Discretionary Benefits

Issue
The form and content of insurance contracts developed over centuries is a consequence, mostly, of national peculiarities, especially peculiarities of the national legal and regulatory system. Historically, insurers were often seen as a kind of fiduciary, or beneficial organization, or a quasi-statutory body, executing the contracts with common welfare in mind. As a consequence, structures developed, and remain, in insurance contracts that are very unusual outside of the insurance industry.

Further, the insurance business contains a much more significant uncertainty than does any other business, because the substance of insurance is simply the transfer of uncertainty. To cope with that an approach developed which can be described as “retrospective pricing”, i.e. initially an overly careful price is charged (the “guarantee”) containing room to return parts of the overcharged premium later in the form of benefits additional to those guaranteed. Depending on the historical development, the repayment is made in a legally described form (performance-linkage, i.e. the obligation to return either a legally specified part of surplus after providing guaranteed benefits, or additional benefits irrespective of actual surplus levels); or is less regulated. Accounting consequences of legal obligations granting policyholders a share in surplus are discussed separately since such obligations are not, in general, discretionary or voluntary but involve, nevertheless, accounting peculiarities that must be considered. Clearly, such obligations are, in principle, to be recognized as liabilities but the timing or recognition and the measurement thereof depends on the form and economic function of such features.

In general, insurance contracts often contain benefits where the amount or timing of those benefits (other than those triggered and determined by insured events) is not precisely defined in the contract or in applicable law. From a formal legal viewpoint, the benefits or a part of the benefits do not appear to be obligatory.

We can distinguish two types of non-obligatory benefits, voluntary and discretionary benefits:

- **Voluntary benefits** are benefits which are provided in addition to those benefits to which specific reference is made in the contract
- **Discretionary benefits** are benefits, which are referred to in the contract but the economic value is not defined, i.e. subject to the decision of the insurer.

A voluntary benefit is not a contractual benefit, although it is paid to contract-holders. It is a pure ex-gratia payment and nobody would miss it specifically if it is not paid. A discretionary benefit is a contractual benefit but not economically a contractual obligation, since the economic value is subject to the decision of the insurer. Contracts may specify
- how that benefit is forward to the policyholder, e.g. used to increase the sum insured,
- when it is paid, if anything is paid, or
- that something is paid without specifying how much is to be paid, allowing as well a benefit of a negligible economic value.

Relevant is, that the terms of the contract does not hinder the insurer to choose a benefit of negligible economic value. Cases are less clear, if the contract requires a benefit of significant economic value, but grants the insurer a right to specify that benefit within a significant range.
In that case, the minimum payment is an obligatory benefit, and just the choice on top is a discretionary benefit. However, such benefits might be subject to constraints. It is possible to describe a spectrum of declining constraint of discretion:

- **Legal constraints** either as legal obligation established by the contract (two-sided agreement) or by law, which are legally enforceable or by equivalent means. Typically these very precisely describe the amount and timing of any benefit. As well a constructive obligation is covered by that constraint, since they are as well – as defined now by the IASB – legally enforceable. The difference is that they are created as a result of unilateral behavior rather than by law or a two-sided agreement and therefore often less precisely defined.

- **Regulatory constraints** established by observable regulatory practice, typically to some extent case specific and, therefore, less precisely describing the amount or timing of any benefit.

- **Presumed regulatory constraints**, which are generally presumed by the industry and experts to exist, but which never were confirmed in the absence of any malpractice avoided by anticipatory behavior of all entities subject to regulation. These are consequently very vague in prescribing the amounts or timing of benefits.

- **Constraints by market practices**, enforcing a particular entity behavior by market conduct demonstrably executed by all market participants, describing amount or timing in a similar strict way as contractual obligations, which are substituted by such practices.

- **Constraints by an independent fiduciary position of the management**, based on a legally granted independence of the management from owners in determining those additional benefits, subject to their professional conduct.

- **Economic constraints** (economic compulsion) caused by the potential marketing effect to new business, or persistency of existing business (policyholder behavior), if the entity does not provide benefits of a certain level, hence the constraint is an assessment to maximize owners’ returns considering the interrelationship of effects.

### The new definition of asset and liability

The IASB has recently considered new definitions of “asset” and “liability”. The new definition of a liability is the following.

