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Project **Insurance Contracts**

Topic **Universal life insurance and other account-driven contracts**

Purpose of this paper

1. This paper addresses the accounting for what we will call *account-driven* life insurance and annuity contracts. Unlike the traditional life insurance contracts, these have an explicit policy account balance that is communicated to the policyholder. Premiums are treated as if they were deposits to the account. Interest is credited to the account, and charges for insurance, expenses, and surrender penalties are debited against the account. The terms of the contract and local regulation grant limited discretion to both the insurer and the policyholder. The IASB's discussion paper *Preliminary Views on Insurance Contracts* identified three variations on account-driven contracts:
 - (a) *Universal life*, in which the insurer has discretion to change the amounts of credits and charges and the policyholder has the discretion to vary the amount of premium paid and life insurance coverage.
 - (b) *Index-linked* contracts, in which the amount of the interest credit is based on a bond or equity index. In many cases, the insurer is required to pay a minimum interest rate, and the amount to which this minimum applies resets periodically.
 - (c) *Unit-linked or variable* contracts, in which the policyholder's account is invested in a separate managed fund and isolated from the general

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creditors of the insurance company. Unit-linked and variable contracts present the issue of whether the managed fund is an asset of the insurance company, and the balance a liability, or whether the fund is like a mutual fund or bank trust account. We will set aside unit-linked and variable contracts for the rest of this paper and address them separately in agenda paper 19B (FASB Memorandum 39B).

2. There is a blizzard of variations on those three contract forms, each tailored to particular policyholders and marketing designs. For our purposes, the three categories mentioned above are sufficient.
3. The questions at hand are whether this particular branch of the insurance tree should have a different measurement method. There are obvious connections here to issues about policyholder behaviour, presentation, and unbundling. There are also similarities between account-driven contracts and participating life insurance. We will deal with the last topic later in this paper.

Summary of staff recommendations

4. The staff recommends that the building-block approach developed in this project be applied to account-driven contracts.

A brief history

5. In his handout for the December Joint Board meeting, Hans presented a box with corners labelled, Protection, Investment, Service, and Derivative. *Every* insurance contract includes those four elements, albeit with differing importance depending on the contract:
 - (a) Protection, because insurance is a contract that pays based on the occurrence of fortuitous events;
 - (b) Investment, because every insurance contract is a “you pay now, we pay (maybe) later” arrangement;

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- (c) Service, because the insurer provides services not found in a purely financial contract, including underwriting and claim processing; and
 - (d) Derivative, because an insurance contract is similar to a written option, although different from the usual financial option.
6. The different elements become more pronounced, and individually more important, as one moves from simple one-year general insurance contracts to multi-year life insurance. Most long-term life insurance contracts, including those known as *whole life* contracts, have had an explicit financial component – cash surrender value – since the middle of the 1800s. The design of the core contract in life insurance – fixed premiums, fixed death benefit, and fixed schedule of cash surrender values – remained unchanged for 100 years. There were new features, like the right to buy more coverage at the original price, but the basic contract was unchanged.
7. Things began to change in the 1960's and 1970's, at least in the US. Consumers began to see the traditional life insurance policy as a bad idea. “Buy term and invest the difference,” became the slogan of many financial advisors. During the pre-Volcker U.S. inflation, an insurance policy with a cash-surrender accumulation based on a 3 or 4 percent interest rate was not very attractive.
8. Universal life attempted to address the problem by giving the customer a look into the contract's pieces. Premiums were added to an accumulation account that looked like a bank account. Interest was credited to the account. Insurance (mortality and morbidity) charges and expense charges were debited. Some early contracts had an up-front fee charged to the accumulation account, but most insurers favoured a penalty charge for early termination of the contract. The penalty charge typically decreased each year the contract remained in force.
9. The idea of an accumulation fund isn't unique to universal life. It has been part of actuarial mathematics for a long time. Universal life made the fund transparent. The big change, though, was the discretion that universal life could allow to both the insurer and the policyholder. Universal life gave the insurer the potential ability to adjust any of the charges and credits against the policyholders' accounts. The interest credit rate became the focus of this new

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ability, and consumer advocates criticised salesmen for projections based on perpetually high crediting rates. Policyholders gained the right to vary the timing and amount of premium payments. Many universal life contracts were replacements of existing traditional contracts and the large initial premium came from the cash surrender value of the old contract. Indeed, one actuary who was instrumental in the development of universal life called it “Cannibal Life,” recognising that many sales would feed off of existing business.

