

Swedish life insurance model facing major challenges

by Erik Alm, Malcolm Campbell, Alexander Dollhopf and Sören Kruse

In May 2007, the International Accounting Standard Board (IASB) published its discussion paper on a revised International Financial Reporting Standard for insurance contracts. The suggested treatment of policyholder bonus in life insurance contracts may create major challenges to the special mutual model for life insurance in Sweden. This article will discuss these challenges in detail, and is based on the comment letter that the Swedish Society of Actuaries has sent to the IASB as response to the discussion paper.

We start by introducing the IASB and then go on to describe the various company forms in Swedish life insurance. Of particular interest for this article are the various methods of distribution of profit to policyholders, which are described in Section 3. The paper then goes on to discuss the treatment of policyholder bonus according to the discussion paper and the implications thereof, and sets out potential challenges if allocated bonuses are accounted for as a liability.

I. The International Accounting Standard Board

The International Accounting Standard Board (IASB) was established in 2001 as part of the International Accounting Standard Committee (IASC) Foundation. The IASB has 14 board members, which are served by a secretariat based in London.

The objectives of the IASB are:

- to develop, in the public interest, a single set of high quality, understandable and enforceable global accounting standards that require high quality, transparent and comparable information in financial statements and other financial reporting to help participants in the world's capital markets and other users make economic decisions;

- to promote the use and rigorous application of those standards;
- in fulfilling the objectives associated with (a) and (b), to take account of, as appropriate, the special needs of small and medium-sized entities and emerging economies; and

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- to bring about convergence of national accounting standards and International Accounting Standards and International Financial Reporting Standards to high quality solutions.

Currently the IASB has published more than 40 standards and interpretations for accounting purposes.

The work on an international accounting standard for insurance contracts was started in 1997. In 2002, the work was split into two phases. The first International Financial Reporting Standard on insurance contracts (IFRS 4) was issued in March 2004, thereby finalising phase 1 of the work. This standard was soon adopted by the European Union and has been applied by member states from 2005.

The second phase of the work was started in September 2004, and in May 2007 an important milestone for this work was reached when the IASB published the discussion paper “Preliminary Views on Insurance Contracts”. The discussion paper was open for comments until November 2007. Based on the comments received, the IASB will now continue its work but does not expect to publish before 2009 an exposure draft of a new International Financial Reporting Standard. A final standard is not expected before 2010, thereby completing the work on phase 2.

2. Company forms in Swedish life insurance

In Sweden, life insurance activities may be run within four different company forms:

- Profit distributing shareholder-owned companies,
- Non-profit distributing shareholder-owned companies (so-called hybrid companies),
- Mutual companies, and
- Pension funds.

The existence of profit distributing as well as non-profit distributing shareholder-owned

companies in Sweden is historically based. After the Second World War, there were political discussions where the left wing parties, who were in power, suggested that all banks and insurance companies should be state owned. As a compromise, a fairness principle was introduced in the Swedish Insurance Company Act in 1948. The fairness principle stated that premiums paid by policyholders shall be fair compared to the benefits received by these policyholders. For life insurance business, this was interpreted to mean that all profits made on premiums should be returned as bonus to the policyholders, present or future. The shareholders of the companies were only allowed a fair return on the share capital, which in most companies was very small. This was in line with how some life insurers already operated, but was a major change for some others.

During the 1960's and 1970's, a practice emerged of paying no dividends at all to shareholders, and this was formalised when the Swedish Parliament in 1982 passed a bill that prohibited the distribution of profits to shareholders of a life insurance company.

This is what makes special the mutual model for non-profit distributing life insurance companies in Sweden: as in a true mutual life insurance company, no profit is distributed to shareholders but the company is still formally a shareholder-owned company. An important aspect of this is that the shareholders retain the right to make important business decisions for the company, without requiring permission from the policyholders or any of their representatives.

Around 1990, unit link life insurance was allowed in Sweden, and unit link companies were allowed to distribute profits to its shareholders through dividends.