A liability is a present economic obligation of an entity. A liability of an entity has three essential characteristics:

- a. The entity is obligated to act or perform in a certain way (or refrain from acting or performing).
- b. The obligation exists at the financial statement date.
- c. The obligation is economic — it is an obligation to provide its economic resources to others, or to stand ready to do so.

On the other hand, the new definition of an asset appears to be less strict:
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An asset is a present economic resource to which an entity has a present right or other privileged access. An asset of an entity has three essential characteristics:

- There is an economic resource.
- The entity has rights or other privileged access to the economic resource.
- The economic resource and the rights or other privileged access both exist at the financial statement date.

Hence, a non-enforceable access to a resource, which is just privileged, can be an asset, while enforceability is required by the definition of a liability. That could be interpreted as resulting in a bias towards easier recognition of an asset compared with a liability. Although prudence is no longer an accounting quality in the new Framework project, such an interpretation would be the opposite of prudence, i.e. as highly biased as prudence could be if wrongly understood. To avoid that, it is necessary to interpret the term “obligation” in the definition of a liability in a manner covering all actually existing constraints except those reflecting simply economic choices and decisions other than those of the owners to be decision-useful.

The historically developed peculiarities of insurance business require here a much more in depth view than in other circumstances, based on general legal approaches.

Application to insurance business
There is no doubt that legal and regulatory constraints of discretion create a liability.

In the case of economic constraints, i.e. where discretion is constrained only by economic considerations regarding new business or persistency, there is little justification for a liability. The decision for the insurer is – without any other constraint – whether to pay certain benefits and, as a consequence, to acquire or retain a certain resource from the resulting new business or persistency, or not to pay the amounts and consequently to lose that specific economic opportunity. Such benefit expenses are entirely comparable with acquisition cost or marketing costs incurred to acquire new business, or persistency commissions paid to agents to improve persistency. That is true even if it might mean that for a relatively small amount not spent that the entire new business perspective is lost or that all existing customers cancel their contracts. Such a situation would not be expected to occur in perfect markets, but is often observable in the real world as a consequence of seeming irrational behavior of policyholders.

One of the most important goals of financial reports is to demonstrate such economic decisions and the underlying alternatives, i.e. to show which costs are associated with which economic benefits. Presenting today as liability future benefits which are based on a future decision to achieve a future economic advantage would impair the ability of users of financial reports to understand the rationale behind the decision. Reporting a liability implies that there is not really a choice in future. Otherwise, it is most informative to report those amounts separately indicating the intention to establish in future voluntarily obligations for that amount. If the economic consequences of a non-paying a voluntary small amount are relatively large, that should be disclosed in the notes to the financial statements rather than reported as a liability. Clearly, the effects of not recognizing economic constraints should be considered in measurement, especially when considering the consistency of assumptions regarding future additional benefits and lapse rates, as is outlined in more detail later.
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The case of **presumed regulatory constraint** is merely a problem of confirming evidence rather than determining presence of an obligation in principle. An presumed regulatory constraint is – if actually present – a current legal, enforceable obligation and, therefore, results in the recognition of a liability. If the general view of the industry and experts confirms that there is a regulatory constraint, that evidence should be sufficient for recognition. The question of extent of that constraint is a measurement question rather than a recognition question. Guidance not to recognize that liability if it cannot be measured reliably would conflict with the requirement not to recognize revenue from the overall transaction if that cannot be measured reliably. Since those additional benefits under the contract do not form a liability of their own but are an integral part of the insurance liability (such additional benefits are an integral part of the overall pricing of the contract), the recognition criteria need to be applied to the insurance liability overall reflecting the entire transaction, i.e. the entire insurance contract, hence, no initial gain from entering into the contract might be recognized in absence of a reliable measurement of presumed regulatory constraints.

**Business practices** may create an obligatory compulsion which is in effect just as strong as a legal obligation. Breaking with business practices usually means, that the entity (and its owner) is no longer looked upon as a serious and prudent business partner and nobody is willing to do business with that entity, regardless of price. The rejection of the entity as a business partner is not an economic question but rather is a matter of principle. The entity looses its reputation rather than its competitiveness. The difference between economic compulsion and pressure by business practices is that, in the case of economic compulsion, the entity might miss a – potentially larger – economic advantage by not complying, while, in case of pressure by business practices, the alternative is cessation of any business activity. The difference between constraints by business practices and legal constraints is that the threat to the entity is not of legal nature but social. Relevant is that non-compliance threatens the entire entity, not only the economics of a transaction.

