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STAFF PAPER

REG FASB | IASB Meeting

Project	**Insurance contracts**		
Paper topic	Riders and Policy Loans		
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What is the purpose of this paper?

1. Policy loans and contract modifications (riders) are features that may be present in insurance contracts. Many respondents to the IASB Exposure Draft *Insurance Contracts* ('ED') and the FASB Discussion Paper *Preliminary Views on Insurance Contracts* ('DP') commented that it was unclear whether and how the guidance on unbundling would be applied to those features which effect the terms of the underlying insurance contract. This paper analyses how to account for such features, considering how the board's most recent tentative decisions on separation (unbundling and disaggregation) would apply to such components.

2. This paper considers features that are present at inception. Contract modifications that are made after inception of the contract are discussed in agenda paper 2G/82G.

Summary of Staff Recommendation

3. The staff recommend the following:

    (a) in applying the general decisions on unbundling and disaggregation, policy loans should be considered in the determining the amount of the investment component which they relate to,

    (b) insurers should account for riders that are part of the insurance contract at inception as part of the contractual terms of the contract. Thus the general decisions on unbundling and disaggregation should apply to riders.

Background Information

4. A policy loan is an amount borrowed by the holder of a life insurance contract (mostly whole life and endowment contracts) that is limited to the cash surrender value (or some percentage of the cash surrender value) of the contract[1]. Typically there is no maturity date for repayment (independent of the termination of the insurance contract). Amounts outstanding under a policy loan, including interest, either will be repaid to the insurer or will offset the amount of any eventual cash payout (i.e., any outstanding principal and interest is deducted from the benefit payment). Many contracts state that if, at specified dates, the policy loan exceeds the cash surrender value of the policy, the insurer can demand payment to reduce the outstanding amount below the cash surrender value or lapse the policy. The ability to receive a policy loan is generally included in the contract terms at inception of the contract.

5. A rider is an attachment or annex to an insurance contract that acts to modify the contract in some way. The primary purpose of using a rider rather than including its contents in

[1] The existence of an outstanding loan generally affects the amount of interest crediting or growth in the cash surrender value of a contract. An insurer might credit a minimum amount for the portion of the account value that relates to policy loans while crediting a higher amount for the remainder of an account balance.

the body of a contract is to avoid rewriting or redrafting the document entirely. The rider, once written, is understood to be part of the underlying contract. A rider may provide for additional benefits to the policyholder or it may take away or restrict benefits (or a combination of both). In most circumstances riders are effective at the inception of a contract; however it is not uncommon for a rider to be added at a later date. This paper discusses only those riders that are effective at the inception of a contract. We discuss riders that modify a contract after inception in paper 2G/82G.

Summary of Feedback Received on the ED/DP[2]

6. Some respondents to the ED indicated that additional guidance is required in the accounting for riders and policy loans, in particular as to how the 'closely related' principle for unbundling should be applied to components other than embedded derivatives.

7. Several respondents noted diversity in practice currently exists when deciding to unbundle these components depending on whether the entity views the loan as part of the insurance contract or a separate financial instrument.

8. Many respondents felt it would not be appropriate to unbundle policy loans, as they believe such loans are closely related to the underlying insurance contracts because they (a) reduce the cash value of the policy until they are repaid and (b) can be taken only up to the amount of the cash surrender value of the contract.

9. Some note that if policy loans were not unbundled, insurers would measure policy loans at the expected present value of cash flows. Some may object to this accounting for the same reasons that respondents were against measuring other loans at fair value under the respective financial instruments guidance/proposal.

[2] The boards have subsequently amended the proposals in the ED: the extract from the ED is included in the Appendix B, tentative decisions to date on unbundling and disaggregation are included in the Appendix A

Existing Accounting for Policy Loans

10. There is currently diversity in practice regarding which guidance to apply to policy loans. Some argue that policy loans should fall under the scope of IAS 39, *Financial Instruments Recognition and Measurement* and ASC Topic 825- *Financial Instruments* because they are freestanding loans, the repayment of which is not necessarily tied to an insurance contract. Supporters of this view argue that the risks associated with policy loans (non-performance and interest rate risk) are unrelated to the risks associated with insurance contracts (mortality risk). Under IAS 39 and ASC Topic 825, policy loans are measured at amortized cost unless the fair value option is used (if available).