10. The policyholder’s account gave insurance companies freedom to innovate, sometimes with disastrous results. For example:
 - (a) Was the policyholder’s account part of the general liabilities of the insurance company, or was it directed to specific investment funds?
We will return to the later case, known as *variable* or *unit-linked* contracts in a separate paper.
 - (b) Was the interest rate set at the insurer’s discretion, or by some other means? Could the interest rate be based on an index of debt or equity securities?
 - (c) Regulators often required a minimum guaranteed interest rate, even for index-linked contracts. How often did the contract reset the amount subject to the guarantee? (Important if the interest rate was based on an index that could be negative.)

11. The accounting for non-traditional insurance contracts came to the FASB in the middle of the 1980s and was assigned to a young practice fellow who had once purchased an insurance contract. US GAAP for life insurance was developed 20 years earlier and was built around the traditional contracts described in paragraph 6.¹ Prior to the development of that guidance, insurers reported liabilities measured using statutory rules provided by insurance regulators. Those rules were criticised as inappropriate for financial reporting because they often used unreasonable assumptions (for example, that policyholders never

¹ Former IASB and FASB member Tony Cope was a junior member of the team.

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surrender policies before death or an out-of-date mortality table) and required that acquisition costs be charged to expense when incurred.

12. The accountants, actuaries, and users who worked on that guidance searched for a way to identify how services were provided under the contract. They knew that the contract had both financial and insurance attributes, but they could find no non arbitrary way to reflect what was going on. They were also constrained by the sophistication of computer resources available. They settled on an approach in which:

- (a) Receipt of premium was deemed to be a surrogate measure of services rendered under the contract. It would be reported as revenue when received. Because most contracts had level premiums that were paid monthly, any difference between received and earned premium was likely to be immaterial.
- (b) If experience developed in line with expectations (including investment earnings), some of net income would emerge as a percentage of premiums and some as a release from the *risk of adverse deviation*.

That term is defined in US GAAP as:

A concept used by life insurance enterprises in estimating the liability for future policy benefits relating to long-duration contracts. The risk of adverse deviation allows for possible unfavorable deviations from assumptions, such as estimates of expected investment yields, mortality, morbidity, terminations, and expenses.

There is no guidance on how a life insurer should determine the amount of a provision for adverse deviation or how the provision goes away, only that the insurer should have one; and

- (c) That assumptions made on initial recognition should be *locked-in*. Assumptions would not be changed unless a premium deficiency developed; what we would call an onerous contract.

13. The model shows a striking similarity to a customer-consideration approach to revenue recognition with a single performance obligation. It has also been characterised as an instalment-sale approach.

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14. Universal life insurance and its cousins were a challenge for this model. Premiums were no longer a surrogate for services provided, especially when the entire premium for the policy might be paid in a single amount. Moreover, industry commentators were raising questions about contracts issued by insurance companies that seemed to provide little insurance protection.

The solution formerly known as Statement 97

15. The FASB had to make a basic decision.
- (a) It could try to fit account-driven insurance contracts into the old premium-driven model by adjusting provisions for adverse deviation. The AICPA issues paper sent to the FASB favoured this approach.
 - (b) It could develop a new insurance accounting model for all contracts; or
 - (c) It could allow the terms of the contract to drive recognition and measurement, and fix some obvious abuses in the existing model.
16. The FASB settled on (c). It rejected (a) because it could find no basis for selecting one set of adjustments to adverse deviation over another. Remember, this was twelve years before Concepts Statement 7 introduced the ideas of expected cash flows and risk adjustment in the context of a fair value measurement. The FASB never seriously considered (b). This project was about fixing the plumbing, not building a new house.
17. In Statement 97, the FASB divided the world of long-duration insurance into four parts:
- (a) Traditional contracts, including traditional participating contracts, with terms that are fixed and guaranteed were left under the premium-driven model described earlier.
 - (b) Investment contracts were defined as those that “do not incorporate significant insurance risk as that concept is contemplated in Statement 60” and were removed from insurance accounting.

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- (c) Limited payment contracts were defined as those that would have been traditional contracts under (a), but for the fact that the premium was collected over a period significantly shorter than the insurer's exposure to mortality risk. Profit was deferred and recognized over the total contract life. Essentially, this made the pattern of profit recognition from limited payment contracts similar to that of traditional contracts.
 - (d) Universal Life-Type contracts were those that had an explicit account balance and that granted discretion to the insurer, the policyholder, or both. They got a new accounting model.
18. The new accounting model made the policyholder's account the centrepiece of the measurement. The FASB reasoned,
- After examining the characteristics of various long-duration insurance contracts, the Board concluded that the balance that accrues to the benefit of individual policyholders represents the minimum measure of an insurance enterprise's liability that is consistent with the definition above. For many universal life-type contracts, this amount takes the form of an account balance that, absent future action by the policyholder, will continue to fund operation of the contract until exhausted or reduced to a contract minimum. The insurer has a present obligation, arising from past transactions, to continue to maintain the contract and provide mortality protection as long as an adequate account balance exists. [Statement 97, paragraph 53.]
19. The balance of the policyholder's account was the basic measure of the liability, increased if necessary for:
- (a) Charges assessed by the insurer for services provided over more than one period;
 - (b) Amounts refundable on termination; and
 - (c) Any premium deficiency (onerous contract adjustment).
20. Please note that the measurement prescribed by Statement 97 does not include a deduction for surrender charges. A policy with an account balance of CU 2,000 and a penalty for surrender of CU 500 would be recorded at CU 2,000.
21. As I recall it, the liability measurement was the easy part of the project. The FASB devoted most of a year to debates around how to amortize deferred policy