The insurance business, especially the reinsurance business, is based on trust and reputation, which includes since long times in many reinsurance treaties a reference to usances of reinsurance business rather than relying entirely on legal enforcement. The market of reinsurers is small and the participants are transparent. A reinsurer breaking from market practices will no longer be able to participate in that market. That forces the business ultimately to close down; it is often not even possible simply to make a change, e.g. business subject since intangible assets will usually not allow that. As well, legal enforceability can have effects that force the closing down of the business, i.e. loosing all intangible assets. That is usually a sufficient threat to enforce any desired behavior. The definition of “enforceability” does not include what the enforcing power is, only that threat exists, and that in no reasonable circumstances is an acceptable alternative. Such a business or market constraint cannot be valued less than legal forms of enforcement. Thus, such business practices should be assumed to create liabilities whose enforcement is commonly recognized by all market participants.

The **fiduciary position** reflects an insurance peculiarity. Unlike all other industries, it is not uncommon in insurance legislation to grant management or specific members of management (e.g. the appointed actuary) independence from owners in executing specific tasks. For example, German law determines that the appointed actuary is not bound to any advice by the board of
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directors or owners in providing the legally required proposal about policyholders’ participation. Further, the executive members of the board are obliged to safeguard policyholders’ interests in all their decisions and to be fair regarding additional benefits, and the owners have no right to influence that decision (owners are allowed to increase voluntary benefits later for economic reasons allocating, as well, a part of their own share to policyholders, if they so wish). In this regard, the executive members of the board are independent from owners.

However, it is not sufficient that the independence is only in form. It has to have demonstrable substance. That might be reflected, for example, as a legal control of the management through a regulatory authority. If the regulatory authority develops the impression that the management is not actually acting independently in that regard, it could dismiss those persons and those persons would be prevented from taking any similar position in the insurance industry again, since such employment is subject to the approval of the regulatory authority. Considering the specialization of insurance managers, that is effectively a professional ban, and would destroy the career of the person. Hence, compliance with those independence requirements might be more important for management than complying with the wishes of owners. The latter could only dismiss a manager but not actually destroy his career. In some countries, regulators may ask discomforting questions of owners of an insurer, if those owners choose to dismiss managers (e.g. the appointed actuary) without good reasons, but just for deviating from the owners’ inappropriate wishes.

Such legislation has the effect that the management is actually acting like a third party or a trustee in determining such benefits. The amounts are subject to the discretion of a third party, not of the “insurer”, i.e. an entity acting to the benefit of its owners.

In all such countries legally granting management a substantially independent position in case of determining additional benefits (participation benefits), the amount expected by management to be decided in future to be paid to policyholders is a kind of liability of management rather than equity, since management can enforce the distribution of those amounts are to policyholders in the future, without the ability of owners to avoid it. Thus, management is a third party, acting independently. An exit value would consider which amounts are expected by market participants to be paid by management in its fiduciary role to policyholders. Those amounts would be reasonably reported as liabilities subject to management’s discretion under legal independence rules, rather than as a part of the insurance liability. That liability is obviously not a contractual liability under the insurance contracts.

Considering the unique legal situation in insurance business, even applying IAS 1.17 would be adequate, if it is not otherwise possible to report that situation adequately, if the IASB feels unable to provide guidance for that special case of an independent fiduciary position.

**Consistent interpretation of asset definition and liability definition in case of expectations of policyholders’ behavior and insurer’s behavior**

Where ever accounting approaches consider future advantageous policyholders’ behavior as asset, as well at least any consistently required voluntary or discretionary benefits needs to be recognized as liability simply to be consistent. An alternative would be to measure that advantageous policyholders’ behavior under the assumption that no voluntary or discretionary benefit is paid. But referring to expectations regarding policyholders’ behavior in recognizing
assets requires as well recognizing expectations regarding management’s behavior in liabilities entirely. The interpretation of the definition of an asset might not be more generous than the interpretation of the definition of a liability. Expectations regarding behavior of other parties are clearly less reliable than expectations regarding own behavior, especially if those other parties did not even provide any clear indication of their intentions. Information about intentions of the own management regarding future behavior (especially if consistent with observable past behavior) are clearly more relevant for users of financial reports than information of assumed intentions of customers (even if consistent with observable past behavior).