11. Others argue that policy loans are specifically scoped out of IAS 39 because the right of a policyholder to take a loan against a policy's cash surrender value is a right which arises under an insurance contract between an insurer and a policyholder. Rights and obligations arising from insurance contracts are within the scope of IFRS 4 *Insurance Contracts*. Policy loans generally do not have stated maturity dates, and they are immediately payable upon a lapse, termination, or settlement of the insurance contract. Supporters of this view argue that from the insurer's perspective, a policy loan represents a right to pay reduced amounts when the insured event occurs (i.e. upon death of the insured). IFRS 4 does not prescribe a method for accounting for policy loans. Supporters of this view also generally measure policy loans at amortized cost currently. The reason is mainly because that's what they have done historically and/or that is how they measure the insurance liability.

12. Article 7 of Regulation S-X requires SEC insurance company registrants to separately present policy loans as an asset on the face of the balance sheet. US statutory accounting also accounts for policy loans as a separate asset. Typically companies include policy loans as part of their total invested assets.

Staff analysis

Disaggregation and unbundling of policy loans

13. In nearly all cases, policy loans occur in contracts that have explicit or implicit account balances and the policy loan will likely be a reduction in the account balance. A policy loan is not itself an account balance within the insurance contract liability. A defining feature of a policy loan is that if the contract is terminated (regardless of whether by lapse, death, surrender, etc...), the amount of any cash distribution will be reduced by the amount of all outstanding policy loans. Thus, the actual amount that would be returned to the policyholder at any given time is the amount of the balance less any outstanding policy loans. Based on this notion, policy loans are actually a component (albeit an offsetting component) of the account balance (i.e., they would reduce the value of investment components as defined during the March 2012 joint board meeting. In this regard, policy loans are interrelated with the investment component. The staff believe that policy loans should not be unbundled as a standalone item but should instead be considered together with the investment components they affect. The boards' general decisions on unbundling and disaggregation, including any future decisions about possible unbundling of distinct investment components, would then be applied to the investment component and the amount of the policy loan would be considered in the determination of the amounts to be returned to policyholders[3].

14. Some believe that policy loans should be unbundled from the insurance contract liability. However, if policy loans are unbundled there may be an accounting mismatch created. As noted in paragraph 4, the amounts available to be borrowed as a policy loan are dependent on the amount of the account balance. Therefore an accounting mismatch will occur if any cash flows dependent upon the account balance (e.g., payments upon a

[3] Policy loans would generally not be considered a distinct feature of the insurance component (if the concept of goods and services were to be applied) because insurers do not regularly sell such services separately. The boards' tentative decisions on unbundling goods and services are set out in the appendix. The staff plans to explore whether 'distinct' investment components should be unbundled at a future meeting.

policy lapse gross of any offset from outstanding loans) and the policy loan are measured using different bases. If the boards decide to unbundle policy loans, the amounts payable on account balance would be measured based on the expected present value of cash flows (as a part of the insurance liability) whereas the amounts receivable as policy loans would be measured using a different measure based on the financial instruments guidance for loans, presumably amortized cost unless the fair value option is used.

15. Accordingly, the staff recommends that policy loans should be considered together with any account balances, and hence their amount should be considered in the determination of the amounts to be returned to policyholders.

Question 1: Policy Loans
Do the boards agree that, in applying the general decisions on unbundling and disaggregation, policy loans should be considered in determining the amount of the investment component which they relate to.

Riders

16. As noted in paragraph 2, this paper discusses only riders added at the inception of the contract.[4]

17. Unless they are embedded derivatives that require separate accounting under existing financial instrument guidance, current accounting would treat most riders as part of the insurance contract they modify. Some riders that are embedded derivatives (eg guaranteed minimum accumulation benefit) are unbundled under the guidance already established in IFRS 9 *Financial Instruments* and Topic 815, *Derivatives and Hedging*. [5]

18. Some questioned whether riders should be accounted for as part of the contract they modify or as a standalone contract.

[4] Some examples of riders are included in the Appendix C.

