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International Accounting Standards Board

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INFORMATION FOR OBSERVERS

Board Meeting: **26 April 2006, London**

Project: **Insurance contracts (phase II)**
This note covers agenda papers 7B, 7C and 7D

AGENDA PAPER 7B
UNIT OF ACCOUNT

Purpose of this paper

1. Participants in the Insurance Working Group have generally argued that insurers should measure their rights and obligations under insurance contracts on a portfolio basis, rather contract by contract. This paper discusses:

   (a) whether there is likely to be a material difference between a portfolio measurement and a contract by contract measurement.

   (b) how the unit of account should be determined, if portfolio effects are likely to affect measurement materially.

Summary of recommendations

2. Risk margins:

   (a) should reflect diversification within a portfolio of contracts that are subject to broadly similar risks and managed together as a single portfolio (paragraphs 6(a) and 7).

(b) Should not reflect diversification with the insurer's other portfolios of insurance contracts or with its other assets and liabilities (paragraphs 6(b) and 9d)).

3. The staff should investigate whether risk margins should reflect risks that would be diversified between such a portfolio and other portfolios that would be expected to be held by a hypothetical average reasonably well diversified transferee (paragraph 6(c)).

Overview

4. This paper discusses whether there could be portfolio effects in the following areas:

   (a) Risk margins (paragraphs 5-8)

   (b) Possible follow up issues (paragraph 9)

   (c) Other matters (paragraph 10)

Risk margins

5. The risk margin for a book of contracts is likely to be lower than when it is determined individually for each contract and then aggregated. Possible reasons for such differences include the following:

   (a) A small book is more exposed than a large book to random statistical fluctuations.

   (b) For a small book, there is less statistical evidence about the model that should be used to simulate the underlying process driving future cash flows (model risk) and about the parameters of that process (parameter risk).

   (c) Contracts may be negatively correlated with each other. For example, term life insurance exposes the insurer to the risk that policyholders will die prematurely, whereas annuities expose the insurer to unexpected longevity. An insurer issuing both kinds of contract is likely to suffer less fluctuation than an insurer that issues only one kind of contract.

   (d) A large book may provide some protection against adverse selection (risk that new or continuing policyholders will be drawn disproportionately from higher-risk groups) and moral hazard (risk that the existence of insurance will change policyholder behaviour). For example, a transferee would rather take the whole portfolio, rather

than individual contracts selected by the transferor. This factor might affect the price that the transferee would require.

6. Should the measurement of insurance contracts reflect the diversification benefit that arises from assembling pools of insurance risk? Diversification might be considered at various levels:

   (a) Between different contracts within a single book of contracts. The essence of an insurer's business is to pool the risks transferred by individual contracts. Determining risk margins for individual contracts and then aggregating those margins is likely to be both difficult and of limited relevance to users. This suggests that risk margins should incorporate the benefits of diversifying risk between different contracts within a book of contracts.

   (b) Between different books of contracts of the transferor. In general, IFRSs do not adjust the measurement of a liability when it is held together with another liability. Moreover, if an insurer were to transfer insurance contracts to another entity, the transferee would determine the acceptability of the transaction price by referring to the level of diversification when combined with the **transferee's** other books of contracts. This implies that the extent of diversification within the **transferor** is not relevant, and therefore that risk margins should not incorporate benefits of diversification between different books of contracts of the **transferor**.

   (c) Between the book of contracts being measured and other contracts that would be held by an average reasonably well diversified transferee. This has some appeal, because such an entity is the most likely bidder for a book of contracts. Before presenting a recommendation, the staff intend to obtain more information on how it might be operationalised. The [European] CFO and CRO Forums have expressed some interest in this approach, as noted in Francis Ruijgt's presentation to the Insurance Working Group in January.

   (d) Between insurance contracts and other assets and liabilities. This would not be consistent with other IFRSs, which do not generally reflect possible synergies between different assets and liabilities. Moreover, the degree of diversification within an insurer is not obviously relevant to a potential transferee. Therefore, it does not appear appropriate to include benefits from diversification between insurance contracts and other assets and liabilities.

7. IFRS 4 refers to a liability adequacy test for a 'portfolio of contracts that are subject to broadly similar risks and managed together as a single portfolio'. The staff recommends using that description to define the unit of account for determining risk margins.

8. Reinsurers sometimes charge lower premiums than those a direct insurer charges for the same exposure. One reason for such differences is the fact that the insurer may be diversifying the exposure more broadly. A risk margin that reflects diversification within an individual portfolio is likely to be lower for the reinsurer than for the direct insurer. If the risk margin reflects the level of diversification for an average well diversified insurer, it may be the same for both the reinsurer and the direct insurer (unless the reinsurer's individual portfolio is larger than the aggregate of several portfolios held by an average well diversified insurer).

Possible follow-up unit of account issues

9. If the Board adopts an approach that calibrates the initial measurement to the actual premium, less relevant acquisition costs, some further unit of account issues may arise:

   (a) The impact of a liability adequacy test depends on the unit of account. If the test is carried out for a large portfolio, positives and negatives for different contracts are offset, and only a net deficiency (if any) is recognised. If the test is carried out by contract, each individual deficiency is recognised.

   (b) If relevant acquisition costs are defined as incremental acquisition costs only, some acquisition costs may be incremental for a portfolio but not for a contract.

