Invitation to Comment **November 2005**

"Policyholder Equity" of Friendly Societies and AASB 1038 *Life Insurance Contracts*

Prepared by the
Australian Accounting Standards Board

Commenting on this Invitation to Comment

The AASB is seeking comment on a proposed amendment to AASB 1038 *Life Insurance Contracts* in relation to friendly societies. Constituents are encouraged to respond to the AASB by 30 November 2005. Comments should be addressed to:

The Chairman
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A copy of all non-confidential submissions will be placed on public record on the AASB's web site: www.aasb.com.au.

Obtaining a Copy of this Invitation to Comment

This Invitation to Comment is available on the AASB's web site www.aasb.com.au. Enquiries about publication should be directed to:

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Purpose of this Invitation to Comment

The AASB issued AASB 1038 *Life Insurance Contracts* in July 2004, which covers life insurance contracts written by friendly societies. The previous version of AASB 1038 (AASB 1038 *Life Insurance Business*) did not apply to friendly societies. Both the new and old versions of AASB 1038 contemplate that life insurers operating in some overseas markets may have unallocated surplus that is in the nature of "policyholder equity", because it cannot necessarily be classed as part of shareholder equity or policyholder liability. The AASB has reached a preliminary conclusion that friendly societies face similar issues to those faced by life insurers in some overseas markets. Accordingly, the AASB is proposing to amend AASB 1038 to acknowledge that friendly societies may have unallocated surplus that is in the nature of "policyholder equity". The AASB plans to amend AASB 1038 before 31 December 2005. The AASB is seeking comments from constituents before it finalises these amendments.

Background

Friendly societies were brought under the Corporations Law (the Law) and *Life Insurance Act 1995* (the Life Act) in 1999. However, at the same time, ASIC issued a class order (99/1225) exempting friendly societies from elements of the Law including AASB 1038. APRA's prudential rules also gave exemptions from AASB 1038 for prudential reporting purposes. In any case, AASB 1038 *Life Insurance Business* (1998) only applied to entities registered under the Life Act and similar entities operating outside Australia – which at the time that AASB 1038 was introduced did not include friendly societies. Accordingly, friendly societies were exempted from measuring their policy liabilities using the Margin on Service (MoS) method used by life insurers.

The version of AASB 1038 operative for periods beginning on or after 1 January 2005 applies to life insurance contracts, no matter who writes them, which includes contracts written by many friendly societies.

In view of a number of factors, including the adoption of IFRS, ASIC has decided that its class order exemption for AASB 1038 will no longer apply to reporting periods on or after 1 January 2005, and the APRA has decided that its Prudential Rules will be adjusted accordingly for prudential reporting. It is expected that friendly societies will adopt the MoS method of measuring policyholder liabilities for general purpose financial reporting and regulatory reporting. Further, the Life Insurance Actuarial Standards Board (LIASB) has issued Discussion Drafts of revised actuarial standards that will require friendly societies to apply the Valuation Standard that applies to life companies generally. These revised standards will apply to annual reporting periods ending on or after 31 December 2005.

Life Regulation 2A.01 was made to exempt friendly societies from certain parts of the Life Act when friendly societies were brought under the Life Act. The exemptions include the provisions that define participating and non-participating business, determine the allocation of profit and provide policyholder protection in the allocation process. The effect of these exemptions is that, whereas life companies have definitively allocated capital and retained profits as either part of shareholder equity or policyholder liabilities, friendly societies have not and can have unallocated profit. The rules of some friendly society benefit funds may allow that surpluses within the fund may alternatively be allocated or distributed to:

- the members (i.e. policyholders) of the approved benefit fund;
- the management fund; or
- another benefit fund of the society.

Until such time as a distribution is made, this surplus remains unallocated and hence has a similar nature to the "policyholder equity" in life companies operating in some overseas markets.

AASB Preliminary Conclusions

The AASB proposes to amend AASB 1038 to acknowledge that friendly societies may have unallocated surplus that is “policyholder equity”.

The proposed amendments are shown in the Appendix to this Invitation to Comment as marked-up paragraphs of AASB 1038.

Request for Comments

The AASB invites comments on the proposed amendments.

APPENDIX

This Appendix shows relevant paragraphs of AASB 1038 marked up for the amendments needed to acknowledge that friendly societies may have "policyholder equity". Paragraph 9.2.1 also shows an amendment to AASB 1038 needed to accommodate both friendly societies and life insurers with foreign life insurance operations.

4.1.2 Equity in a shareholder-owned life insurer will generally comprise only shareholder equity. Although participants in the industry commonly refer to "policyholder retained profits", in relation to Australian business such amounts are unvested policyholder benefits liabilities. Under Australian legislation, "policyholder retained profits" relating to Australian *life insurance business* are paid to policyholders, although the timing of the payment is at the discretion of the life insurer. A life insurer ~~will only~~may have policyholder equity if ~~that life insurer~~ it is a friendly society or has foreign life insurance operations in a jurisdiction that permits retained profits to remain unallocated between policyholders and shareholders, and the policyholders' component has yet to be determined.