[5] During their March 2011 meeting the boards tentatively confirmed the proposals in the ED to unbundle those embedded derivatives.

19. In the staff's view riders that are added at inception are no different than features that are incorporated in the contract, as the related information is known at inception and can be considered by the insurer in its measurement of the insurance liability. In this regard, they should be accounted for in the same manner as features that are part of the contract at inception.

20. Paragraphs 28 and 29 of the ED indicate that features or options present in insurance contracts should be included in the measure of the insurance contract unless they are options, forwards and guarantees unrelated to the insurance coverage under the existing insurance contract. The guidance also indicates that options, forwards and guarantees are outside the contract boundary if they do not relate to the insurance coverage under the existing contract and that the insurer should account for such features as standalone instruments.

21. Applying paragraphs 28 and 29, riders added at the inception of a contract would be included in the measure of the insurance contract unless they are options, forwards and guarantees unrelated to the insurance coverage under the existing insurance contract (when they would be treated as a standalone instrument).

22. Some suggest that riders should be unbundled from the insurance contract they modify in all cases. However, it is important to note that most riders transfer separate insurance risk from that of the contract, meaning that they would be accounted for under insurance contracts guidance regardless of whether they are unbundled. Any unbundling of such components would not generally[6] result in a change in recognition or measurement. As a result, many thinks that the benefits of unbundling riders would not outweigh the costs.

[6] A rider could affect the determination of whether a contract (or portfolio) it is added to qualifies for the premium allocation approach (PAA). According a rider might mean that a contract would not qualify to account for under PAA anymore, and this might affect the measurement. For example, the insurance contract liability might not require discounting under the PAA because of the practical expedient but, under the BBA, discounting would be required unless its effect is insignificant. Also, based on the FASB's tentative decisions there is no single margin in the liability for incurred claims measured under the PAA but there is a margin included in the insurance contracts liability under the BBA.

Staff Recommendation

23. The staff believe that riders that are effective at the inception of a contract are characteristic of contractual options or features. If a rider is deemed to be more characteristic of a good/service, investment, or embedded derivative component, then it should be accounted for under the guidance for those types of components. Therefore the staff recommend that riders that are part of the insurance contract at inception should be accounted the same way as would be as a part of the contract.

Question 2: Riders
Do the boards agree that insurers should account for riders that are part of the insurance contract at inception as part of the contractual terms of the contract. Thus the general decisions on unbundling and disaggregation should apply to riders.

Appendix A: Tentative decisions to date on unbundling and disaggregation

Investment component

A1. At their meeting in the week commencing 19 March 2012, the IASB and FASB tentatively decided that:

(a) an investment component in an insurance contract is an amount that the insurer is obligated to pay the policyholder or a beneficiary regardless of whether an insured event occurs.

(b) In the statement of financial position, insurers should not be required to present investment components separately from the insurance contract. However insurer should disclose both:

(i) the portion of the insurance contract liability that represents the aggregated portions of premiums received (and claims / benefits paid) that were excluded from the statement of comprehensive income; and

(ii) the amounts payable on demand.

A2. In addition, the IASB tentatively decided that insurers should exclude from the aggregate premium presented in the statement of comprehensive income the present value of the amounts the insurer is obligated to pay to policyholders or their beneficiaries regardless of whether an insured event occurs, determined consistently with measurement of the overall insurance contract liability. The FASB did not vote on this issue.

A3. Both boards directed the staff to consider whether any investment components (as defined) are sufficiently distinct from the insurance component that they should be recognised separately and measured applying the financial instrument standard, rather than the insurance contracts standard. We will discuss this in a future meeting.

Embedded derivatives

A4. At their meeting in the week commencing 21 March 2011, the boards tentatively confirmed the proposal in the ED/DP that an insurer should account separately for embedded derivatives contained in a host insurance contract that is not closely related to the embedded derivative.

A5. At their meeting on week commencing 12 December 2011, the boards tentatively confirmed that options and guarantees embedded in insurance contracts that are not separately accounted for as derivatives under the financial instrument requirements should be measured within the overall insurance contract obligation using a current, market-consistent, expected value approach.