Other matters

10. We list below two areas that are sometimes described as depending on the unit of account, though in the staff's view the unit of account is not relevant in these cases:

    (a) Some have suggested that the expected value notion is relevant only for a portfolio, not for an individual contract. However, in principle, the expected (probability-weighted) cash flows from a portfolio equal the sum of the expected cash flows of the individual contracts. Nevertheless, in practice, some types of estimate are more easily performed in aggregate for a portfolio, than for individual contracts. For example, IBNR (incurred but not reported) estimates are typically carried out in aggregate. However, conceptually, this is no different from making expected value estimates for individual contracts and aggregating the results. This implies that the unit of account

does not affect the expected cash flows, in principle. Nevertheless, to avoid misunderstandings, practical guidance should emphasise that unbiased estimates of cash flows should reflect all relevant inputs, regardless of whether they are derived by contract or in aggregate.

(b) Policyholder behaviour, future premiums, renewals and related issues. Some argue that these recognition and measurement issues can be 'resolved' by using a portfolio approach. However, our consideration of these issues is based on an analysis of contractual rights and contractual obligations stemming from individual contracts. Aggregating them into a portfolio does not bring new contractual rights into existence, nor does it eliminate individual contractual obligations.

AGENDA PAPER 7C
UNBUNDLING

Purpose of this paper

1. This paper discusses whether a measurement model should unbundle the individual elements of an insurance contract and measure them individually.

Summary of recommendations

2. This paper recommends the following:

   (a) Unbundling deposit and service components for the purpose of recognition and measurement is likely to require arbitrary allocation and complex systems, and is unlikely to result in more representationally faithful financial statements. It should not be required. The staff plans to discuss in May whether premiums should be recognised always as revenue, always as deposit receipts, or sometimes as revenue and sometimes as deposit receipts. (paragraphs 15-16 and 19-20)

   (b) An insurer should recognise separate account assets, and the related obligation to pay policyholder benefits, unless the insurer has a contractual obligation to pay all cash flows from the separate account assets to the separate account policyholders (a 'pass-through' obligation). An insurer has a pass-through obligation if it meets four criteria, based on the derecognition criteria for pass-through arrangements in paragraphs 19 and 20 of IAS 39 (paragraphs 24-26 of this paper)

   (c) An insurer should present the recognised portion of a customer relationship as part of the related liability, not as a separate asset. The staff plans to investigate how best to provide useful disclosure about the extent to which the overall liability 'package' incorporates cash flows that are enforceable. (paragraph 31)

3. This paper is divided into the following sections:

   (a) Background (paragraphs 4-5)

   (b) Deposit components (paragraphs 6-16)

   (c) Service components (paragraphs 17-20)

   (d) Separate accounts (paragraphs 21-26)

(e) Customer relationships related to insurance liabilities (paragraphs 27-31)

(f) Issues to be discussed separately, namely (i) embedded derivatives, (ii) linkage and discretionary participation features (paragraph 32)

Background

4. Participants in the Insurance Working Group have commented that three measurement models co-exist in IFRSs now, and unbundling would not be needed if the three models were consistent with each other. The three models are as follows:

   (a) Financial instruments are carried at amortised cost or fair value.

   (b) Rights and obligations under insurance contracts are measured using various bases, mostly inherited from pre-existing national practices. If the Board agrees with the recommendation in agenda paper 7A, rights and obligations under insurance contracts would be measured at current exit value.

   (c) Revenue from service contracts is recognised by reference to the stage of completion of the transaction (see IAS 18 *Revenue*).[1] The nominal amount of revenue received in advance is recognised as a liability. The appendix to IAS 18 also gives specific guidance on investment management fees (reproduced in the appendix to this paper).

5. Based on the Board's decisions to date, phase II of this project may eliminate or reduce some, but not necessarily all, of these inconsistencies. Inconsistencies may still remain if:

   (a) An insurer does not classify financial instruments as at fair value through profit or loss (though in most cases the fair value option enables an insurer to avoid this inconsistency).

   (b) The IAS 18 model is used to recognise revenue from stand-alone service contracts (or from service contracts embedded in long-term savings contracts), but the release from risk notion inherent in the current exit value model is used for servicing features of insurance contracts.

[1] IAS 18, paragraphs 20-28

Deposit components

6. Because the policyholder must generally pay premiums in advance, virtually all insurance contracts have an implicit or explicit deposit component (ie a non-derivative[2] component that would, if it were a separate instrument, be within the scope of IAS 39). Here are some examples of contracts that contain more significant deposit components:

   (a) Some reinsurance contracts and commercial insurance contracts contain features such as experience accounts (eg features in which policyholders share in the experience of the contract). These may, in some cases, be deposit components (as illustrated in IG Example 3 of the Guidance on Implementing IFRS 4).

   (b) Some unit-linked (variable) contracts pay a surrender or maturity benefit equal to the unit value (perhaps with some deduction for early surrender), and a death benefit equal to the higher of (i) the unit value and (ii) a specified amount. These may be viewed as a combination of (iii) an insurance component and (iv) an additional benefit. That additional benefit is the amount specified in (ii), less the unit value.

   (c) Similarly, endowments might be viewed as a combination of (i) a deposit component that pays the specified maturity value if the policyholder survives, or the specified surrender value if the policyholder dies before maturity, or surrenders the contract, and (ii) a death benefit equal to the aggregate death benefit, less the surrender value at the date of death.[3]

7. Some argue that an insurer should 'unbundle' the deposit component from the insurance component. Unbundling a deposit component has some or all of the following consequences:

   (a) measurement consequences:

      (i) The insurance component is measured as an insurance contract.

      (ii) The deposit component is measured under IAS 39 at either amortised cost or fair value. This might not be consistent with the basis used for insurance contracts.

[2] This paper does not address embedded derivatives. See paragraph 26(a)

[3] An alternative analysis sees an endowment as a combination of two insurance components, rather than as an insurance component plus a deposit component: (a) a term insurance contract (benefit paid only on death, or perhaps earlier surrender) and (b) a pure endowment (benefit paid only on survival to maturity, or perhaps earlier surrender).