Sweden became a member of the European Union in 1996, and a change to the Swedish Insurance Company Act in 2000 again opened up for distribution of profits to shareholders in

traditional life insurance companies. However, a process has been established to transform an existing life insurance company to a profit distributing company, where a transformation for example depends on the approval of the policyholders.

Since then, only a few existing life insurance companies have changed into profit distributing companies following the change of the company act. In these cases all existing capital of the company has been distributed to the policyholders while the shareholders have injected new risk capital in the form of equity into the company.

Table 1 sets out the assets under management at 31 December 2006 and premiums earned in 2006 of the different company forms in the Swedish life insurance market, for traditional life and unit linked business combined.

The following sections describe the different company forms in more detail.

2.1 Profit distributing shareholder-owned companies

A profit distributing shareholder-owned company's liabilities towards the policyholders emerge fully from the contractual obligations in the policy agreement. Through the policy agreement, the policyholders' rights to profit need to be directly linked to different measurable outcomes of the insurance activities. The company shall continuously set up technical provisions for these liabilities. Shareholders participate in profits, but their participation needs to be made contractually conditional in a well-defined (formula based) manner on specific variables, for example investment return in a certain period or biometric variables.

TABLE 1 Market share associated to different company forms in the Swedish life insurance market

	Assets under management (SEK million) <small>1</small>	Assets under management (% of total)	Premiums earned (SEK million) <small>1</small>	Premiums earned (% of total)
Profit distributing shareholder-owned companies ²	485	22%	44	35%
Hybrid companies	974	45%	45	35%
Mutual companies	586	27%	30	24%
Pension funds	125	6%	7	6%
Total	2 170	100%	126	100%

¹ Traditional life and unit linked business combined.

² SEB Trygg Liv Nya is already counted as a profit distributing shareholder-owned company and not a hybrid company,

although this transfer took place in 2007.

Source: Swedish Insurance Federation

2.2 Mutual companies, hybrid companies and pension funds

Mutual companies, hybrid companies and pension funds are all operated under mutual principles. The policyholders in such mutually operated life insurance companies are collectively entitled to all profits arising from the undertaking.

Under current Swedish accounting rules, the insurance liabilities arising from the contractual agreements with the policyholders relate to guaranteed benefits only, and are therefore called guaranteed insurance benefits. For these benefits only, the insurance company currently sets up technical provisions as a liability. The technical provisions are thus an estimate of what it may cost the undertaking to fulfil its guaranteed insurance benefits.

Mutually operated companies shall establish a so-called consolidation fund, containing annual profits to the extent that these profits are not immediately credited to the policyholders as cash payments or through guaranteed bonuses, and the profits are not used to support any required increase in the guaranteed liabilities. In line with the mutual character of the companies, the primary purpose of the consolidation fund is to cover deficits within the companies. If stated in a company's Articles of Association, the consolidation fund may also fully or partially be used as bonus to policyholders or for other purposes. The assets related to the consolidation fund may therefore be used as risk capital for the company as well as for bonus payments to the policyholders. A final allocation of bonus to individual policyholders, the so-called crediting, will normally first take place simultaneously with the payment of the guaranteed benefits. Until then, the assets in the consolidation fund may be used to cover deficits of the company. For this reason, the consolidation fund forms part of the equity

and not of the liability under current accounting rules, and is eligible as available capital under the current solvency framework.

In the following we will try to be consistent in terminology: Where we refer to "allocated bonus", we mean a preliminarily allocated bonus which is in no way guaranteed. Where we refer to "credited bonus" we mean a bonus that is formally credited to the policyholder and is guaranteed (either as a payment now or as a future guaranteed benefit).

In mutually operated companies offering with-profit policies, the allocated bonus reflects a substantial part of the expected future payments under the insurance policy. Handling and distribution of this profit is therefore of core importance to the policyholders.

3. Methods for profit allocation in mutually operated life insurance companies

To understand the challenges facing mutually operated life insurance companies in Sweden we have to go through the methods for profit allocation to policyholders of these companies:

- Collective premium discount method
- Pension supplement method
- Retrospective reserve method

These are described further in the following sections.

