. In practice, lapse rates over a large portfolio of policies are relatively stable and predictable and losses on those that are surrendered in the early years are more than offset on the large proportion of policies that are not.

8.17 It is also the case that with a single premium with-profits policy the application of the normal principles of asset and liability recognition can result in the recognition of profit on inception. As the premium is received at the beginning of the policy life, there is no uncertainty as regards the receipt, but the life assurer has a performance obligation, including the bearing of the risks under the policy, throughout its life.

## **9 Equity**

9.1 A further area where they may conflict with the conceptual framework concerns the ownership of the surplus held within a life fund. This applies in particular to proprietary with profits funds and arises as a consequence of the participatory nature of the policies – the policyholders have a direct financial interest in the overall performance of the with profits fund.

9.2 Traditional life assurance accounting for with-profits funds has used the Fund for Future Appropriations (FFA) as a way of dealing with the uncertainties as to the ownership of the surplus in the fund. The FFA comprises two main components of surplus:

- The difference between the constructive obligation to policyholders and the actual guaranteed liability recognised (together with prudential margins) under the modified statutory solvency basis of reporting. For with profits policies, the return to policyholders is provided by way of reversionary and terminal bonuses. Once a bonus is declared it is guaranteed, so there is an understandable tendency on the part of life funds to defer declaration of bonuses until they can be confident that the liability so created can be met at maturity. This is particularly the case with policies where premiums are invested in equities and other volatile asset categories. Whilst the investment policy is valid for the long term returns being sought, it is clearly inappropriate to base annual bonuses on the market value of the underlying assets given that there is an exposure to subsequent declines in value. A consequence of this approach is that a surplus of assets over declared bonuses will tend to build up over the lifetime of the policy with a large proportion of the eventual total return being included in the terminal bonus (at which point there is no mismatch risk between the asset value and the total policy proceeds).



- Any excess of the surplus over the constructive obligation to policyholders. It is generally the case that with-profits life funds will hold surplus in excess of the constructive obligations to policyholders. Such capital can be held to meet regulatory capital requirements, to fund future developments or to provide enhanced future bonuses in excess of asset share. It can arise as a consequence of the original financing of the life fund as adjusted by the investment returns subsequently earned and any over or under declaration of bonuses in respect of policies no longer in force.

Of these two elements, the second is generally termed the 'estate'. Entities using the realistic liabilities approach under FRS 27 will include the policyholders' share of the first element as a liability; the FFA will then contain two elements, the estate, and the shareholders' share relating to bonuses not yet declared but included in the constructive obligation.

9.3 Historically, many companies have allowed the estate to build up to provide capital for the business, and therefore this does not represent a surplus that can be regarded as 'belonging' to any particular group of current policyholders. Although the Articles of the insurer will usually govern the principles of allocation between shareholders and policyholders that apply when a distribution of the estate by way of bonus is made, these will not generally address the question of *when* such distributions are to be made nor provide any guidance on ownership of the undistributed estate. For such a surplus there are the following ownership issues:

- The allocation between shareholders and policyholders;
- The allocation between various cohorts of existing policyholders;
- The allocation between current and future policyholders.

9.4 The eventual destination of the estate will only be determined by subsequent actions by the life fund. As at the balance sheet date there will generally be no anticipated distribution – the estate could be applied in a variety of ways dependent on future external and internal developments and actions. To this extent it has the nature of capital of the life fund.

9.5 This uncertainty as to the ownership of the estate gives rise to difficulty in determining how it should be accounted for in accordance with the IASB conceptual framework. Prima facie as the estate does not seem to meet the definition of a liability, it would be expected to be treated as equity. However it is also clear that the extent of the shareholders interest in the estate is usually severely restricted (often the shareholders are limited to taking no more than 10% of the value of any distribution out of the life fund). To treat all of the estate as equity could well be misleading. A possible treatment would be to view the estate as being similar in nature to a minority interest – an equity interest not held by shareholders of the entity.