(iii) A portion of the transaction costs incurred at inception is allocated to the deposit component if this allocation has a material effect. (For deposit components measured at amortised cost, the related transaction costs are deducted in determining the initial carrying amount. Also, this treatment applies only to incremental transaction costs for the deposit component, whereas in phase I many existing accounting treatments for insurance contracts capitalise a broader range of acquisition costs.)

(b) presentation consequences:

(i) Premium receipts for the deposit component are recognised as changes in the deposit liability, not as revenue. Premium receipts for the insurance element are typically recognised as revenue (in current practice).

(ii) If the deposit component is regarded as third-party funds under management, rather than as a direct obligation of the insurer, the deposit component might be reported off balance sheet. This is consistent with how most fund managers account for mutual funds that they manage.

Arguments for unbundling

8. Supporters argue that unbundling of deposit components would:

(a) mean that an entity accounts in the same way for the deposit component of an insurance contract as the issuer of a separate, but otherwise identical, financial instrument (eg one issued by a bank or a fund manager).

(b) avoid sharp discontinuities in the accounting between a product that transfers just enough insurance risk to be an insurance contract, and another product that falls marginally on the other side of the line. This would reduce the pressure on the definition of insurance contract. The staff currently recommends that the Board should not reconsider its existing definition of an insurance contract in the initial discussion document for phase II of this project. However, the staff plans to provide an update at the May meeting on the FASB's project to clarify what constitutes significant transfer of insurance risk for US GAAP.

(c) distinguish between premium revenue earned for accepting insurance risk and premium receipts that are, in substance, investment or deposit receipts.

Arguments against unbundling

9. Opponents of unbundling give the following arguments:

   (a) The components are closely interrelated and the value of the bundled product may differ from the sum of the individual values of the components.

   (b) Unbundling would require significant and costly systems changes for many types of product.

   (c) Insurance contracts are designed, priced, managed and regulated as packages of benefits. Furthermore, the insurer cannot unilaterally terminate the agreement or sell parts of it. Any unbundling required solely for accounting would be artificial.

   (d) Surrender options may cause interdependencies between the components. Conceptually, the deposit component does not include the portion of the surrender value needed to compensate the policyholder for forfeiting the right to future insurance coverage. However, it may not be straightforward to identify that portion.

   (e) Some users want information about gross premium inflows, as an indicator of new business activity. They would prefer that either all products are unbundled or no products are unbundled.

10. Some have suggested that unbundling should be required only when the components are completely separable, when there is an account in the name of the policyholder or when contracts are combined artificially.

11. In US GAAP, products within the scope of FAS 97 are unbundled and deposit accounting is used for the policyholder account. (This is particularly true for the income statement presentation, because premium is treated as a deposit receipt and the reported income reflects contractual charges and margins, rather than premiums receipts and benefit payments).

12. At the Working Group meeting in January 2005, several participants suggested that FAS 97 provides a useful analysis of margins. However, views were mixed on the treatment of premiums under FAS 97. Some participants felt that it would be more informative to treat premiums as revenue, rather than as deposit receipts. Others saw deposit treatment as consistent with the treatment of, for example, bank deposits.

Unbundling of deposit components in IFRS 4

13. IFRS 4 requires an insurer to unbundle an insurance contract if that treatment is needed to ensure the recognition of rights and obligations arising from the deposit component and those rights and obligations can be measured separately. If only the second of these conditions is met, IFRS 4 permits unbundling, but does not require it.[4] The Board's objective was to require unbundling only when it is easiest to perform and the effect is likely to be greatest (eg for some large customised financial reinsurance contracts).[5] The Board did not wish to pre-judge a discussion of unbundling in phase II and thus wished to avoid requiring unbundling in those cases where it was not clear whether phase II would require it.

Different approaches for different types of deposit component

14. Some might regard unbundling as appropriate for some types of deposit component, but not for others, given that a wide range of components that might, conceivably, be viewed as deposit components. Therefore, some might distinguish various categories, such as, for example, some or all of the following:

    (a) Components for which a policyholder assumes all investment risks (as with some types of unit-linked (variable) contract, and some types of special account. Paragraphs 21-26 discuss special accounts).

    (b) An interest-bearing account value, as found in some universal life products (see agenda paper 7D).

    (c) Some experience accounts and similar mechanisms in some reinsurance contracts.

    (d) 'Excess' premiums paid in the early years of a long-term life insurance or health insurance contract to fund 'excess' benefits in later years.

Staff recommendation

15. Unbundling deposit and service components for the purpose of recognition and measurement is likely to require arbitrary allocation and complex systems, and is unlikely to result in more representationally faithful financial statements. It should not be required.

16. The staff plans to discuss in May whether premiums should be recognised always as revenue, always as deposit receipts, or sometimes as revenue and sometimes as deposit receipts.

Service components

17. Some financial services contracts involve both the origination of one or more financial instruments and the provision of investment management services. The appendix to IAS 18 *Revenue* notes that these components are unbundled, so that IAS 18 addresses the service component and IAS 39 addresses the deposit component. The relevant extract is in the appendix to this paper.