Conclusion
A liability is recognized for any present obligation on the reporting date. An obligation is present if there is a
- legal obligation
- constructive obligation
- regulatory constraint based on observed or declared behavior of the regulatory authority as a special form of legal obligation
- regulatory constraint based on general expectation by market participants and experts of the expected, though not yet observed, behavior of the regulatory authority, since anticipatory obedience avoided any issue up to now, as a special form of legal obligation
- business practice as assessed by the general view of market participants and experts, any violation of which would affect the reputation of the entity or management and question any acceptability to a serious contract partner, as a special form of constructive obligation
- legal independence of management in determining the benefits in question and a general accepted requirement of the management to act in a fiduciary role even if that is not in the interest of the owners, as a special form of legal obligation to the management assumed to act independently.

Guidance
It is necessary to avoid any misuse of those constraints. However, the fact that regulatory behavior, independence laws and market practices affect all entities of in a jurisdiction or the market requires that the guidance in question is applied consistently by all insurers in that jurisdiction. If a significant number of entities insist that the behavior of the regulatory authority, the substance of the independence rules or practices would be different, there is obviously no common view in that regard and no entity would be allowed to recognize a liability on that basis. For example, there is a demonstrable tradition of the necessity for such practices before it can be recognized. Further, it must be demonstrable that those practices have an enforcing effect. In case of reinsurance business, it can be assumed that those practices have an enforcing effect only for reinsurers rather than for cedants and might cause liabilities on reinsurers’ side.

Consequences
Reporting future benefits subject to unconstrained discretion as equity (possibly as a separated component of equity) might cause higher equity than is usually the case today. In many cases, presumed regulatory constraints or independence of management will be present and the measurement of the liability will require investigation of which amounts are actually subject to those constraints. This is often a subjective decision. There will be some contracts where the
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discretion regarding additional benefits is actually unconstrained and of a significant volume compared with realistic profit expectations. However in many cases, other features of IFRS will limit the surplus recognized in equity despite the expectation that it will be paid voluntarily to policyholders in future.

First, it can be expected that IFRS will not allow anticipation of future gains subject to policyholder’ behavior, at least not significantly above initial cost spent indicating the value which market participants at least associate with the policyholder relationship asset. To this extent, gains will only be recognized as they are released from lapse risk. That limits the amount of recognized accumulated surplus which can be subject to unconstrained discretion.

A significant part of that surplus will be immediately allocated to regular bonuses or dividends and is a liability subsequently. Only revocable terminal bonuses or dividends or revocable allocations to collective participation funds would remain equity for a considerable time. It is observable that markets actually granting total discretion typically allocate amounts irrevocably rather providing terminal payments. Policyholders would not normally rely on insurer’s behavior if a significant part of pricing is made at insurer’s discretion decades after issuing the contract. There will be a constructive obligation, or presumed regulatory constraints or a fiduciary position. Cutting terminal payments amounting to a significant part of overall benefits without good reason based on surplus levels would not be accepted.

As far as those terminal payments are actually declared irrevocably in case of surrender, they are also at the reporting date subject to the minimum deposit floor and, therefore, should be considered in the measurement of the insurance liability, even if they are revocable regarding the amount payable at the maturity date.

To the extent that the amounts are paid voluntarily to avoid lapses, measurement of the contracts should consider that interrelationship. However, the measurement of the liability itself will not include any consideration of favorable persistency, just the policyholder relationship asset. Hence, considering voluntary payments could only result in an increase of the liability, which is not reasonable. But the assumed persistency within the policyholder relationship assets must be consistent with the voluntary expenses. That means, no policyholder relationship asset can be recognized as long as any amount, that must voluntarily be paid to policyholders to achieve the assumed persistency, is reported as equity. As a consequence, if such amounts arise, they would first be eliminated by writing off the policyholder relationship asset to the same amount. Only if no policyholder relationship asset remains, would such amounts be reported in equity.

As a result, it is not expected that non-recognition of actually voluntary or discretionary benefits would cause often significant initial gains in an environment of non-recognition of future advantageous policyholders’ behavior. Special care is needed to avoid reporting as initial gain (or gain in subsequent measurement) any amount which might be subject to any constraints except economic constraints.