3.1 Collective premium discount method

The collective premium discount method usually relates to risk and disability business (but also certain property casualty product lines).

When the consolidation fund is larger than what can be motivated as a buffer and considering a company's financial situation as a whole, the company will normally credit parts of the consolidation fund as a collective premium discount, usually distributed in equal

proportions to all current policyholders. A relatively new policyholder may thereby benefit from a profit share despite the fact that he or she may only have contributed marginally, or even negatively, to the emergence of the consolidation fund. On the other hand, a policyholder may lose its part of the consolidation fund if the insurance policy has ceased due to claim, surrender or termination.

3.2 Pension supplement method

For defined benefit pension schemes held in mutually operated insurance companies, profits are usually distributed according to the so-called pension supplement method.

In a defined benefit scheme, the employer (the policyholder) has assumed the liability to pay pension benefits to the employee (the beneficiary) of a well-defined amount – expressed as a guaranteed monetary amount or as a percentage of the final salary. The emerging profits are usually used to adjust old age pensions or survivor pensions in payout for inflation. Also paid-up policies are adjusted for inflation or according to a certain index. The pension supplementary method is therefore an indexation of the defined benefit schemes. Please note that in most defined benefit schemes, indexation is not stipulated by the contractual insurance agreements but rather arises from profits emerging from the insurance activity.

Companies may also credit parts or all of the profits from defined benefit schemes through collective premium discounts or lump sum repayments to the employers.

In addition to the insurance liabilities reflecting guaranteed benefits, additional capital is held in the consolidation fund to provide the possibility of future benefit indexation in years with low profits. However, past indexations can be taken back if the financial situation of the company so requires. The entire consolidation fund thus serves as risk capital.

3.3 Retrospective reserve method

For traditional with-profit defined contribution business held in mutually operated insurance companies, profits are usually distributed according to the so-called retrospective reserve method.

3.3.1 Purpose and concept

The purpose of the retrospective reserve method is to distribute the profits to policyholders in relation to their contribution to the emergence of these profits on a smoothed basis, whilst ensuring that short term variations do not fully influence benefit payments to policyholders. For each individual insurance contract, a retrospective reserve is maintained that may be characterised – in a simplified manner – as an account where premiums, investment returns, expenses, risk premiums and benefit payments are accounted for on a smoothed actual basis. This reserve could be compared with the asset share used in British life insurance to calculate terminal bonus. While policyholders pay premiums, the value of their retrospective reserves is increased accordingly and then decreased through benefit payments.

The retrospective reserve is viewed as the “value” of the insurance policy and is usually communicated regularly to the individual policyholders, together with information on the terminal bonus that would be paid if financial and other developments follow current projections, and together with the information that both the retrospective reserve and terminal bonus projection may be lowered if financial or other developments are unfavourable. Note that the retrospective reserve contains both a guaranteed part and a non-guaranteed part:

- The guaranteed part represents the benefits that the policyholder is entitled to according to contractual terms in the policy agreement. It is often referred to as the guaran-

teed reserve. Two different approaches for the calculation of the guaranteed reserve are observed in the market, either the sum of premiums paid accumulated with the guaranteed rate of interest or the present value of guaranteed future benefits according to the policy agreement less present value of contractual future premiums.

- The non-guaranteed part is the part of the retrospective reserve that exceeds the guaranteed reserve. It is often called allocated bonus or preliminarily allocation of profit and is an estimate of the value share of the accumulated profit that the policyholder in a mutually operated company may have at a certain point of time. Today, the non-guaranteed part of insurance policies constitutes up to 70 or 80 percent of the retrospective reserve in certain cases.

The policies' surrender value often reflects guaranteed benefits only.

3.3.2 Simplified balance sheet of mutually operated companies

The following figure illustrates a simplified

balance sheet of a mutually operated life insurance company as of today, excluding accounting items such as intangible assets, deferred acquisition costs, receivables, prepaid costs, prepaid income and other liabilities.