18. This guidance was inserted in IAS 18 by IFRS 4. The Basis for Conclusions on IFRS 4 gives the following explanation:

> BC118 Some entities incur significant costs in originating long-term savings contracts. Some respondents argued that most, if not all, of these costs relate to the right to charge future investment management fees rather than to the financial liability that is created when the first instalment is received. They asked the Board to clarify whether the cost of originating those rights could be recognised as a separate asset rather than as a deduction in determining the initial carrying amount of the financial liability. They noted that this treatment would:
>
> (a) simplify the application of the effective interest method for a financial liability carried at amortised cost.
>
> (b) prevent the recognition of a misleading loss at inception for a financial liability that contains a demand feature and is carried at fair value. IAS 39 states that the fair value of such a liability is not less than the amount payable on demand (discounted, if applicable, from the first date when that amount could be required to be paid).
>
> BC119 In response to these comments, the Board decided that incremental costs directly attributable to securing an investment management contract should be recognised as an asset if they meet specified criteria, and that incremental costs should be

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[4] IFRS 4, paragraphs 10-12 and *Guidance on Implementing IFRS 4*, paragraph IG5 and IG example 3.
[5] *Basis for Conclusions on IFRS 4*, paragraphs BC40–BC54.

defined in the same way as in IAS 39. The Board clarified these points by adding guidance to the appendix of IAS 18 *Revenue*.

19. The guidance in the appendix to IAS 18 refers specifically to the investment management service component of an investment contract. The staff plans to discuss in May whether that guidance is still appropriate for investment contracts, and whether it is also relevant for other service components of an investment contract.[6]

20. The staff sees no particular reason to apply that guidance to the investment management and other service components of an insurance contract.

Separate accounts

21. Terms such as 'separate account' (in the US) and 'segregated account' (in Canada) are sometimes used to describe contracts that link the benefit amount directly to the fair value of a designated pool of assets operated in a way similar to a mutual fund. In other words, the contract holder bears the risks and rewards of the account's investment performance and the issuer derives only fee income as an asset manager.

22. Some life insurers sell contracts that combine such elements with other elements, such as life insurance cover or guarantees of minimum investment performance. Canadian GAAP requires the issuer to account for the mutual fund element separately, outside the issuer's own financial statements relating to the insurer's 'general account' business.[7] Arguments for this approach:

    (a) In substance, the assets are held for the direct beneficial interest of the contract holders.

    (b) In some cases, the assets are not available to the insurer for general business purposes.

    (c) This treatment is consistent with the way that an asset manager accounts for funds that it manages.

23. Arguments against the treatment in Canadian GAAP:

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[6] **Investment contract** is an informal term for a contract that is within the scope of IAS 39 because it does not transfer significant insurance risk.

[7] In some other national GAAPs, separate accounts are on balance sheet, but are reported as a single line item on the asset side and a single line item on the liability side. Agenda paper 7E on unit-linked contracts discusses whether this presentation is appropriate.

(a) Arguably, the insurer controls the assets.

(b) There may be interdependencies between the components (such as the investment component and guarantees of investment performance).

(c) Unbundling may cause complexity and cost.

(d) Reporting part of the insurer's obligation off balance sheet is not appropriate if the insurer is required to satisfy the entire obligation.

Staff recommendation on separate accounts

24. The staff recommends that an insurer should recognise separate account assets, and the related obligation to pay policyholder benefits, unless the insurer has a contractual obligation to pay all cash flows from the separate account assets to the separate account policyholders (a 'pass-through' obligation).

25. An insurer has a pass-through obligation if it meets the following four criteria, based on the derecognition criteria for pass-through arrangements in paragraphs 19 and 20 of IAS 39:[8]

(a) The insurer has no obligation to pay amounts to the eventual recipients unless it collects equivalent amounts from the separate account assets. This condition is not breached if the insurer provides such benefits as guarantees of investment performance or guaranteed minimum death benefits, but the insurer would need to recognise its stand-ready obligation to provide those benefits, and measure that obligation at current exit value (if the guarantee meets the definition of an insurance contract) or fair value (if the guarantee is a financial instrument).

(b) Contract, law or regulation, prohibit the entity from selling, pledging or lending the separate account assets except for the benefit of the separate account policyholders.

(c) The entity has an obligation to remit any cash flows it collects on behalf of the eventual recipients without material delay. In addition, the entity is not entitled to reinvest such cash flows outside the separate account, except for investments in cash or cash equivalents during the short settlement period from the collection date to the

[8] Paragraphs BC54-BC64 of the basis for conclusions on IAS 39 describe the rationale for these criteria.

date of required remittance to the separate account, and interest earned on such investments is passed to the separate account.

(d) The insurer has substantially none of the risks and rewards of ownership of the separate account assets (other than the right to collect fees for providing investment management services).

26. This paper does not discuss the following related issues:

(a) The measurement attribute for assets held in separate account arrangements, and for the related portion of the obligation to pay benefits (see agenda paper 7E).

(b) Whether the assets held in separate account arrangements should be presented separately from general account assets, or commingled with them in the insurer's balance sheet (see agenda paper 7E).

(c) Whether investments held through separate account arrangements are relevant in assessing whether an insurer controls (or significantly influences) an investee. This question might arise if, for example, an insurer holds 10% of an investee through its general account and 45% through one or several separate accounts.

Customer relationships

27. The Board decided the following in February 2006: When an insurer recognises rights and obligations arising under an insurance contract, it should also recognise the portion of the customer relationship that relates to future payments that the policyholder must make to retain a right to guaranteed insurability. Agenda paper 7A for this meeting recommends that the same measurement attribute should be used for that portion of the customer relationship and for the related insurance liability.

28. The Board has not yet discussed whether the customer relationship should be presented as an asset separate from the related liability, or whether they should be presented together as a single package. The argument for a separate presentation is that the liability relates to enforceable cash flows, whereas the customer relationship relates to cash flows that are likely to occur but are not enforceable, although they derive from the existing contract.

29. The arguments for presentation as a single package are that separating the enforceable cash flows from the unenforceable cash flows is likely to be time-consuming, costly, arbitrary to some extent and of limited benefit to users. The simplified example the staff

presented in February (healthy and unhealthy policyholders) may have implied that the distinction would be easy to make, but it would be much more complex in a realistic example. Furthermore, the distinction would, at least conceptually, need to be made at the contract level. The extent to which an insurer can actually make the distinction will depend on how much effort the insurer is willing to devote to drilling down to the contract level, which is where the rights and obligations arise.