## **10 Recognition of value of in-force business - embedded value methods**

10.1 An alternative approach to developing the framework for life assurance accounting is to build on methods for valuing the in-force life assurance business. These methods, often referred to as embedded value methods, are used by some entities (generally in supplementary statements, although entities such as bancassurers use these methods for their primary financial statements). The recognition of an asset representing the value of in-force business gives rise to certain conceptual questions, as discussed below; an alternative would be to include information on the value of in-force business as supplementary information only, and not incorporate it into the financial statements themselves.

10.2 The embedded value approach is a prospective valuation of anticipated cash flows arising from policies already in force and from the estate and as such is consistent with the general approach to valuation adopted by investors. Various forms of embedded value analysis have been provided by the leading UK life insurers for a number of years in the form of supplementary statements. Note, however, that the embedded value information normally provided does not provide analysis of the timing of the future cash flows.

10.3 There are considerable similarities between embedded value methods and the prospective approach to measurement of realistic liabilities discussed in section 7 above. Both involve the projection of future expected cash flows from policies in force, making appropriate assumptions for mortality, policy surrenders and future bonus payments. However, whilst the measurement of liabilities uses the projected cash flows to determine the future obligation to policyholders in the form of bonuses, the embedded value methods determine the value of the contracts to shareholders by forecasting the future amounts transferable from the fund to shareholders' interests. For with-profits business, there is a close link between bonuses and distributions from the fund to shareholders' interests, and as a consequence the underlying methodology is seeking to achieve similar objectives.

10.4 Prima facie, as a basis involving a prospective evaluation of the future cash flows anticipated to arise from the contracts in force at the balance sheet date and the estate, the embedded value methodology has some of the same issues of compliance with the IASB conceptual framework as the prospective approach to valuation of liabilities (see section 7 above); however, there is a significant difference in that whilst the measurement of liabilities may take future premiums into account solely for the purpose of the measurement of a liability, the embedded value methods discussed below can in addition involve the recognition of an asset representing the future value of in-force business to shareholders.

10.5 There are a number of different embedded value approaches, including:

- the European embedded value basis (EEV) as developed by the CFO Forum and which is being adopted in 2005 by most leading European life insurers as supplementary information;
- the Market Consistent Embedded value (MCEV) which is more restrictive in its approach.

10.6 FRS 27 permits entities to continue to recognise as an asset the value of in-force business in their financial statements; this applies principally to bancassurers who have used embedded value methodology in their financial statements for several years. However, the standard restricted the valuation of embedded value by excluding any value attributed to future investment returns in excess of a risk-free rate.

10.7 IFRS 4 'Insurance Contracts' also permits entities that use embedded value methods at the date of transition to IFRS to continue to use such methods, but entities are specifically prohibited from adopting an embedded value method that:

- (a) attributes a value to future investment returns in excess of a risk-free rate, or
- (b) values contractual rights to investment management fees at an amount in excess of fair value, which the standard states is unlikely at inception to exceed the origination costs paid.

A change of policy must also result in an improvement of the relevance and reliability of the financial statements.

### ***Potential conflicts with the IASB Framework***

10.8 One of the major issues with embedded value methodologies concerns the extent to which the approach is compatible with general accounting concepts as set out in the IASB Framework.

#### *Future premium*

10.9 A potential conflict with the IASB conceptual framework arises because the future premiums anticipated to arise on the policies in force do not seem to represent of themselves an asset that meets the criteria of the framework. In particular there is the absence of the ability by the insurer to control the asset by requiring the policyholder to renew.