Liabilities are shown with four different splits into subparts. The first two are as presented in the balance sheet under current Swedish accounting rules. The third and fourth split are not directly obvious to the readers of the accounts, but usually can be reconstructed in an approximate manner since the collective consolidation ratio is disclosed (see the following sub-section).

To the extent that the policyholder allocation rate (see following sub-section) does not directly correspond to the emergence of profits, an unallocated surplus or deficit can arise. This is then accumulated into what is termed collective consolidation, a liability which represents the policyholders' interests in unallocated surpluses (or deficits).

Please note that the height of the boxes may not be illustrative for the relative size of the different balance sheet items.

Assets	Liabilities current				
Investment assets	Equity	Shareholder capital ¹	Shareholder capital ¹	Shareholder capital ¹	
		Consolidation fund	Collective consolidation ²	Collective consolidation ²	
	Technical provisions	Technical provisions	Allocated bonus	Retrospective reserve	
			Technical provisions	Technical provisions	

¹ Only applicable for hybrid companies, where shareholders provide small amounts of shareholder capital, often below SEK 1 million.

² Can be negative.

3.3.3 Collective consolidation ratio

The total sum of retrospective reserves for the contracts that an insurer holds under the retrospective reserve method may not necessarily correspond to the total value of assets associated with these contracts. The ratio between the total market value of assets and the total retrospective reserve is called the collective consolidation ratio. If the collective consolidation ratio is above 100%, the actual value of the company's assets is higher than the value of the contracts that has been communicated to the policyholders. Disregarding shareholder capital for hybrid companies, the collective consolidation is then positive. If the collective consolidation ratio is below 100%, the opposite is true and the collective consolidation is negative.

For most companies, the currently observable collective consolidation ratios are between 105% and 110%. Historically, the ratio has also been below 100% for a number of consecutive months. Companies usually accept that the collective consolidation ratio may fluctuate around a target value. This is formulated such that the ratio shall remain within a certain interval, while on deviations aiming to reach back to the target value within a 2 to 3 year time horizon. Should the collective consolidation ratio get outside defined upper or lower boundaries, companies usually perform a one-time allocation or re-allocation of assets to or from the retrospective reserve, thus raising or lowering the communicated value of the affected policies. Both allocations and re-allocations have in reality taken place during recent years.

3.3.4 Policyholder allocation rate

The allocation rate is the interest rate applied in the roll-forward calculation of the retrospective reserve, with the aim to allocate the achieved total asset return to policyholders on a smoothed basis. By changing the allocation rate relative to the actual return on assets, a

company may increase or decrease its collective consolidation ratio. An allocation rate lower than the actually achieved total asset return will increase the collective consolidation ratio, whilst a higher rate will decrease it. Historically, the rate has often been based on a forecast for the return on assets, and it has with minor exceptions been identical for all contracts of a company. Companies' established practice is to only gradually change the allocation rate for changes in assets returns.

Instead of defining an allocation rate, certain insurers also distribute positive or negative profits immediately to the retrospective reserve through an instantaneous re-allocation or allocation. In case of a re-allocation, the value of the allocated bonus (and thereby of the retrospective reserve) is decreased. In case of an allocation, the opposite is the case. Companies that apply this method for profit distribution always have a collective consolidation ratio of 100%.

3.3.5 When is the surplus credited to the policyholders?

The model for allocation of profits applied by mutually operated insurance companies using the retrospective reserve method implies that the policyholders do not receive their share of profits before the individual payments of guaranteed benefits under the insurance contract are made: all allocated bonus is distributed as terminal bonus. The benefits under an insurance contract may either be lump sum payments or periodical payments during a specific time period. In case of periodical payments, a part of the allocated bonus is added as a supplementary benefit to the guaranteed benefit payments at each payment date. The level of supplementary benefit is based on the available allocated bonus at that point in time. This means, in the case of a negative collective consolidation ratio, the payment is higher than the corresponding value of assets, and vice versa in case of a positive collective

consolidation. This method is a way to eliminate random fluctuations in the value of assets. If a fall in stock market leading to a negative consolidation is regarded as temporary, the company may pay a supplementary benefit that is higher than the insurance policy's corresponding part of the actual value of the company's assets. A target level of the collective consolidation ratio that is higher than 100% means that the company on average builds up and maintains a capital buffer over time.