30. Presentation as a package would mean that debits on some contracts are offset against credits on other contracts when no right of offset exists. That is not conceptually preferable, but the practical impediments are too great to permit a more conceptually rigorous separation.

Staff recommendation

31. The staff recommends that the (recognised portion of) the customer relationship should be presented as part of the related liability. The staff plans to investigate how best to provide useful disclosure about the extent to which the overall liability 'package' incorporates cash flows that are enforceable.

Issues to be discussed separately

32. We plan to address some issues separately:

    (a) Paragraph 6 describes a deposit component as a non-derivative component. IAS 39 requires an entity to account separately (at fair value) for **embedded derivatives** in some circumstances.

    (b) Some have suggested that if a contract has been artificially separated through the use of side letters, the separate components should be considered together. This is a wider issue for work that the Board may do in the future on **linkage** (ie accounting for separate transactions that are connected in some way). The footnote to paragraph B25 of IFRS 4 refers to simultaneous contracts with the same counterparty. We do not plan to address linkage at this stage of this project.

    (c) This paper does not discuss whether discretionary participation features should be unbundled from the guaranteed features of the contract.

Appendix

Extracts from appendix to IAS 18

14 Financial services fees

…

(a) Fees that are an integral part of the effective yield of a financial instrument

…

(iii) Origination fees received on issuing financial liabilities measured at amortised cost.

These fees are an integral part of generating an involvement with a financial liability. When a financial liability is not classified as 'at fair value through profit or loss', the origination fees received are included, with the related transaction costs incurred, in the initial carrying amount of the financial liability and recognised as an adjustment to the effective interest rate. An entity distinguishes fees and costs that are an integral part of the effective interest rate for the financial liability from origination fees and transaction costs relating to the right to provide services, such as investment management services.

(b) Fees earned as services are provided

…

(iii) Investment management fees.

Fees charged for managing investments are recognised as revenue as the services are provided.

Incremental costs that are directly attributable to securing an investment management contract are recognised as an asset if they can be identified separately and measured reliably and if it is probable that they will be recovered. As in IAS 39, an incremental cost is one that would not have been incurred if the entity had not secured the investment management contract. The asset represents the entity's contractual right to benefit from providing investment management services, and is amortised as the entity recognises the related revenue. If the entity has a portfolio of investment management contracts, it may assess their recoverability on a portfolio basis.

Some financial services contracts involve both the origination of one or more financial instruments and the provision of investment management services. An example is a long-term monthly saving contract linked to the management of a pool of equity securities. The provider of the contract distinguishes the transaction costs relating to the origination of the financial instrument from the costs of securing the right to provide investment management services.

AGENDA PAPER 7D
UNIVERSAL LIFE CONTRACTS

Purpose of this paper

1. This paper discusses the treatment of universal life contracts.

Summary of recommendations

2. The staff recommends that an insurer should measure liabilities under universal life contracts by reference to future cash flows (paragraph 20).

3. This paper:

   (a) does not address various implementation issues (listed in paragraph 12).

   (b) analyses the rate used to credit interest to policyholder balances as made up of the market rate for a pure deposit, less an implicit fee. The insurer typically has discretion to vary that implicit fee (within contractual and legal limits.) We plan to consider the implications of this discretion at a future meeting (paragraph 21).

   (c) discusses the cash flows to be included, in the light of the Board's previous conclusions on customer relationships associated with insurance contracts (paragraphs 25-30).

4. The rest of this paper deals with the following topics:

   (a) What is universal life insurance? (paragraphs 5-8)

   (b) Possible accounting approaches (paragraphs 9-20)

   (c) Crediting rates (paragraphs 21-22)

   (d) Which future cash flows? (paragraphs 23-28)

   (e) Some relevant extracts from US GAAP (appendix)

What is universal life insurance?

5. The American Council of Life Insurers (ACLI) defines **universal life insurance** (or **adjustable life**) as 'A type of permanent life insurance[9] that allows you, after your initial payment, to pay premiums at any time, in virtually any amount, subject to certain minimums and maximums. This policy also permits you to reduce or increase the death benefit more easily than under a traditional whole life policy. To increase your death benefit, the insurance company usually requires you to furnish satisfactory evidence of your continued good health.'[10]

6. A universal life contract will typically operate as follows:

   (a) Premiums are added to a policyholder account.

   (b) The contract may permit the policyholder to vary premiums, within specified limits.

   (c) The contract may permit the policyholder to increase or decrease the amount of life insurance cover, within specified limits. In some cases, an increase in cover may not require a medical examination (up to a specified limit).

   (d) Depending on the contract, the death benefit may be:

      (i) An amount specified in the contract. The insurer's risk is the difference between the specified amount and the policyholder account balance.

      (ii) The policyholder account balance plus a specified amount.

   (e) Deductions are made from the policyholder account for mortality charges and perhaps for other items, such as administration costs or acquisition costs. The contract may limit the level of mortality and/or other charges.

[9] The ACLI defines permanent life insurance as 'Life insurance designed to provide lifelong financial protection. As long as you pay the necessary premiums, the death benefit will be paid. Most permanent policies have a feature known as cash value that builds up, tax-deferred, over the life of the policy and can be used to help fund financial goals, such as retirement or education expenses.'

