30 Cannon Street, London EC4M 6XH, United Kingdom
Tel: +44 (0)20 7246 6410 Fax: +44 (0)20 7246 6411
Email: iasb@iasb.org Website: www.iasb.org

International Accounting Standards Board

This document is provided as a convenience to observers at IASB meetings, to assist them in following the Board's discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.
These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting: **20 September 2006, London**

Project: **Insurance Contracts Phase II**

Subject: **Universal life contracts (Agenda Papers 12G and 12H)**

AGENDA PAPER 12G UNIVERSAL LIFE CONTRACTS

Purpose of this paper

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

2. The Board previously discussed some aspects of these topics in May 2006, without reaching a conclusion.

Summary of recommendations

3. This paper concludes the following:

   (a) In principle, it does not matter whether the account balance is measured at face amount or based on future cash flows (paragraph 8-12).

   (b) The staff should carry out further research on the operationality and relevance of the guaranteed insurability test for universal life contracts. However, the Board need not resolve this issue before publishing a discussion paper (paragraphs 13-16).

(c) Estimates of crediting rates in each scenario should reflect what the insurer actually expects to do in that scenario, rather than assume that the insurer pays the absolute minimum that can be contractually required (paragraphs 17-20).

What is universal life insurance?

4. The American Council of Life Insurers (ACLI) defines **universal life insurance** (or **adjustable life**) as 'A type of permanent life insurance[1] 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.'[2]

5. 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.

---

[1] 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.'

[2] 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

6. The appendix to agenda paper 4A for the May meeting included 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.

7. In April 2005, 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

8. In May, the staff suggested that two types of accounting approach could be considered for universal life contracts. The staff labelled them as a components approach and an integrated prospective approach.

9. The components approach would account separately for various components of the contract, such as the account balance, the obligation to provide mortality cover during the remainder of the current period for which mortality charges have already been deducted from the policyholder account, options and guarantees embedded in the contract (eg guaranteed maximum mortality or expense charges and guaranteed minimum crediting rates).

10. An integrated prospective approach would discount all future cash flows arising from the contract, and apply appropriate risk margins and service margins.

11. In the light of the discussion at the May meeting, the staff has analysed further how a prospective measurement would operate. The staff now concludes that the two approaches would lead to the same overall measurement. Example 1 in agenda paper 12H illustrates how the staff arrived at that conclusion. In summary, the conclusion depends on the fact that a prospective market-consistent measurement of the cash flows arising directly from the account balance would result in a measurement that equals the account balance.

12. The staff has not considered whether it would be appropriate to require insurers to disclose the amount of the account balance. The Board does not plan to address disclosure until after the discussion paper stage.

Which future cash flows?

13. The Board has decided tentatively 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. (February 2006)

(b) An insurer should present the recognised portion of the customer relationship as part of the related liability, not as a separate asset. (April 2006)

14. For many traditional life insurance contracts, all future premiums specified in the contract would pass the guaranteed insurability test. However, because universal life contracts give the policyholder considerable freedom to vary the premiums, some of the premiums for those contracts would probably pass the test but others would probably fail. Example 2 in agenda paper 12H illustrates how this might apply.

15. The motivation for the guaranteed insurability test is derived from an analysis of the insurer's contractual rights and contractual obligations. In principle, therefore, this test is applied contract by contract, not in aggregate for an entire portfolio of contracts.

16. Some may have concerns about the operationality of this test for contracts of this type and may question whether it will give users the most relevant and reliable information about these contracts. The staff intends to carry out further research on the operationality and relevance of the guaranteed insurability test for these contracts, but believes that the Board does not need to resolve this issue before publishing a discussion paper.

Crediting rates and analogy to participating contracts

17. 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.

18. 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.

19. In the staff's view, a measurement based solely on the contractually guaranteed minimum crediting rate is unlikely to provide useful information for users. The staff recommends that estimates of crediting rates in each scenario should reflect what the insurer actually expects to do in that scenario, rather than assume that the insurer pays the absolute minimum that can be contractually required.

20. The staff acknowledges that this recommendation may appear inconsistent with the Board's conclusions so far on participating contracts. The staff notes one possible distinction: for participating contracts, it might be argued that the contract contains an embedded equity instrument, whereas some might argue that the holder of a universal life contract has no direct contractual right to share in the performance of the entity or a pool of its contracts. One the other hand, some may feel that there is no difference of substance and that some participating contracts can have economic effects that are very similar to those of some participating contracts.