Insurance policies in payment remain in the risk collective (including full exposure to asset risks and insurance risks) and – as a consequence – an allocation rate cannot be determined with certainty for the entire payment term. Thus, the allocation of profits is continued in the usual manner during the payment term, crediting the allocation rate to the retrospective reserve while expense loadings and payments are debited. The supplementary benefits are calculated based on the available allocated bonus at each date of payment. The supplementary benefits of a particular policy may therefore subsequently increase or decrease over time. The right to decrease supplementary benefits has been unsuccessfully challenged in court by affected policyholders.

4. Treatment of policyholder bonus according to the discussion paper

Following this introduction to company forms and profit allocation principles in Swedish life insurance we can present the major challenges to the special mutual model for life insurance that may be created by the discussion paper on a revised international accounting standard for insurance contracts.

The discussion paper suggests that future bonus to policyholders should be accounted for as part of the technical provisions and thereby as a liability if the company has a legal

on constructive obligation to pay these bonuses.

The reader of the discussion paper is referred to the accounting standard IAS 37 Provisions, Contingent Liabilities and Contingent Assets to determine whether a legal or constructive obligation to pay bonuses may exist.

The accounting standard IAS 37 defines legal and constructive obligations as follows:

A legal obligation is an obligation that derives from:

- (a) a contract (through its explicit or implicit terms)
- (b) legislation; or
- (c) other operation of law

A constructive obligation is an obligation that derives from an entity's actions 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.

Currently, there are arguments for and against classifying cash flows arising from preliminarily allocated bonus at Swedish mutually operated life insurance companies (hybrid companies, mutual companies and pension funds) as a constructive obligation. As the question is of legal nature, this article will not discuss or make any conclusions on this question.

We can, however, mention that the ultimate interpretation might differ amongst insurance companies, subject to their individual bonus allocation strategies and the extent to which this strategy is communicated to policyholders. This could result in two very similar companies showing largely different balance sheets due to different classifications of their consolidation fund.

In the remainder of this article we will discuss the implications to policyholders of mutually operated life insurance companies under the assumption that preliminarily allocated bonus is regarded as a constructive obligation under IAS 37 and thereby accounted for as a liability as suggested by the discussion paper.

4.1 Implications

Based on the above interpretation, we identify the following implications for Swedish insurance companies operated under mutual principles. As discussed above these implications do not apply to profit distributing shareholder-owned companies.

(1) The balance sheet is less relevant to users of the financial statements

Based on the assumption that allocated bonus is regarded as a constructive obligation, the simplified balance sheet shown in Section 2.3 above may change as shown in the following figure. The first liabilities column indicates the IFRS 4, phase 2 balance sheet, the second column the current picture as described above. Again, the height of the boxes may not be illustrative for the relative size of the different parts of the balance sheet.

This means that the equity in Swedish mutual life insurance operations will be reduced substantially, close to a level of zero or even negative:

- For companies in run-off, equity will, by definition, be zero as all assets ultimately need to be paid to existing policyholders (disregarding the small shareholder capital for hybrid companies).
- For companies writing new business, a number different from zero would indicate an amount of cross-subsidisation between current policyholders and future new policyholders.

We would regard the relevance of such a balance sheet as minimal to the users of the financial statements, as

- It would give the impression that the company is undercapitalised or even insolvent, even if this will not be the case under the regulatory solvency framework.
- The level of equity will give no indication of financial strength and the ability to meet creditor claims.
- The important difference between liabilities reflecting guaranteed benefits and non-guaranteed benefits is lost. This is relevant information to policyholders.

Assets	Liabilities IFRS	Liabilities current
Investment assets	Equity ²	Shareholder capital ₁
	Technical provisions	Collective consolidation ²
		Retrospective reserve

¹ Only applicable for hybrid companies, where shareholders provide small amounts of shareholder capital, often below SEK 1 million.
² Can be negative.