Goods and services

A6. At their meeting in the week commencing February 2012, the boards tentatively decided on the following criteria for unbundling goods and services:

a. An insurer shall identify whether any promises to provide goods or services in an insurance contract would be performance obligations as defined in the exposure draft *Revenue from Contracts with Customers*. If a performance obligation to provide goods or services is distinct, an insurer shall apply the applicable IFRSs or US GAAP in accounting for that performance obligation.

b. A performance obligation is a promise in a contract with a policyholder to transfer a good or service to the policyholder. Performance obligations include promises that are implied by an insurer's customary business practices, published policies, or specific statements if those promises create a valid expectation by the policyholder that the insurer will transfer a good or service. Performance obligations do not include activities that an insurer must undertake to fulfil a contract unless the insurer transfers a good or service to a policyholder as those activities occur. For example, an insurer may need to perform various administrative tasks to set up a contract. The performance of those tasks does not transfer a service to the policyholder as the services are performed. Hence, those promised setup activities are not a performance obligation.

c. Except as specified in the following paragraph, a good or service is distinct if either of the following criteria is met:

   i. The insurer regularly sells the good or service separately.

   ii. The policyholder can benefit from the good or service either on its own or together with other resources that are readily available to the policyholder. Readily available resources are goods or services that are sold separately (by the insurer or another entity), or resources that the policyholder has already obtained (from the insurer or from other transactions or events).

d. Notwithstanding the requirements in the previous paragraph, a good or service in an insurance contract is not distinct and the insurer shall therefore account for the good or service together with the insurance component under the insurance contracts standard if both of the following criteria are met:

   i. The good or service is highly interrelated with the insurance component and transferring them to the policyholder requires the insurer also to provide a significant service of integrating the good or service into the combined insurance contract that the insurer has entered into with the policyholder.

   ii. The good or service is significantly modified or customised in order to fulfil the contract.

Appendix B: Extract from the ED Insurance contracts

This extract contains paragraphs from the ED which are mentioned in the paper. The paragraphs' numbers are the same as in the ED.

8. Some insurance contracts contain one or more components that would be within the scope of another IFRS if the insurer accounted for those components as if they were separate contracts, for example an investment (financial) component or a service component. If a component is not closely related to the insurance coverage specified in a contract, an insurer shall apply that other IFRS to account for that component as if it were a separate contract (ie shall *unbundle* that component). The following are the most common examples of components that are not closely related to the insurance coverage:

(a) an investment component reflecting an account balance that meets both of the following conditions:

  (i) the account balance is credited with an explicit return (ie it is not an implicit account balance, for example derived by discounting an explicit maturity value at a rate not explicitly stated in the contract); and

  (ii) the crediting rate for the account balance is based on the investment performance of the underlying investments, namely a specified pool of investments for unit-linked contracts, a notional pool of investments for index-linked contracts or a general account pool of investments for universal life contracts. That crediting rate must pass on to the individual policyholder all investment performance, net of contract fees and assessments. Contracts meeting those criteria can specify conditions under which there may be a minimum guarantee, but not a ceiling, because a ceiling would mean that not all investment performance is passed through to the contract holder.

(b) an embedded derivative that is separated from its host contract in accordance with IAS 39 (see paragraph 12 below).

(c) contractual terms relating to goods and services that are not closely related to the insurance coverage but have been combined in a contract with that coverage for reasons that have no commercial substance.

9. In unbundling an account balance specified in paragraph 8(a), an insurer shall regard all charges and fees assessed against the account balance, as well as cross-subsidy effects included in the crediting rate, as belonging to either the insurance component or another component, but are not part of the investment component. Thus, the crediting rate used in determining that account balance reflects a crediting rate after eliminating any cross-subsidy between that rate and the charges or fees assessed against the account balance.

10. An insurer shall not unbundle components of a contract that are closely related to the insurance coverage specified in the insurance contract.

11. Throughout this [draft] IFRS, the term *insurance contract* refers to the components of an insurance contract that remain after unbundling any components in accordance with paragraph 8.

