

# Non-Profit Business in a With-Profit Fund

## Background

This paper considers the treatment under IFRS 17 of non-profit business written in a UK-style participating (with-profits) fund.

In a UK-style with-profits fund, profits are distributed between policyholders and shareholders, typically on a 90:10 basis. The profit sharing is governed by the Financial Conduct Authority's Conduct of Business Regulations, the Articles of Association of the insurance entity and a document entitled the Principles and Practices of Financial Management (PPFM) which sets out how the fund is managed and how discretion is exercised. Shareholders can only receive distributions from the fund if profits are distributed to policyholders in which circumstance shareholders receive their share.

Benefits paid to policyholders are generally calculated by reference to "asset shares" which broadly reflect the policyholders' share of the with-profits fund assets attributable to their policies taking account of the investment performance of the fund.

With-profits funds typically include excess assets ("inherited estate") which are available to support existing and future contracts. These excess assets will have arisen from a number of sources and either:

- the entity has undertaken a formal court approved attribution exercise in which case ownership of the estate (between shareholders and policyholders) is known and any distribution from the estate must be in accordance with a court approved scheme; or
- no attribution exercise has been undertaken in which case the estate is not owned either by the shareholders or policyholders in which case distributions to policyholder and shareholders can only be made as described above (e.g. on a 90:10 basis).

For UK-style with-profits business, there is full mutualisation between contracts, i.e. there is full sharing of all risks such that benefits of certain contracts can be reduced to meet claims payments in respect of other contracts. Such sharing of risks can be between generations of policyholder, i.e. across annual cohorts. The mutualisation can either occur directly between contracts or indirectly via the inherited estate.

It is common for non-profit business (e.g. annuities and unit linked business) to be written in a with-profits fund. This business can either be:

- owned by with-profits contracts in the fund, in which case the profits on the non-profit business accrue to the asset shares of the with-profits contracts and are distributed between policyholders and shareholders in accordance with the profit sharing mechanism described above (e.g. on a 90:10 basis); or
- owned by the inherited estate, in which case the profits of the non-profit business accrue to the estate and can only be distributed in accordance with the rules for distributing the estate described above.

In summary, the shareholder is generally entitled to no more than 10% of the profits arising on all of the contracts in the fund (with-profits and non-profit). Shareholders are only required to inject assets into the fund in circumstances where guarantees are biting on all with-profits contracts and any inherited estate is exhausted – this is generally referred to as "burn-through".

To provide an indication of the scale of such business, total existing liabilities for non-profit business written in the with profits funds of 3 major UK insurers are circa GBP 25 billion.

### **IFRS 17 requirements**

The measurement of liabilities for non-profit business written in a with-profits fund comprises the:

- Best estimate liability - the estimated future cash flows adjusted to reflect the time value of money and any financial risks related to those cash flows.
- Risk adjustment - IFRS 17.37 states that this reflects the compensation that the entity requires for bearing the uncertainty about the amount and timing from non-financial risk. Our interpretation is that the risk adjustment should only reflect the shareholders' exposure to the non-financial risk and should not include the risk absorbed by with-profits policyholders.
- CSM – IFRS 17.38 states that this represents the unearned profit that the entity will recognise as it provides services in the future. The entity will only receive the shareholder's share of profits on the non-profit business in the with-profits fund. However, the IASB educational material entitled "Insurance contracts issued by mutual entities" dated July 2018, although not directly applicable to with-profits funds in proprietary companies, suggests that the CSM would reflect the total unearned profit on the non-profit contracts, i.e. both the shareholders' and policyholders' share.

IFRS 17 paragraphs B67-B71 describing the requirements for contracts with cash flows that affect or are affected by cash flows to policyholders of other contracts are not considered to be applicable as the with-profits contracts and the non-profit contracts do not share in the returns on the same specified pool of underlying items.

The measurement of the liabilities of the non-profit contracts is determined on a fulfilment basis in accordance with the requirements of IFRS 17. However, where these contracts form part of the underlying items of the with-profits contracts in the fund, in accord with IFRS 17 the measurement of the CSM of the with-profits contracts should reflect the fair value of the contracts determined in accordance with IFRS 13.

### **Implications**

The IFRS 17 requirements described above result in the following outcome:

- In circumstances where the non-profit contracts are owned by with-profits contracts, the non-profit contracts form part of the underlying items. As described above, underlying items are measured at fair value (in accordance with IFRS 13) whereas non-profit insurance contract liabilities are measured at fulfilment value (in accordance with IFRS 17) and non-profit investment contracts are measured in accordance with IFRS 9. There could be a number of reasons why these values differ, including exit value versus fulfilment value principles or the allowance for a deposit floor. We note the IASB's intention to avoid accounting mismatches. However, the issue described above results in an accounting mismatch, the movement on which is recognised in P&L and shareholder equity. We are concerned that this issue will result in significant volatility that cannot be mitigated by existing options in IFRS 17.

- In circumstances where the non-profit contracts are owned by the inherited estate, the CSM on those contracts is fully (100%) recognised in P&L over their coverage period and flows into shareholder equity, despite the fact that shareholders would only be expected to receive a limited proportion of these profits (typically 10%). The outcome is that profit and shareholder equity will be overstated.

The Basis for Conclusions on IFRS 17 (BC266-BC267) recognises that such an approach to measurement will result in accounting mismatches. However, we believe that in either circumstance described above, the accounting outcome is not a faithful representation of the economics of the business.

### **Proposed solution**

The following amendments to IFRS 17 would address the concerns described above:

- Where non-profit contracts are owned by with-profit contracts, the non-profit contract liabilities should reflect the extent to which payments are made from the non-profit contracts to groups of with-profit contracts. This results in any uncertainty in the non-profit contract cash flows being met by the with-profit contract cash flows and any profit emerging on the non-profit contracts being paid to the with-profit contracts. The outcome is that the non-profit contracts have a zero risk adjustment and a zero CSM.
- Where non-profit contracts are owned by an inherited estate, the non-profit contract liabilities should reflect the expected distribution of the estate between policyholders and shareholders. This results in any uncertainty in the non-profit contract cash flows being met by the estate and any profit emerging on the non-profit contract being paid to the estate. The outcome is that the non-profit contracts have a risk adjustment and a CSM that reflects the shareholders' interest in the estate.
- Where the assets of with-profit contracts include profits from non-profit insurance contracts, those non-profit insurance contract assets should be measured at fulfilment value in accordance with IFRS 17, and when the assets of with-profit contracts include profits from non-profit investment contracts, those non-profit investment contract assets should be measured in accordance with IFRS 9.