[10] http://www.acli.org/ACLI/Consumer/Glossary/Default.htm

(f) Interest is added to the policyholder account, based on the account balance. Depending on the contract, this may be:

(i) Interest determined using a **crediting rate** set by the insurer. The crediting rate will reflect factors such as the returns on the assets backing the contract(s), market conditions, competitive considerations, expectations established in marketing literature and regulatory requirements. The contract may specify a minimum crediting rate.

(ii) The return on a specified pool of assets dedicated to a series of contracts. This is a form of unit-linking and is sometimes called **variable universal life**. The contract may specify a minimum crediting rate, for example a return of premiums. The contract may permit the insurer to deduct a periodic investment management fee from the pool of assets.

(g) The contract provides mortality coverage as long as funds remain in the policyholder account to pay the mortality and other charges. Some contracts contain 'secondary guarantees' that permit mortality coverage to continue even if the policyholder account is exhausted.

(h) The contract may permit the policyholder to withdraw the account balance. Withdrawals may be subject to surrender charges, and the contract may restrict the timing of withdrawals.

Further information

7. The appendix to this paper includes some extracts from the relevant US standard, SFAS 97 *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*. This gives further information on the nature of these contracts and their treatment under US GAAP.

8. In April, the Insurance Working Group discussed a report by the American Council of Life Insurers and International Actuarial Association on *Renewal Premiums and Discretionary Participation Features of a Life Insurance Contract*. That report focused on an example of a universal life contract. We do not plan to discuss that paper at this meeting, but Board members may wish to refer to it if they wish to see a comprehensive example.

Possible accounting approaches

9. Two types of accounting approach could be considered for universal life contracts:

   (a) components approach

   (b) integrated prospective approach

Components approach

10. This approach would account separately for various components of the contract:

   (a) the account balance

   (b) obligation to provide mortality cover during the remainder of the current period for which mortality charges have already been deducted from the policyholder account. Essentially, this is term insurance for the current period. There may also be an element of prepayment if the charges already deducted are to compensate the insurer for mortality charges in future periods. Similarly, the insurer has an obligation to provide services (eg investment management) during the remainder of the period for which the insurer has already charged explicit fees.

   (c) options and guarantees embedded in the contract, for example:

      (i) guaranteed maximum mortality charges for future periods under the existing contract.

      (ii) guaranteed maximum expense charges

      (iii) guaranteed minimum crediting rates

      (iv) secondary guarantees (described in paragraph 6(g) above)

   (d) the portion of the customer relationship associated with the contract. If recognised, this would, in existing practice, be measured by reference to acquisition costs incurred (perhaps less front-end fees charged to the policyholder).

11. A components approach would probably not consider the following items (except perhaps if they are an unavoidable consequence of making payments under options and guarantees):

(a) the profit the insurer expects to generate from future mortality and other charges

(b) the estimated spread between the return on the assets backing the contract and the amount credited to policyholders. Some may view this spread as an implicit investment management charge.

(c) the flexibility inherent in the insurer's ability, within specified limits, to vary crediting rates and mortality and other charges. Some may view this flexibility as a form of option.

Integrated prospective approach

12. An integrated prospective approach would discount all future cash flows arising from the contract. It would not account separately for the account balance. To implement this approach, various issues would need to be addressed, including:

(a) estimating the cash flows.

(b) determining appropriate margins for the risk associated with the cash flows. If appropriate, margins might also be needed for profit related to future services to be provided under the contract.

(c) determining a discount rate that reflects the time value of money and, to the extent not captured in margins in (b), the characteristics of the liability.

(d) reflecting embedded options and guarantees.

(e) customer relationships.

(f) presentation of the income statement and balance sheet.

(g) benefit of the insurer's ability to vary charges and crediting rates

13. This paper does not address these implementation issues because we are discussing them in the context of other types of life insurance contract.

Arguments for a components approach

14. Supporters argue that a components approach would create more consistency with other contracts in the financial services sector. For example, the policyholder account functions in some respects like a bank account.

Arguments for an integrated prospective approach

15. Supporters argue that an integrated prospective approach is more consistent with the way these contracts are priced and managed. They also argue that the components are interdependent and that separating them would be arbitrary. For example, if the death benefit is a specified amount including the account balance, the components approach would split the contract into the account balance and a separate death benefit (excess, if any, of the specified amount over the account balance). However, in this case, the amount of the death benefit depends on the account balance and so cannot be measured without considering the account balance and future movements in the account balance.

Implications for other forms of life insurance

16. In thinking about universal life insurance, it may be worth considering the implications for other forms of life insurance. Life insurance contracts form a continuum. At one end, a universal life contract unbundles many or all components (mortality, expenses, investments) and makes these transparent to the policyholder. At the other end, a traditional life insurance bundles together virtually all the components, and these are not typically transparent to the policyholder.

17. Some may feel that it would be conceptually appropriate to apply a components approach to all life insurance contracts, though they acknowledge that practical implementation would be more difficult for some contracts, and in some cases perhaps arbitrary or even impossible.

18. Others may feel that a components approach is feasible, and perhaps appropriate, for universal life, but not for, for example, traditional life insurance.

19. Still others may feel that a components approach is not feasible for traditional life insurance and that it would be undesirable to introduce a different approach for universal life contracts.

Staff recommendation

20. The staff recommends that the Board adopt the integrated prospective approach to life insurance contracts. In other words, an insurer should measure the contract prospectively by reference to the future cash flows, not by reference to the account balance.

Crediting rates

21. As noted before, the insurer typically has discretion to change credits, though often subject to a contractually (or in some cases legally) required minimum crediting rate. If the measurement is based on estimates of future cash flows, we need to consider how to deal with crediting rates:

    (a) Guarantees of minimum crediting rates need to be measured using option pricing techniques that capture the inherent optionality.

