International Review of Business Research Papers
Vol. 3 No.4 October 2007 Pp.152-160

Critical Information for "DPF contracts" Policyholders: Evidence from Italian Listed Issuers

Alessandro Lai* and Riccardo Stacchezzini**

Information about performances and risks is critical for making investment decisions. In the financial market, an investor can obtain information: a) directly from a financial instrument issuer; b) indirectly from the "market". Such information may permit to reduce asymmetry between issuer and subscriber of financial instruments. These topics are analysed in the paper considering the contracts with discretionary participation features, normally issued by companies operating in insurance and "bancassurance" sectors. We demonstrate that insurer's financial reports (that are the financial reports of the DPF contract issuers) help investor to reduce its information gap. The assumption is tested by focusing on the disclosure presented in the financial reports prepared in compliance with international financial reporting standards (IFRSs) and it is supported by: i. a financial report documental analysis prepared by all the Italian listed companies operating in insurance and "bancassurance" sectors; ii. interviews to insurers and audit companies managers.

Fields of Research: Bank and Insurance Companies, Assets and Liability Risks, Business Disclosure

1. Introduction

1.1. Critical information in "DPF contracts" markets

Every rational investment decision is taken by considering information about performances and risks. In the financial market, an investor can obtain information: *1)* directly from financial instrument issuer; *2)* indirectly from the "market" – that is the information offered in financial reports, analysts forecasting reports, etc. Such information permits to reduce asymmetry (Arrow, 1963; Akerlof, 1970) between an issuer and a subscriber of financial instruments.These topics are analyzed in the paper by considering the contracts with discretionary participation features (henceforth, DPF contracts), normally issued by companies operating in *insurance* and *"bancassurance"* sectors.The DPF contracts are subscribed by investors that will receive: *a)* guaranteed benefits; *b)* additional benefits whose amount or timing is contractually at the discretion of the issuer and that can be contractually based on:

*Alessandro Lai, Full Professor, Department of Business Administration, University of Verona (Italy), email: alessandro.lai@univr.it.
**Riccardo Stacchezzini, Assistant Professor, Department of Business Administration, University of Verona (Italy), email: riccardo.stacchezzini@univr.it.

(i) the performance of a specified pool of contracts or a specified type of contract; *(ii)* realised and/or unrealised investment returns on a specified pool of assets held by the issuer; or *(iii)* the profit or loss of the company, fund or other entity that issues the contract.

A DPF arises from a contractual right to receive additional benefits in addition to the guaranteed minimum payments as specified in the contract. Contractual rights may be enforceable legally or in some other way. However, the issuer has some discretion to vary the amounts that are linked in those ways. Moreover, although the right to receive the additional benefits is defined by reference to the contract language, the amount or timing of benefits payable under this feature will not be guaranteed until the point at which the amount or timing of these benefits has been determined.

The characteristics mentioned highlights that the issuer can use its discretion when it manages the related financial investments – that belong to a so-called “separate account” – and it recognises yields to subscribers (i.e., the policyholders). In particular, the issuer has to recognise guaranteed benefits to subscriber, but it can manage financial instruments by: *i.* keeping substantially unaltered the composition of the portfolio of financial assets that form the “separate account” and by recognizing gradually financial assets yields to the subscriber; *ii.* modifying frequently and/or substantially the composition of the portfolio, in order to maximize annual performances or to compensate losses due to bad sells or falls in market price.Obviously, a policyholder can be interested in receiving information about policies and about the related investment decisions made by the issuer of DPF contracts. But an issuer does not offer such information “directly” to the subscriber. The latter receives from the former only “customized” information about annual recognized performance. No information about issuer’s policies and related investment decision is offered.

It means that the problem of information asymmetry assumes a particular configuration in the insurance and “bancassurance” markets: each actor (issuer and subscriber of DPF contracts) does not know the future yields of financial assets in which the issuer will invest the sums given by the subscriber, but the latter neither know the former expected yield and its investment discretionary policies. This while this information is critical to figure out fairness and effectiveness of the issuer’s investment policies.

1.2. Looking for additional disclosure

Issuers offer to their DPF contracts subscribers a “customised” disclosure that do not contain some critical information useful for comparing performance and risk of DPF contracts issued by different insurers and “bancassurance” entities. This paper is aimed to focus on verifying whether the issuer’s financial report may help to reduce information asymmetry mentioned before.Someone could be sceptical: why the financial report that explains the financial performances of the issuer may help DPF contracts subscribers to make investment decisions? Normally a buyer does not analyse the seller’s financial performance when it decides to buy something from the latter. It looks for information about quality and reliability of products to be bought. No

information about seller's financial performance – leaving out the case of probable seller's default. And the seller does not prepare the financial report to accomplish the disclosure needs of the buyer.