10.10 Life policies generally come in two forms – single premium and regular premium. Regular premium policies are generally structured with a level periodic premium calculated on commencement of the policy. This will be calculated by an underwriting process that takes into account the circumstances of the insured at the inception date (notably mortality and morbidity risk) and the anticipated term of the policy. For most policies, the premium once set cannot be amended by the

insurer and nor can they cancel the policy. This means that the policyholder in effect has an increasingly valuable option to renew the policy on terms that would not be available to someone else of the same age and circumstances as the policyholder. For many regular premium savings policies there is also the incentive on the policyholder to renew because the surrender value may represent a poor return compared to the benefits that accrue from maintaining the policy in force. Although not able to enforce renewal of regular premium policies, insurance companies price them on the assumption of them lasting for the full term – or at least for a substantial proportion of the full term – and this is borne out by actual experience.

10.11 It is therefore possible to argue that although there is no contractual obligation on the part of the policyholder to continue payment of premiums, it is nevertheless in their interests to do so, as it can be argued that they thus obtain better terms for the cover obtained than they would by terminating the policy and taking out a similar one with a new provider. However, this leads to an apparent paradox, in that what appears to be an obligation of the insurer to continue the contract on terms favourable to the policyholder nevertheless represents an asset to the insurer.

#### *Management fees*

10.12 Many life policies include the provision for the life fund to levy a charge against the policy benefits to cover the costs of the provision of investment management and administration. These charges can take several different forms dependent on the type of policy:

- unit linked – for unit linked policies the management fee is a specified percentage of the accumulated policy fund value;
- with-profits (excepting unitised with-profits) – for this business, the costs of management are charged to the fund and prima facie do not get directly deducted from policy liabilities. For funds that use asset shares as the basis of calculation of realistic liabilities, the asset share will include a deduction for management fees and expenses;
- non participating – in general there are no separate charges levied against non participating business – the policyholder liability is calculated independently (for example using mortality data) from the accumulated assets and the difference accrues to shareholders.

10.13 Although each of these situations involves different bases of calculation, when projecting the eventual outcome of the policy it is clear that in each case this will result in the recognition of the future management fees as an asset. It should be noted that this will also apply to single premium business – the liability to policyholders will be reduced by the amount of the future management charges expected to be levied against the policy until its maturity.

10.14 As with renewal premium, it would appear that the recognition of the future management fees as an asset is inconsistent with the conceptual framework

*Taxation*

10.15 The embedded value approach generally values the shareholder's interest on the basis of the realisable value that would arise on distribution from the life fund. This value therefore takes into account any tax that would arise on the distribution (in many cases a distribution from the life fund is a taxable event). The taking into account of the tax that would arise is logical from a valuation perspective however it does not appear to be consistent with the usual principles that apply to the valuation of investments in subsidiaries where no account is generally taken in the consolidated accounts of the tax that would arise on the distribution of any profits from subsidiaries up to the holding company.

***Concerns specific to the EEV methodology***

10.16 The EEV methodology was developed by the CFO Forum as a basis for consistent reporting of supplementary information on life assurance business; it was not intended as a basis to be adopted in financial statements themselves. There are the following specific aspects on which this basis would appear not to conform to the conceptual framework, in addition to the issues concerning the compatibility of the general embedded value approach discussed above.

*Risk margins/performance analysis*

10.17 A characteristic of the EEV version of the embedded value approach is that the risks relating to the projected cash flows being valued tend to be dealt with by way of a single adjustment to the discount rate rather than by way of a series of specific risk margins amending the individual cash flows. This approach has been adopted primarily for practical reasons but does give rise to a number of difficulties in respect of the quality of the analysis. In particular using a single risk factor means that the movement in the embedded value represented by the unwind of the discount rate cannot easily be attributed to the various component elements of performance such as expense, lapse, investment or mortality experience and thus compared with the actual experience in the period. The EEV approach would be significantly improved by the provision of an analysis of the movement in the period between these various component elements. As indicated above, the methodology adopted has largely been driven by issues of practicality and it is acknowledged that the separate modelling of individual risk margins in the projected cash flows for each component (and for each type of business) represents a significant increase in the complexity of the calculation and in the analysis needed to interpret the information. The "Accruals" basis of embedded value accounting adopted in the late 1980's and early 1990's sought to provide this sort of analysis and did prove very challenging to produce. It is inherent in the nature of a net present value of future cash flows approach that it is difficult to analyse the cause of movements in value over the period.