    (b) If the crediting rate is always the market rate for similar deposit balances outside universal life contract, cash flows would be projected using the crediting rate and discounted back at the same rate. This gives the same answer as just using the account balance.

    (c) If the crediting rate differs from the market rate, the answer may be more complex. This is because the contract provides various sources of income for the insurer (such as mortality charges, expense charges, interest spreads) and the insurer may be able to obtain the same overall result by different combinations of charges and by cross-subsidies between the different charges. It may be worth thinking of the crediting rate as made up of the market rate for a pure deposit, less an implicit fee. If this is done, the cash flows from the deposit could be projected and then discounted back at the market rate (giving the same rate) and the implicit fee could be treated in the same way as the explicit fees (agenda paper 7F on profit margins is relevant here).

22. The implicit fee discussed in the paragraph 21(c) has an important feature: the insurer has discretion to vary it (within the contractual or legal limits.) We plan to consider the implications of this at a future meeting.

Which future cash flows?

23. The Board decided tentatively in February that:

    (a) When an insurer recognises rights and obligations arising under an insurance contract, it should also recognise as an asset the portion of the customer relationship (relationship with the policyholder) that relates to future payments that the policyholder must make to retain a right to guaranteed insurability. A right to guaranteed insurability permits continued coverage without reconfirmation of the policyholder's risk profile, at a price that is contractually constrained.

(b) The staff should investigate whether an insurer should present or disclose that customer relationship separately from its other rights and obligations.

24. The following table summarises the implications of that decision for universal life contracts.

Treatment	*Type of cash flow*
1. Included in the measurement of the insurance liability	1.1 Stand-ready obligations arising from guarantees of insurability, or other guarantees, for example, of (i) maximum mortality charges, (ii) maximum expense charges or (iii) minimum crediting rates. The measurement of the stand-ready obligation reflects both the additional payments resulting to policyholders resulting from the guarantees, and the additional premiums needed to keep the guarantees in force. The measurement would reflect both the intrinsic value and time value (optionality) of the guarantees. 1.2 Excess, if any, of the surrender value over the measurement assuming no surrender. Thus the liability is measured at the higher of (i) the amount assuming no surrender and (ii) the surrender value (see also 2.2 below for related customer relationship)

Treatment	*Type of cash flow*
2. Included in the measurement of the portion of the customer relationship associated with the contracts	2.1 Future premiums that the policyholder must make to retain guaranteed insurability, and resulting additional benefits to policyholders (to the extent that the benefit to the insurer from receiving those premiums exceeds the resulting additional benefits to policyholders). 2.2 Excess, if any, of (i) the measurement using estimated surrender rates over (ii) surrender values (see also 1.2 for measurement of the related liability). However, this excess is capped at the level required to maintain guaranteed insurability.
3. Not included	3.1 Future premiums that the policyholder must make to retain guarantees of maximum mortality charges, maximum expense rates or minimum crediting rates 3.2 Future premiums beyond those needed to retain guaranteed insurability (for guaranteed insurability, see 2.1 customer relationship) 3.3 Net benefits to the insurer from surrender 3.4 Net benefits to the insurer if policyholders maintain account balances beyond the level needed to retain guaranteed insurability (including maintenance of account balances that are needed to keep other guarantees in force, but are not needed to maintain guaranteed insurability).

25. The above table notes that the cash flows resulting from a single contract may need to be split into as many as three portions (liability, customer relationship, not recognised). The motivation for this split is derived from an analysis of the rights and contractual rights and obligations. In principle, therefore, this split is made contract by contract, not in aggregate for an entire portfolio of contracts.

26. Some may have concerns about the relevance and operationality of this split. It may be worth seeking feedback from the Insurance Working Group in June.

Analogy to participating contracts

27. For some types of participating contract, policyholder benefits reflect returns on a specified pool of assets, although the insurer has some discretion to vary the amount and timing of that participation. The crediting rate mechanism for a universal life contract can have very similar effect in practice, because actual asset returns can be an important influence on crediting rates, though actual asset returns are not the sole determinant. Therefore, some argue that an insurer should account for interest credits on universal life contracts in the same way as for bonus distributions to participating policyholders.

28. Some may take the view that the insurer has no obligation to credit more than the guaranteed minimum and that the liability should be measured on that basis. If that approach is adopted, it would presumably be necessary to use lapse assumptions consistent with a strategy of crediting the contractual minimum and no more. We plan to analyse that approach more fully at a future meeting, using a framework that views the crediting rate as a market rate less an implicit fee (see paragraph 21(c)).

Appendix

Extracts from FAS 97

APPLICABILITY AND SCOPE

10. Except as provided in paragraph 11, long-duration insurance contracts with terms that are not fixed and guaranteed are referred to in this Statement as universal life-type contracts. Universal life-type contracts include contracts that provide either death or annuity benefits and are characterized by any one of the following features:

    a. One or more of the amounts assessed by the insurer against the policyholder-including amounts assessed for mortality coverage, contract administration, initiation, or surrender-are not fixed and guaranteed by the terms of the contract.
    b. Amounts that accrue to the benefit of the policyholder-including interest accrued to policyholder balances-are not fixed and guaranteed by the terms of the contract.
    c. Premiums may be varied by the policyholder within contract limits and without consent of the insurer.

11. This Statement does not apply to conventional forms of participating and nonguaranteed-premium contracts. Those contracts are addressed by Statement 60 and Statement 120. A participating or nonguaranteed-premium contract is covered by this Statement, however, if the terms of the contract suggest that it is, in substance, a universal life-type contract. The determination that a contract is in substance a universal life-type contract requires judgment and a careful examination of all contract terms. Paragraphs 12 and 13 describe some circumstances in which a participating or nonguaranteed-premium contract shall be accounted for as a universal life-type contract. The provisions of paragraphs 12 and 13 are not intended to be either all-inclusive or limiting.