The assumption tested in the paper is about the possibility that financial report of the DPF contracts issuer helps investor to reduce its information gap. This assumption is tested by considering the disclosure offered in the financial reports prepared in compliance with international financial reporting standards (henceforth, IFRS). The application of such standard is rising worldwide, and it must be considered that IASB – the Board that publishes IFRSs – and FASB – the Board that issues U.S. GAAPs – agreed on a convergence path.

By now, IASB is permitting to continue in adopting measurement methods provided for by local regulation, that does not impose to measure insurance liabilities at fair value, while financial assets are measured at fair value, with gains (losses) due to fair value increases (decreases) recognized to equity or net profits (in accordance with classification as "available for sale" or "fair value through profit and loss" provided for by *IAS 39 – Financial Instruments*). It is a particular permission made by *IFRS 4 – Insurance Contracts*, that represents a "stepping stone" to phase II of the IASB Insurance Project (Phase II, originally scheduled for 2007, is unlikely to come into effect before 2010).

Anyway, IFRS 4, paragraph 30, permits to change accounting policies so that a recognised but unrealised gain or loss on an asset affects those measurements in the same way that a realised gain or loss does. The related adjustment to the insurance liability shall be recognised in equity if, and only if, the unrealised gains or losses are recognised directly in equity. This practice, described as "shadow accounting", allows: *i)* to reduce the "accounting mismatch" due to non consistent evaluation of assets and liabilities; *ii)* to make "economic mismatches" emerge.The insurance liabilities measurement model must be considered in order to verify whether the financial reports prepared in compliance with IFRSs allows reducing the subscriber information gap. Before explaining the main research findings, we propose: *a.* a brief of literature review; *b.* illustration of research methodology adopted for the empirical analysis.

2. Literature review

If we observe from an economic perspective the topic of DPF contracts issued by insurers and "bancassurance" entities, we can note that, by now, business literature has given limited attention to: *i.* the way in which these contracts are managed by insurers; *ii.* the investor's yield and risk expectation and its disclosure needs; *iii.* the relationship between DPF contracts investment decision and the financial report disclosure. In particular, it can be stated that:
i. the issue of DPF contracts management is mainly discussed by practitioners that highlight the characteristics of such contracts (Focarelli & Doni, 2006a and 2006b; KPMG, 2006a and 2006b; Ernst & Young, 2006a). Moreover, limited attention has been given on how issuers make discretionary choices when they manage financial assets that belong to "separate account" and they calculate the rate according to which gains and losses are recognized to policyholders;

ii. the international literature has always given great attention to identify theories and interpretative models focussed on investment decisions about shares (ordinary shares, preference shares, etc.), explaining the shareholder's performances expectation in respect of systematic and specific risks (Markovitz, 1952; Black, Jensen and Scholes, 1972; Ross, 1976; Fama & French, 1991). No attention has been given to yield expectation and risk-aversion of DPF contracts policyholders and to the disclosure needs of such investors, who want to understand and compare discretionary choices made by managers of different companies;
iii. the topic of DPF contracts has been recently analysed to highlight recognition and measurement methods of such contracts in the financial reports prepared in accordance to international accounting standards. The main differences with local GAAPs have been described (Gutterman, 2002; PricewaterhouseCoopers, 2004; Ernst & Young, 2006b). A particular focus ha been addressed to the shadow accounting technique (Floreani & Selleri, 2006; Lai & Stacchezzini, 2006). No researchers have analysed whether the specific financial report disclosure can help to reduce the information asymmetry between the investor and the subscriber of DPF contracts.

The paper is focused on the study of the relationship between DPF contracts and financial report disclosure and it explains how DPF contracts subscriber may obtain specific information by analysing the financial reports of DPF contracts issuers. The paper highlights how an issuer's financial report can help investor to make investment decisions more rational.

3. Methodology

In order to test the research hypothesis mentioned above, we made an empirical analysis based on two complementary techniques: *financial report documental analysis* and *interviews to qualified and indicative operators of insurers and audit companies*. Although the techniques are used separately, they have been developed together in order to: *i)* achieve a correct interpretation of the information included in the public documents analysed, as they are often incomplete; *ii)* address the interviews towards a critical and exhaustive knowledge of the issues contained on the paper.