(2) The treatment is inconsistent with Solvency II

We recognise that accounting and regulatory capital requirements will be two distinct areas in the future. However, harmonisation would be desirable, in particular when it comes to the underlying balance sheet and calculation of the company's capital.

The Solvency II draft Framework Directive, issued by the EU Commission in July 2007, proposes the following treatment of participation contracts: When calculating technical provisions, an insurer shall take account of payments from future discretionary bonuses which the insurer expects to make, whether or not these payments are contractually guaranteed, unless those payments fall under Article 89 of the Framework Directive, which says:

- In so far as authorised under national law, realised profits appearing as surplus funds in the statutory annual accounts shall not be considered as insurance and reinsurance liabilities, to the extent that these surplus funds may be used to cover any losses which may arise and where they have not

been made available for distribution to policyholders and beneficiaries.

It is our current understanding that the consolidation fund falls under Article 89, with the only remark that it is also made up of non-realised profits on investment assets, as assets are accounted for at market value in Sweden.¹ Thus, its resulting payments should not be included in the calculation of technical provisions under Solvency II.

Therefore, seen from the perspective of Swedish mutually operated companies, the treatment of participating contracts proposed by the IASB differs significantly from the treatment proposed by the EU Commission. The balance sheet in the Solvency II context will be broadly similar to today's balance sheet, as illustrated in the figure below. This fact would cause difficulties for many Swedish insurers.

In a Solvency II context Available capital is the capital that is available to cover the solvency requirement of a company. Differences between the technical provisions under Solvency II and current accounting principles may arise from differences in discount rates and other parameters used.

Assets	Liabilities IFRS	Liabilities Solvency II	Liabilities current
Investment assets	Equity ²	Available capital (own funds)	Equity
	Technical provisions		Technical provisions
		Technical provisions	

(3) The effort to calculate the balance sheet stands in no relationship to the additional use

Except for companies in run-off where the calculation is trivial, the calculation of the insurance liability would require sophisticated financial projection models, as future cash flows depend heavily on the bonus allocation strategy and investment management strategy, themselves depending in a path-dependent and non-linear manner on the economic environment. The large calculation effort stands in no relationship to the usefulness of the accounts.

(4) Results can be manipulated

In case the calculation of technical provisions is dependent on a subjective view on future decisions on allocation rates, we are concerned that there will be a tendency for the desired answer to drive the assumptions rather than assumptions driving the answer.

5. Conclusion

Given the implications set out above, it is our recommendation that allocated bonuses are not accounted for as a liability for mutually operated life insurance companies.

A decision to exclude allocated bonus from the liability of the company could be motivated by the following line of argumentation:

In a mutual company, the policyholders are both customers and owners. As customers they pay a premium in exchange for a guaranteed benefit to be paid out at a later point in time. In their capacity as owners of the company they agree for this premium to be calculated in a prudent way and so provide the company with risk capital that is used to build up the assets that support the future bonus payments. This means, policyholders get their guaranteed benefit payments as customers and the bonus as owners. This would be consistent with general accounting practice,

where a company's obligations to its customers are accounted for as liability and the assets that will be distributed to the owners are accounted for as equity.

For a hybrid company, the above would not hold in a strictly legal interpretation. However due to the prohibition against profit-distribution to shareholders, the policyholders have effectively been given the owners role as providers of capital to the company. Furthermore as explained, the actual products and the treatment of allocated bonus of a hybrid company do not differ from that of a mutual company and thus the accounting principles should be identical.

Sources

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- Försäkringsutredningen: Förslag till Lag om försäkringsrörelse mm.; 1946

Notes

- ¹ Regarding the word "realised" in Article 89, it can be pointed out that in an economic valuation approach such as the one generally proposed under Solvency II, the concept of realised and unrealised profits is mis-placed as everything is valued at market value. Hence, the word "realised" should be dropped in Article 89.