*Investment risk margins*

10.18 Recent developments in the embedded value approach (known as market consistent embedded values) have sought to ensure that the embedded value does not include capitalised investment risk premiums. A number of companies have however sought to retain a value for investment risk margins in their embedded values and this is not explicitly forbidden by the EEV approach.

10.19 The argument to exclude the investment risk premium is based on the principle that such premiums represent margins for risk that should only be recognised as the experience occurs. This applies whether the premium is in respect of the type of investment (for example an equity risk premium or the higher returns from junk bonds as a consequence of the lower credit quality of the investment). In each case the premium exists because of greater uncertainty as to the outcome, and it is inappropriate to anticipate the additional return by capitalising it in the embedded value. Adopting the market consistent approach ensures that the embedded value will not vary dependent on the choice of investment in which the currently held assets of the fund are invested.

10.20 The argument in favour of recognition of the investment risk premium in the embedded value is based on the precept that a fund that has the financial strength to invest in higher risk investments should be able to reflect the higher anticipated returns that such a policy is based on. This is particularly relevant in respect of providing policyholders and shareholders information as regards the expected performance of the fund, with the stronger funds able to anticipate better returns than the weaker ones.

10.21 Although it is acknowledged that the choice of investment policy is a crucial element of communication to policyholders and shareholders, and that a stronger fund should be more attractive than a weaker one in respect of its ability to take a more risky investment approach, it does not follow that this should impact the embedded value. The principal arguments against including the investment risk margin are:

- by definition the risk margin is related to a risk that the return will not arise and therefore the value should not be recognised until the risk has passed;
- the strength of the fund is already reflected in the excess of assets over liabilities and to increase the value still further by capitalising the investment risk margin represents a form of double counting;
- it is inappropriate for the embedded value to be able to be varied simply by changing the composition of the investments held at the balance sheet date. Such a change cannot impact the value of the liabilities nor the value of the future profit stream for shareholders.

*Issues relating to the 90:10 arrangements*

10.22 A feature of most UK with profit life funds is that the participation of the shareholders is governed by a set of principles generally known as the 90:10 arrangements. With these arrangements, the shareholders are able to take up to 10% of the value of any distribution to policyholders. For embedded value purposes it is generally assumed that any surplus held in the fund (the estate) will be distributed over the run off of the policies in force with a proportionate increase in bonuses (and therefore shareholders participation) sufficient to exhaust the surplus. There are a number of aspects of this assumption that can be questioned:

- **Deterministic approach** – the embedded value approach represents a projection of future cash flows and as with any projection there is a probability distribution of the potential outcomes; however, the valuation is generally based on a single central projection, ignoring the asymmetry of the distribution above and below this central projection. For example, for positive outcomes (ie those that increase the estate) the 90:10 principles of participation will apply across the whole range. For the negative outcomes there is an asymmetry feature in that, in circumstances where the estate is exhausted, it will not be appropriate to assume that the shortfall will be shared 90:10 between policyholders and shareholders. There is no liability on the part of policyholders to contribute to the shortfall. The actual outcome will depend on the circumstances of the fund but could include the shareholders making a disproportionately greater level of contribution. Although the probability of these negative outcomes is usually small, the potential impact on shareholder value can be very significant. It is not clear to what extent current embedded value practice takes account of such asymmetry issues.
- **Distribution assumption validity** – the assumption that the estate will be distributed evenly over the run off period of the in force policies is clearly an artificial one and in reality it is very unlikely that ongoing life funds will follow this practice. Historically the estate tends to be retained by the fund to meet future solvency requirements and to provide the financial strength that is an attraction to potential policyholders. It can also be applied to finance investments and other developments intended to improve the operation. It can be argued that a wide range of value could be placed on the estate and that the present embedded value approach disguises the true nature of the surplus by presenting it as emerging in an artificial way.