The *documental analysis* is based on the consolidated financial reports of the greatest groups operating in the Italian life and savings business as well as bancassurance sector (about 47% of the Italian "life business" – re: ANIA, 2006). We made an in-depth analysis of the consolidated financial reports of *all* the companies that are listed at the Italian Stock Exchange and that operate directly or indirectly in the Italian insurance market. They are (the Italian "life business" market shares shown between brackets):

a. Alleanza (14.7%)
b. Cattolica Assicurazioni (4.5%)
c. Fondiaria-Sai (3.2%)
d. Generali (25.7%)
e. Mediolanum (3.3%)
f. Milano Assicurazioni (0.8%)
g. Premafin Finanziaria (3.2%)
h. Ras Holding (3.4%)
i. Toro Assicurazioni (0.7%)
j. Unipol (5.8%)
k. Vittoria Assicurazioni (0.2%)

The documental analysis is focussed on these financial statement items:
a. financial assets related to "separate accounts" of DPF contracts and their related classification choices and performances;
b. insurance liabilities arising from DPF contracts and the related value of the deferred policyholder liabilities arising from the application of shadow accounting technique;
c. equity and the impact on it made by changes in fair value of financial assets classified as AFS and FVTPL (through income) and related to DPF contracts "separate accounts" and by shadow accounting.
Three levels of disclosure quality are identified: *poor*, *standard* and *enhanced*.

i) We speak about *poor disclosure* when a subscriber can find only generic "descriptive" information; with a poor level disclosure, it is possible to verify if the shadow accounting is adopted but the impact of the change in accounting principles on insurance liabilities, equity, and net earnings can not be measured.
ii) We speak about *standard disclosure* when a subscriber can identify "descriptive" information while the "quantitative" information is disclosed for the total value of DPL: the insurance companies disclose information about assets, liabilities, expenses and income arising from the application of shadow accounting. Nevertheless, with this level of information is not possible to measure the alignment between assets and their related insurance liabilities.
iii) We speak about *enhanced disclosure* when: *a.* a subscriber can identify "descriptive" information; *b.* the "quantitative" information are specified for each single "separate account"; *c.* financial assets related to DPF contracts are mentioned separately so that the link between the results of the adoption of IFRSs on insurance liabilities and the assets counterbalancing them can be measured.

In order to gain a better understanding of the public data, we also interviewed some account preparers and actuaries of the listed insurance companies mentioned before, as well as some partners or managers of largest Italian (*rectius*, worldwide) auditors. We totally made twelve interviews with managers of different companies. Moreover, interviews are conducted to highlight how account preparers may use their discretion when they recognise and measure liabilities related to the shadow accounting technique (*i.e.*, DPL).

4. Findings

4.1. The significance of the "deferred policyholder liabilities" to investigate DPF contracts yields and risks

The 2005 financial reports, in which IFRSs have been applied for the *first time*, offer a disclosure about the items we are speaking about. That is due to a mismatching situation between the measurement methods of assets and liabilities in compliance with IFRS 4.

In fact, while assets measurement is fair value based (as IAS 39 settles), their related insurance liabilities are measured using domestic principles, that is by considering assets connected to DPF contracts at their original cost, corrected by realized gains or losses, and by ordinary returns. So, while liabilities are moved by

effectively realized gains or losses, assets values are moved by simple market variations, as they are exposed at fair value in financial reports.The difference between assets fair value and their original cost explains the ability of an issuer to have returns to be recognized in future to DPF policyholders, when a discretionary decision (to sell assets) will occur, that is when it is useful to increase ordinary return (the recognition is discretionary) or when the amount of contracts decreases and insurers have to sell the related assets or, in any case, when the issuer itself is convinced to take an immediate advantage by selling part of its assets.

So, the more information the investor can find in financial reports about this difference (called deferred policyholder liability, DPL), the more it can know about yield and risk related to DPF contracts.In the Italian life insurance markets, this information is quite different and sometimes the investor has to look for it carefully. In the Italian life insurance market, the weight of DPF contracts is very high and it represents a large amount of insurance liabilities. On the contrary, other life insurance liabilities are related to index-linked and unit-linked contracts (non DPF contracts).

	Weight of life insurance liabilities related to "DPF Contracts" (DpfL) on total life insurance liabilities (Lil)										
	a	b	c	d	e	f	g	h	i	j	k
DpfL / Lil	78%	53%	89%	75%	11%	88%	89%	84%	94%	96%	89%

The Deferred Policyholder Liability weight is also considerable as respect to equity and to the whole DPF liabilities, as it appears by analysis as here below.