AGENDA PAPER 12H UNIVERSAL LIFE CONTRACTS: EXAMPLES

Purpose of this paper

1. This paper provides two examples to support the discussion in agenda paper 12G.

Example 1 Components approach or integrated prospective approach

Background

2. An insurer issues contracts with the following features:

   (a) Throughout the example, all cash flows are expressed as expected present values.

   (b) Initial premium CU 1,000, credited to policyholder account balance.

   (c) Expected present value of future premiums CU 1,400. When received, premiums are added to the account balance. This example assumes that it is appropriate to include all those premiums in the measurement. (Example 2 is designed to review whether that is appropriate.)

   (d) Expected present value of debits to account balance for mortality coverage CU 480. The expected present value of death benefits is CU 410. Thus, the expected present value of the profit from mortality is CU 70 (CU 480 – CU 410).

   (e) Interest is credited to the account balance at a rate determined by the insurer. The insurer's internal policy (not announced publicly) is to set a rate that passes to policyholders the actual investment return less 1%. In effect, the insurer aims to deduct an (implicit) annual investment management fee of 1%. The expected present value of those fees is CU 220.

   (f) The insurer estimates that market participants would require margins with an expected present value of CU 185, as follows:

      (i) a risk margin with an expected present value of CU 95 for bearing the risk associated with the contracts: principally mortality and lapse, with some indirect investment risk because of the impact on the implicit investment management fee.

(ii) a service margin with an expected present value of CU 90 for providing the services associated with the contract (principally investment management).

(g) When contracts mature or are cancelled, policyholders receive the account balance. The expected present value of those payments is CU 1,700 (initial premium CU 1,000 plus future premiums CU 1,400 minus mortality fees CU 480 and implicit investment management fees CU 220).

(h) The contract guarantees a minimum crediting rate and a maximum mortality charge. In principle, the example should attribute a value to those guarantees. For simplicity, the example assumes their value is negligible. Including the guarantees would not affect the issues this example is designed to illustrate.

(i) The insurer incurs acquisition costs of CU 90 at inception.

(j) It follows from (d) and (e) that the expected present value of the insurer's profit is CU 290 (CU 70 from mortality and CU 220 from implicit investment management fees). This compares with the risk and service margins of CU 185 (CU 95 plus CU 90) that market participants would require. (Note that there is a cross-subsidy from the investment management component to the mortality component.) After risk and service margins, the current exit value of the contracts is CU 105 (CU 290 less CU 185). CU 90 of this is needed to recover acquisition costs, so there is a small net profit of CU 15 at inception.

Integrated prospective approach

3. Using an integrated prospective approach, the insurer's liability would be analysed as follows:

Expected present value of future:	*CU*
Death benefits	410
Repayments to policyholders	1,700
Premiums	(1,400)
Sub-total before margins	710
Risk and service margins	185
Current exit value of the liability	895

4. The insurer has cash of CU 910 (initial premium of CU 1,000 less acquisition costs of CU 90. Thus, the insurer's equity at inception is CU 15 (assets CU 910 less liabilities CU 895).

Components approach

5. Using a components approach, the insurer's liability would be analysed as follows:

	CU
Account balance	1,000
Expected present value of profits	(290)
Sub-total before margins	710
Risk and service margins	185
Current exit value of the liability	895

6. This approach generates the same total liability as the integrated prospective approach.

Why do the two approaches give the same result?

7. The two approaches give the same result because both implicitly or explicitly include the account balance at face amount. This may seem surprising because the integrated prospective approach uses future cash flows, rather than the account balance itself. The key to understanding why this is to consider how credited interest affects the current exact value.

8. Suppose in this example the risk free rate is 5% and the expected return on actual assets is 7.5%. Thus, the expected crediting rate is 6.5% (expected return 7.5% less implicit fee of 1%). Therefore, after one year, the account balance would be CU 1,065 if there were no deductions for mortality. The appropriate discount rate for a liability that exactly matches the asset in all respects is the same as for the asset, in other words 7.5%. Therefore, the present value, after risk margins, of the account balance in one year is CU 1,065 / 1.075 = CU 990.70 (ie CU 1,000 less the present value of the investment management fee).

9. It follows that there are three equivalent ways of including the account balance, with credited interest, in the measurement:

   (a) Include estimated interest that will be credited (ie asset return less implicit fee), and discount at the rate appropriate for the assets that drive the crediting rate.

   (b) Include estimated interest based on a risk-free rate (ie risk-free rate less implicit), and discount at the risk-free rate.