10.23 In summary, there are a number of concerns with the EV methodology when considering its adoption for mainstream reporting. These include concerns with compliance with the conceptual framework and with the detail of the EEV approach as proposed by the CFO forum. For these reasons, the IASB might

conclude that its standard should not be based on European EV principles. It is essential to remember in this context though that:

- conceptual frameworks are not set in stone; they are living documents that evolve as new issues are explored at a conceptual level and new thinking emerges;
- users find embedded value information useful; therefore, before dismissing it as the basis for a new standard standard-setters need to understand what it is that makes EV useful and whether that is something that it is reasonable for the financial statements to reflect. The issue of whether there is something unique to the insurance industry that justifies either a different approach to the mainstream financial statements, or a long-term role for supplementary information on an embedded value (or similar) basis should be considered. If a different basis is to be used for supplementary reporting, reconciliation between that and the main accounts is essential.

10.24 Comparison with other industries in which analysts are very interested in the value of 'in-force business' and how is that information need satisfied may prove useful. On the other hand, if insurance is unique, analysis of what the factors are that make it unique and whether they justify a difference in accounting should be considered.

10.25 Consideration should also be given to extending the embedded value disclosures to provide additional information on the timing of the future cash flows, since these can emerge over a long period of time.



## **Appendix**

### **Letter to the Chairman of the Accounting Standards Board from the Financial Secretary to the Treasury**



HM Treasury, 1 Horse Guards Road, London, SW1A 2HQ

Mary Keegan  
Chairman  
Accounting Standards Board  
Holborn Hall  
100 Gray's Inn Road  
London WC1X 8AL

8 March 2004

*Dear Mary*

#### **PENROSE INQUIRY INTO EQUITABLE LIFE**

In August 2001, I invited Lord Penrose to enquire into the circumstances leading to the then current situation of the Equitable Life Assurance Society. His report was handed to the Treasury on 23 December 2003 and will be published when it is laid before Parliament today. I am writing to request the assistance of the Accounting Standards Board and its committee, the Urgent Issues Task Force, in relation to that Report.

Lord Penrose acknowledges that improvements have been made recently in accounting for with-profits business in both life insurers' statutory accounts and their "realistic" regulatory reporting. However, his Report is critical of the accounting framework for with-profits business, asserting a need for accounting standards that result in a "realistic" view of the financial position of life insurers. Lord Penrose also describes a number of areas where he considers that the disclosures provided in company accounts are opaque or insufficient.

The Government recognises the importance that Lord Penrose attaches to these concerns and requests that the Accounting Standards Board initiate an urgent study into the accounting for with-profits business by life insurers.

The details of the study, and the mechanism by which its recommendations are implemented, will need to be finalised once you have considered the contents of the Report. However, we would expect that the study will consider the role of "realistic" accounting and will have a particular emphasis on identifying ways of improving the transparency of reporting by life insurers. The recommendations emerging from the study should be made against the background of the developments in the FSA regulatory regime and the requirement for listed companies to use International Accounting Standards in their group accounts from 1 January 2005.



Lord Penrose emphasises the necessity for urgent consideration of the issues raised and I would anticipate that the recommendations from your study should be made by the end of this year. The study will no doubt benefit from the involvement of a number of bodies, including members of the Association of British Insurers (in its role as the body issuing Standards of Recommended Practice for insurance business). However, you may wish to involve the Urgent Issues Task Force, given the urgent nature of the matters typically dealt with by that body.

I am sending copies of this letter to Jacqui Smith at the Department of Trade and Industry and to John Tiner at the Financial Services Authority. I hope that their organisations contribute, as appropriate, to the study. I am particularly concerned that the study is appropriately informed by the work carried out on realistic accounting by the Financial Services Authority. My officials will continue to keep in touch with theirs, on an ongoing basis, as the work underlying the study develops.

*Yours sincerely*  
*Ruth Kelly*

**Ruth Kelly MP**