12. A participating contract that includes any of the following features shall be considered a universal life-type contract:

    a. The policyholder may vary premium payments within contract limits and without consent of the insurer.
    b. The contract has a stated account balance that is credited with policyholder premiums and interest and against which assessments are made for contract administration, mortality coverage, initiation, or surrender, and any of the amounts assessed or credited are not fixed and guaranteed.
    c. The insurer expects that changes in any contract element will be based primarily on changes in interest rates or other market conditions rather than on the experience of a group of similar contracts or the enterprise as a whole.

13. A nonguaranteed-premium contract that includes either of the following features shall be considered a universal life-type contract:

    a. The contract has a stated account balance that is credited with policyholder premiums and interest and against which assessments are made for contract administration, mortality coverage, initiation, or surrender, and any of the amounts assessed or credited are not fixed and guaranteed.

b. The insurer expects that changes in any contract element will be based primarily on changes in interest rates or other market conditions rather than on the experience of a group of similar contracts or the enterprise as a whole.

14. This Statement does not apply to the following types of long-duration insurance contracts:

a. Contracts with terms that are fixed and guaranteed and for which premiums are collected over the same period that benefits are provided
b. Contracts that provide benefits related only to illness, physical injury, or disability.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

…

Universal Life-Type Contracts

17. The liability for policy benefits for universal life-type contracts shall be equal to the sum of:

a. The balance that accrues to the benefit of policyholders at the date of the financial statements[4]
b. Any amounts that have been assessed to compensate the insurer for services to be performed over future periods (paragraph 20)
c. Any amounts previously assessed against policyholders that are refundable on termination of the contract
d. Any probable loss (premium deficiency) as described in paragraphs 35-37 of Statement 60.

18. Amounts that may be assessed against policyholders in future periods, including surrender charges, shall not be anticipated in determining the liability for policy benefits. In the absence of a stated account balance or similar explicit or implicit contract value, the cash value, measured at the date of the financial statements, that could be realized by a policyholder upon surrender shall represent the element of liability described in paragraph 17(a). Provisions for adverse deviation shall not be made.

19. Premiums collected on universal life-type contracts shall not be reported as revenue in the statement of earnings of the insurance enterprise. Revenue from those contracts shall represent amounts assessed against policyholders and shall be reported in the period that the amounts are assessed unless evidence indicates that the amounts are designed to compensate the insurer for services to be provided over more than one period.

20. Amounts assessed that represent compensation to the insurance enterprise for services to be provided in future periods are not earned in the period assessed. Such amounts shall be reported as unearned revenue and recognized in income over the period benefited using the same assumptions and factors used to amortize capitalized

[4] Accounting methods that measure the liability for policy benefits based on policyholder balances are known as retrospective deposit methods (FAS 97 footnote 4)

acquisition costs. Amounts that are assessed against the policyholder balance as consideration for origination of the contract, often referred to as *initiation* or *front-end fees,* are unearned revenues.

21. Payments to policyholders that represent a return of policyholder balances are not expenses of the insurance enterprise and shall not be reported as such in the statement of earnings. Amounts reported as expenses shall include benefit claims in excess of the related policyholder balances, expenses of contract administration, interest accrued to policyholders, and amortization of capitalized acquisition costs.

22. Capitalized acquisition costs shall be amortized over the life of a book of universal life-type contracts at a constant rate based on the present value of the estimated gross profit amounts expected to be realized over the life of the book of contracts. The present value of estimated gross profits shall be computed using the rate of interest that accrues to policyholder balances (sometimes referred to as the *contract rate*). If significant negative gross profits are expected in any period, the present value of estimated gross revenues, gross costs, or the balance of insurance in force shall be substituted as the base for computing amortization.

23. *Estimated gross profit,* as the term is used in paragraph 22, shall include estimates of the following elements, each of which shall be determined based on the best estimate of that individual element over the life of the book of contracts without provision for adverse deviation:

    a. Amounts expected to be assessed for mortality (sometimes referred to as the *cost of insurance*) less benefit claims in excess of related policyholder balances
    b. Amounts expected to be assessed for contract administration less costs incurred for contract administration (including acquisition costs not included in capitalized acquisition costs as described in paragraph 24)
    c. Amounts expected to be earned from the investment of policyholder balances less interest credited to policyholder balances
    d. Amounts expected to be assessed against policyholder balances upon termination of a contract (sometimes referred to as *surrender charges*)
    e. Other expected assessments and credits, however characterized.

24. The amortization method based on the present value of estimated gross profits described in paragraphs 22 and 23 of this Statement differs from that provided in Statement 60, which is based on expected premium revenues. This Statement does not define the costs to be included in acquisition costs but does describe those that are not eligible to be capitalized under this Statement. Acquisition costs are addressed in paragraphs 28-31 of Statement 60. Acquisition costs that vary in a constant relationship to premiums or insurance in force, are recurring in nature, or tend to be incurred in a level amount from period to period shall be charged to expense in the period incurred.

25. In computing amortization, interest shall accrue to the unamortized balance of capitalized acquisition costs and unearned revenues at the rate used to discount expected gross profits. Estimates of expected gross profit used as a basis for amortization shall be evaluated regularly, and the total amortization recorded to date shall be adjusted by a charge or credit to the statement of earnings if actual experience or other evidence suggests that earlier estimates should be revised. The interest rate

used to compute the present value of revised estimates of expected gross profits shall be either the rate in effect at the inception of the book of contracts or the latest revised rate applied to the remaining benefit period. The approach selected to compute the present value of revised estimates shall be applied consistently in subsequent revisions to computations of expected gross profits.