   (c) Do not include credited interest and do not discount the account balance. Deduct the present value of the implicit fee. Example 1 uses this approach.

Example 2 future premium inflows

Background

10. Example 2 uses the same basic data as example 1, but divides the cash flows into four categories:

    (a) Cash flows that will occur if policyholders pay no further premiums.

    (b) Additional cash flows that increase the measurement of the liability and are not in (a) but will occur if policyholders continue to pay premiums. For example, some policyholders may have suffered deterioration in health, such that the expected present value of death benefits exceeds the expected present value of mortality. The insurer has an unconditional stand ready obligation to accept these premiums. Under the Board's tentative conclusions, these cash flows are included in the measurement of the liability.

    (c) Additional cash flows that are not in (a) or (b) and will occur if policyholders continue paying premiums that they must pay if they wish to retain guaranteed insurability. Under the Board's tentative conclusions these cash flows relate to a portion of a customer relationship, rather than to contractual rights and contractual rights and obligations. However, that portion of the customer relationship is presented together with the contractual rights and contractual obligations, and is measured in the same way as them.

    (d) Additional cash flows that are not in (a), (b) or (c) and will occur if policyholders pay additional premiums.

11. The table on the following page summarises the cash flows in each of these categories. It also shows the total cash flows for the four categories combined, as well as separate sub-totals for categories A+B and A+B+C.

12. The top half of the table summarises the movements in the account balance over the life of the contract.

13. The lower half of the table:

    (a) shows the cash flows that impact the insurer (death benefits paid by the insurer, as well as charges to the account balance for investment management and the implicit fee for investment management).

(b) deducts from those cash flows the risk margin and service margin that market participants would require, to arrive at the current exit value of the liability (excluding the account balance).

Movements in account balance

	A	B	C	D	**Total**	A+B	A+B+C
Account balance at inception	1,000				**1,000**	1,000	1,000
Future receipts from policyholders		300	400	700	**1,400**	300	700
Future mortality fee charges to account balance	(200)	(60)	(80)	(140)	**(480)**	(260)	(340)
Future interest deductions from account balance	(100)	(25)	(35)	(60)	**(220)**	(125)	(160)
Future repayments to policyholders	(700)	(215)	(285)	(500)	**(1,700)**	(915)	(1,200)
Account balance at end of contract terms	**0**	**0**	**0**	**0**	**0**	0	0
Cash flows for the insurer (other than account balance)							
Future mortality fee charges to account balance	200	60	80	140	**480**	260	340
Future death benefits	(150)	(100)	(60)	(100)	**(410)**	(250)	(310)
Net benefit (loss) from mortality	50	(40)	20	40	**70**	10	30
Future interest deductions from account balance	100	25	35	60	**220**	125	160
Total benefit from contracts (mortality+ interest)	150	(15)	55	100	**290**	135	190
Required risk margin	(40)	(10)	(15)	(30)	**(95)**	(50)	(65)
Required service margin	(35)	(12)	(18)	(25)	**(90)**	(47)	(65)
Current exit value of the asset (liability) at inception, before account balance	75	(37)	22	45	**105**	38	60

A = cash flows assuming no further premiums
B = cash flows arising from further premiums that increase the net liability
C = cash flows arising from further premiums to maintain guaranteed insurability
D = cash flows from other premiums, not in B, C or D
A+ B = cash flows included in the measurement of the liability
A+ B+C = cash flows included in the measurement of the liability with related customer relationship

Comments on the table of cash flows

14. If the measurement excludes all cash flows that depend on future premiums (ie includes only those cash flows in category A), the contract is worth only CU 75 to the insurer - less than the acquisition costs of CU 90, so the insurer would recognise at net loss of CU 15 at inception. The total measurement of the contract at inception is CU 1,075 (CU 75 plus account balance of CU 1,000).

15. If the measurement includes cash flows in categories A and B, the contract is worth CU 38 to the insurer, so the insurer would recognise a net loss of CU 52 at inception (CU 90 less CU 38).

16. If the measurement includes the cash flows in categories A, B and C, the contract (including related customer relationship) is worth CU 60 to the insurer – net loss of CU 30 at inception.

17. If the measurement includes cash flows in all four categories, the contract is worth CU 105 at inception – net gain of CU 15 at inception (CU 105 less CU 90).

18. In practice, separating the cash flows into the above categories may not be straightforward and may require distinctions that management might not otherwise consider particularly relevant.