(…)

28. Many insurance contracts have features that enable policyholders to take actions that change the amount, timing, nature or uncertainty of the benefits they will receive. Such features include surrender options, conversion options and options to cease paying premiums but still receive some benefits. The measurement of insurance contracts shall reflect the future behaviour of policyholders on an expected value basis, with an adjustment for the risk that the actual behaviour of the policyholder may differ from the expected behaviour. For example, the measurement of an insurance contract:

(a) shall not assume that all policyholders surrender their contracts only because surrender would be unfavourable to the insurer.

(b) shall not assume that all policyholders continue their contracts only because continuation would be unfavourable to the insurer.

29. If options, forwards and guarantees do not relate to the insurance coverage under the existing insurance contract, they are not within the boundary of that contract. The insurer shall account for those features as new insurance contracts or other stand-alone instruments according to their nature.

Appendix C: Common insurance riders

Common Name	Description	Attached To:	Insured Event per Contract	Insured Event with Rider
Accidental Death Double Indemnity	Beneficiary receives 2X stated death benefit if insured dies in an accident	Permanent life insurance	Death	Death
Mortgage Protection	Separate mortgage insurance policy attaches to life insurance to be used to pay off outstanding mortgage balance at death	Permanent life insurance	Death	Death while mortgage outstanding
Waiver of Premium	Allows insured to stop making premium payments in event of permanent disability or extended hospital stay	Permanent life insurance / Health insurance	Death / Medical expenses	Permanent disability / Medical expenses
Guaranteed insurability	Guarantees the right to purchase new policy regardless of health	Life insurance	Death	Death
Accelerated death benefit	Allows part of death benefit to be paid in advance if insured is diagnosed with terminal illness	Permanent life insurance	Death	Terminal illness
Personal property protection	Increase coverage amounts for personal property. Useful for those who own especially valuable items (e.g. fine art)	Homeowners	Loss relating to primary residence	Loss relating to property specifically named in rider

Common Name	Description	Attached To:	Insured Event per Contract	Insured Event with Rider
Second home	Insures second home using coverage under existing policy	Homeowners	Loss relating to primary residence	Loss relating to primary residence and/or second home
Home office	Covers home office equipment and inventory	Homeowners	Loss of property (most often excludes home office)	Loss of home office
Workers compensation	Protects against injury to service providers working in the insured person's home.	Homeowners	Loss of property	Injury to service provider
Guaranteed Minimum Death Benefit	Guarantees a minimum death benefit, regardless of account value.	Variable annuities	Death	Death
Guaranteed Minimum Income Benefit	Guarantees insured will get minimum income stream after annuitization	Variable annuities	Death	Death
Guaranteed Minimum Withdrawal Benefit	Same as above, but does not require annuitization	Variable annuities	N/A	N/A
Guaranteed Minimum Accumulation Benefit	Guarantees that account value will equal at least a specific value at a point in the future	Variable annuities	N/A	N/A

Common Name	Description	Attached To:	Insured Event per Contract	Insured Event with Rider
Disability income	Provides income equivalent to the insured person's salary/wages in the event of disability	Permanent Life insurance	Death	Disability
Family income benefit	Provides stream of steady income to beneficiary, rather than lump-sum death benefit	Permanent Life insurance	Death	Death
Level term	Provides a fixed amount of term insurance added to a permanent policy for a period of time	Permanent Life insurance	Death	Death
Adjustable features	Policyholder can make changes to two of the following elements: face amount, premium amount/payment period, and duration of coverage. Elected changes will affect the nature or amount of the remaining element.	Adjustable life contract	Death	Death
Guaranteed living benefit	Ensures that variable annuity payments will not go below a specific amount, regardless of investment performance	Variable annuity	N/A	N/A
Spousal protection or supplementary contract	At death, beneficiary has option of receiving lump-sum or continuing with distribution of income unchanged	Variable annuity	Death	Death
Long-term care	Provides medical care to insured in event	Health	Medical Expenses	Permanent

Common Name	Description	Attached To:	Insured Event per Contract	Insured Event with Rider
	of permanent disability	insurance		Disability
Extended stay	Extends the maximum duration of hospital stay for which the insured is covered	Health insurance	Medical Expenses	Medical Expenses
Exclusions	Provides that certain conditions and/or conditions arising from specified events are not insured	Health insurance Life insurance	N/A	N/A