9.2 Participating benefits relating to Australian insurance contracts (excluding contracts issued by friendly societies) that have been allocated in relation to the reporting period to participating policyholders generally, but that have not yet vested in specific policyholders, shall be recognised as expenses for the reporting period. Amounts relating to Australian insurance contracts (excluding contracts issued by friendly societies) that have been allocated to participating policyholders generally, but that have not vested in specific policyholders as at the reporting date, shall be recognised as unvested policyholder benefits liabilities.

9.2.1 Some life insurers sell participating business. Participating policyholders are generally eligible to receive the same types of benefits as other policyholders and, in addition, are entitled to participate in the profits relating to participating business. For example, a participating policyholder may receive a low contractually determined rate of return on savings together with term life cover and, in addition, receive benefits that depend on the investment performance of the pool of assets associated with participating policies and on the risk experience of participating policyholders. These additional benefits are often called bonuses and are at the discretion of the life insurer. In some reporting periods the life insurer may withhold a portion of the "profits" from the pool of participating business and recognise these "profits" as unvested policyholder benefits liabilities or, in the case of friendly societies and life insurers with foreign life insurance operations, as "policyholder equity". In other reporting periods the life insurer may “top up” the vested benefits to participating policyholders. Such vesting of benefits is often done to provide a reasonably level vesting of benefits over time, despite volatility in periodic profits from participating business.

9.2.2 It is sometimes argued that the discretionary nature of participating benefits means that they should be treated as appropriations of profit in the same way as dividends to shareholders. Because life insurance liabilities relating to all types of policyholders are recognised as liabilities under the Life Insurance Act, in respect of Australian insurance contracts (excluding contracts issued by friendly societies)~~,~~ it is appropriate for the participating benefits allocated or vested in relation to the reporting period, other than transfers from unvested policyholder benefits liabilities, to be recognised as expenses of the reporting period. However, for friendly societies and life insurers with foreign life insurance operations, where part of the profit remains unallocated, an expense is not recognised until the benefit actually vests.

17.5.2 A life insurer that has issued participating business may have “retained profits” generated from that business. In relation to Australian participating policyholders, these “retained profits” are liabilities in accordance with the Life Insurance Act. However, in friendly societies or foreign life insurance operations, “retained profits” may exist which have yet to be allocated between policyholders and shareholders. Such “retained profits” are separately disclosed. It is relevant to note that “retained profits” directly attributable to shareholders may reside in both statutory funds and a shareholder fund.

17.5.3 Where, in friendly societies or foreign life operations, “retained profits” exist, which have yet to be allocated and which are treated as equity then the insurer applies paragraphs 17.5.4 and 17.5.5 to this participating business~~ written by foreign life operations~~.

17.5.4 Where a life insurance contract with a discretionary participation feature is issued by a friendly society or foreign life operation, the issuer of such a contract:

(a) may, but need not, recognise the guaranteed element separately from the discretionary participation feature. If the issuer does not recognise them separately, it classifies the whole contract as a liability. If the issuer classifies them separately, it classifies the guaranteed element as a liability;

(b) shall, if it recognises the discretionary participation feature separately from the guaranteed element, classify that feature as either a liability or a separate component of equity. This Standard does not specify how the issuer determines whether that feature is a liability or equity. The issuer may split that feature into liability and equity components and shall use a consistent accounting policy for that split. The issuer shall not classify that feature as an intermediate category that is neither liability nor equity;

(c) may recognise all premiums received as revenue without separating any portion that relates to the equity component. The resulting changes in the guaranteed element and in the portion of the discretionary participation feature classified as a liability shall be recognised in profit or loss. If part of the entire discretionary participation feature is classified in equity, a portion of profit or loss may be attributable to that feature (in the same way that a portion may be attributable to minority interests). The issuer shall recognise the portion of profit or loss attributable to any equity component of a discretionary participation feature as an allocation of profit or loss, not as expense or income (see AASB 101 *Presentation of Financial Statements*);

(d) shall, if the contract contains an embedded derivative within the scope of AASB 139, apply AASB 139 to that embedded derivative; and

(e) shall, in all respects not described in paragraphs 14-20 of AASB 4 and paragraphs 34(a)-(d) of AASB 4, continue its existing accounting policies for such contracts, unless it changes those accounting policies in a way that complies with paragraphs 21-30 of AASB 4.

17.5.5 The requirements in paragraph 17.5.4 also apply to a life investment contract issued by a friendly society or foreign life insurer that contains a discretionary participation feature. In addition:

(a) if the issuer classifies the entire discretionary participation feature as a liability, it shall apply the liability adequacy test in paragraph 8.6 to the whole contract (i.e. both the guaranteed element and the discretionary participation feature). The issuer need not determine the amount that would result from applying AASB 139 to the guaranteed element;

(b) if the issuer classifies part or that entire feature as a separate component of equity, the liability recognised for the whole contract shall not be less than the amount that would result from applying AASB 139 to the guaranteed element. That amount shall include the intrinsic value of an option to surrender the contract, but need not include its time value if paragraph 2.2.2 exempts that option from measurement at fair value. The issuer need not disclose the amount that would result from applying AASB 139 to the guaranteed element, nor need it present that amount separately. Furthermore, the issuer need not determine that amount if the total liability recognised is clearly higher; and

(c) although these contracts contain financial instruments, the issuer may continue to recognise the premiums for those contracts as revenue and recognise as an expense the resulting increase in the carrying amount of the liability, subject to the requirements of paragraphs 5.1 and 5.2.