	Weight of Deferred Policyholder Liabilities (Dpl) on Equity (E)										
	a	b	c	d	e	f	g	h	i	j	k
Dpl / E	39%	8%	9%	63%	1%	10%	10%	32%	3%	-1%	21%

	Weight of Deferred Policyholder Liabilities (Dpl) on life insurance liabilities related to "DPF" (DpfL)										
	a	b	c	d	e	f	g	h	i	j	k
Dpl / DpfL	4.0%	1.6%	3.3%	5.8%	0.9%	4.7%	3.3%	8.4%	2.4%	-0.4%	7.4%

While "Dpl/E" analysis is useful to investigate the insurer's account policies (especially with regards to earnings management), "Dpl/DpfL" ratio gives some information useful to a DPF policyholder. In effects, "Dpl/DpfL" ratio may represent the amount of extra return on DPF contracts that a policyholder can obtain, at the date of the financial report, if the insurer would sell all the assets related to DPFs. It means a return overwhelming the normal yield obtained and yearly recognized to the policy holder by ordinary ways.

Even if this extra return might have never been recognized, because an insurer does not have to realize all its assets in a short time, otherwise it shows an insurer's ability in obtaining returns recognizable to policy holders. In effect, being "discretionary", a DPF contracts issuer may choice to recognize immediately the difference between

market value and cost value of assets (by selling them), or to wait for successive times. In any cases, this difference is to be considered by policyholders together with yearly return ordinary recognized by insurers to have a complete opinion about their ability in financial management.

Empirical data shows many differences among Italian listed insurance groups. At first, only one insurance company has a negative Deferred Policyholder Liability: its assets related to DPF contracts have a market value lower than the previous purchase cost. It may bring a policyholder return not higher than the guarantee yield. Besides, other insurers “Dpl/DpfL” ratio (from 0.9% to 8.4% of total life insurance liabilities) has a range so wide that it must be known by an aware investor: better insurers can assure a possible future return of about two or three years ordinary yield at actual conditions. For other insurance groups, the only return to be assured to policyholders is that obtained by ordinary management of their assets.

Nevertheless, a full understanding of the “Dpl/DpfL” ratio can be assured only if investor looks forward through subsequent financial reports (also through interim ones) because the ratio itself is moved according to financial policy in assets. So, a lower ratio may be explained not by a bad financial policy, but by a risk-averse one, or by the decision to realize gains (or losses) in the previous year. That is why investor has to follow the DPL trend through some periods to get an opinion about insurers financial policy, able to complete other direct information about DPF contracts yields and risks. So, to have useful information, “Dpl / DpfL” ratio (as it appears in financial reports and in interim reports) would be determined as regards to each separate DPF issued by an insurer, to be considered with each DPF return as it is shown in periodical information given to policyholders. Our empirical analysis sounds different.

4.2. The disclosure level of the Italian listed insurers

If we consider what it is described in paragraphs *3* and *4.1*, it is possible to state that *all* the Italian listed insurance companies offer at least a *standard disclosure* about DPL. A policyholder of DPF contracts can obtain information about the average future gains (losses) that issuers expect to be recognised to (receive from) them. However this information is delivered for each whole company and not for each separate DPF.

Besides, this information is really difficult to find in balance sheets, as it requires a more than medium knowledge of the IFRS financial report technique and the ability to discover data not often available in accounts, but to be found in tables and notes prepared in compliance with the specific insurance regulation.Only after this difficult discovery, information can be considered together with the “customised” disclosure that a policyholder receives from issuer (while “separate accounts” the yields are shown in about 50% of financial reports of the total Italian listed companies). In this way, subscriber can: *i.* correctly compare the effectiveness of the DPF management of different issuers; *ii.* try to figure out the discretion applied in their investment policies.

Unfortunately, no Italian listed companies offer an *enhanced disclosure* that would be appreciated if a policyholder separately and immediately finds yields, assets and

DPLs related to each separate DPF: only one of the investigated listed companies shows specific tables indicating yields and the amounts of assets related to each separate DPF, but even in this case it is impossible to split the whole DPL into separate DPFs to obtain a separate potential return; besides, three of the investigated companies shows DPF yields separately, but not yet the amount of assets or DPLs related to each DPF.

So, the exact amount of yield and risks referable to a DPF may only be figured out. This assertion is confirmed (and explained) by interviews we have done: account preparers and audit company managers have explained that a significant discretion is possible in applying IFRS rules. These discretionary choices are about: *a.* parameters to be considered to measure unrealized gains and losses; *b.* the possibility to "rebalance" unrealized gains and losses related to insurance liabilities; *c.* the calculation of withdrawal rate of gains and losses to be recognized to policyholders is measured; *d.* the measurement of a guarantee rate of DPF contracts; *e.* the attribution of DPL to the balance sheet or to the income statement in case of coexistence, in the same portfolio, of assets classified as FVTPL and as AFS (Lai & Stacchezzini, 2006).

5. Conclusions

Even if the analysis of IFRS financial reports may give useful information about the yields and risks of DPF contracts issued by an insurer, as long as one has a difference in evaluating principles of assets and insurance liabilities, in the Italian life insurance market a *standard level* of disclosure is now accomplished.So, it is possible to evaluate financial management related to DPF contracts, as regard to the whole of them, but it is not quite possible to find distinguished information about separate DPFs, even if, in some cases, yields and/or amounts of assets of each DPF are shown in the financial report. On the contrary, to have a complete information, investor would have to find also the amount of assets and liabilities of each DPF, separate recognized yields and, finally, the DPL related to each DPF. By now, we have not the whole of this disclosure.Perhaps, the Italian insurance regulatory Authority has to think about improving DPF contracts disclosure.

References

Akerlof, G.A. 1970. "The market for "Lemons": Quality Uncertainty and the Market Mechiamism", *The Quarterly Journal of Economics*, vol. 84, no. 3, August, 488-500.

Alternburger, O.A. 2005. "IFRS 4 Insurance Contracts — Improved Insurance Accounting?", 28th Annual Congress of the European Accounting Association, Goteborg 18th – 20th May 2005.

Arrow, K.J. 1963. "Uncertainty and the Welfare Economics of Medical Care", *American Economic Review*, vol. 53, no. 5, 941-973.

ANIA 2006. "Premi del lavoro diretto italiano 2005", Updated to April 2006, www.ania.it.

Black, F., Jensen, M.C., Scholes, M. 1972. "The Capital Asset Pricing Model: Some Empirical Tests", in Jensen, M. (ed.), Studies in the Theory of Capital Markets, Praeger.

Ernst & Young 2006a. "IFRS Insurance Reporting – Beyond Transition. Suggestions for improvements to industry presentation and disclosures", www.ey.com.

Ernst & Young 2006b. "Phase II Insurance Accounting – Which view will prevail?", www.ey.com.

Fama, E.F. & French, K.R. 1992. "The Cross-Section of Expected Stock Returns", *Journal of Finance*, June.

Floreani, A. & Selleri, L. 2006. Principi contabili internazionali e bilancio delle imprese di assicurazione. La valutazione dei contratti assicurativi sulla vita nell'ambito della fase II del progetto insurance, I.S.U. Università Cattolica, Milano.

Focarelli, D. & Doni A. 2006a. "IAS/IFRS. Contesto di riferimento e analisi comparative delle principali scelte effettate dalle compagnie quotate nel 2005", Presentation to the Conference "Bilanci consolidati 2005 — Adozione dei principi contabili internazionali", Milano — 26 January 2006.

Focarelli, D. & Doni, A. 2006b. "IAS/IFRS: informativa sui rischi assicurativi e fase 2 del progetto IASB contratti assicurativi", Presentation to the Conference "Bilanci IAS/IFRS: problematiche applicative e prospettive future nel settore assicurativo", Roma, 5 July 2006.

Gutterman, S. 2002. "The coming revolution in insurance accounting", *North American Actuarial Journal*, January 2002.

KPMG 2006a. "Adozione degli IAS/IFRS: le principali problematiche interpretative", Bilanci consolidati 2005 Adozione dei principi contabili internazionali IAS/IFRS Conference, Milan — 26 January 2006.

KPMG 2006b. "Problematiche connesse alle disclosures rilevate dai bilanci consolidati al 31 dicembre 2005. Aggiornamento sull'evoluzione degli IAS/IFRS", Presentation to the Conference "Bilanci IAS/IFRS: problematiche applicative e prospettive future nel settore assicurativo", Roma, 5 July 2006.

Lai, A. & Stacchezzini, R. 2006. "Matching and Mismatching between Insurers' Assets and Liabilities: Emerging Patterns of "Shadow Accounting", in Aa. Vv., Emerging Issues in International Accounting & Business Conference 2006 — Proceedings, Vol. 1, University of Padua, July 20-22, 2006, Padova, Cluep.

Markovitz, H.M. 1952. "Portfolio Selection", *Journal of Finance*, March, 77-91.

PricewaterhouseCoopers 2004. "The future of insurance reporting — for now", www.pwc.com.

Ross, S.A. 1976. "The Arbitrage Theory of Capital Asset Pricing", *Journal of Economic Theory*, vol. 13, no. 13, 341-360.