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acquisition costs. In particular, the question was whether or not the amortization scheme should be present-value based.

22. The FASB made two other changes that were very controversial. They are also familiar in light of some of the Boards' current projects.
23. Having redefined the measurement of an insurer's liability, the FASB redefined revenue and expense for universal life-type contracts. It shifted the presentation from gross to net. The amounts assessed against policyholders' accounts would be revenue as realised. Expenses would include death benefits paid in excess of the account value, administrative expenses incurred, amortization of acquisition costs, and interest credited to the accounts. However, presentation of revenue for other contracts was not changed.
24. The FASB also changed a specialized presentation practice for insurers. Prior to Statement 97, insurers presented realized gains and losses from sales of investments on a line below operating earnings and net of tax. Statement 97 required the amounts to be reported pretax as a component of other income. The FASB reasoned:

The Board concluded that investment activities, including realized gains and losses, are an integral part of an insurance enterprise's operations and that operating income should include the results of all investment operations. The Board could find no compelling reason to continue the exception granted to the insurance industry from financial reporting practices that apply to most other financial institutions. [Paragraph 74.]

About participating contracts

25. Over the years, some Board members have noted the similarity between account-driven contracts and participating contracts. Both potentially provide policyholders with benefits beyond the fixed and guaranteed amounts in a traditional contract. There is probably a participating universal life contract somewhere, just to complicate the distinction.
26. The difference between the two classes of contracts comes from the reason why the benefits differ from the guaranteed amounts.

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27. In a participating contract, policyholders share in the favourable results of their cohort of contracts, usually subject to contract minimums. An insurer may decide to distribute more than the contract minimum to policyholders, but it cannot distribute experience that is not there. If the cohort of policies is performing at a loss, the insurer cannot make a distribution. A participating contract usually does not have an explicit account balance.
28. In an account-driven contract, amounts credited and charged are set by competitive forces or contract indices. They are independent of the performance of the particular cohort of contracts. Thus it is possible that an insurer might credit interest at 7 percent even though it is only earning 6 percent.

Analysis and recommendations

29. For the moment, we ask that you place unit-linked contracts to one side. The structure of these contracts raises a question about whether the amount the policyholder has directed to a managed fund is a liability of the insurer. The focus for now is on other account-driven contracts. The question for now is whether the nature of account-driven contracts is a basis for requiring a different recognition and measurement model.

Did the FASB make the wrong decision?

30. Given the scope of the project and the development of conceptual thinking at the time, no. The accounting model in Statement 60 was not equal to the task, and the two-sentence concept of adverse deviation did not provide a rigorous basis for an adaptation. The account balance was available, verifiable, and was the basis on which the insurer contracted with the policyholder.
31. The IASB could adopt the same recognition and measurement model for these contracts. There are some problems with using the account balance as the measurement, though, and the staff does not recommend it.
32. *The accounting makes an unusual and unlikely assumption about policyholder behaviour.* Consider one passage from the Basis for Conclusions paragraph

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already cited. The account balance is the amount that “absent future action by the policyholder, will continue to fund operation of the contract until exhausted . . .” Stated differently, every policyholder will be inert, and will not die, surrender the contract, or pay premiums, until the account balance is exhausted. That is a very unlikely possibility, but it is the single assumption inherent in the Statement 97 measurement. (Some contracts contain “secondary guarantees” that continue to provide mortality coverage even if the account balance is exhausted).

33. It is worth noting that the FASB did not carry that assumption through to its amortisation of acquisition costs. The amortisation model is constructed from the insurer’s estimate of policyholder behaviour, including future premium receipts (as they affect interest credited to accounts and mortality margins) and is not constrained to the current account balance as is the liability measurement.
34. The staff also notes that the Statement 97 measurement is not a deposit floor. The amount that a policyholder would recover on surrender is the account balance, less penalties for surrender.
35. *The model is not transferable to other types of long-duration insurance contracts.* Everything in the Statement 97 model builds on the presence of an explicit account balance. Other life insurance and annuity contracts are designed with the same economic factors in mind, but they lack that one feature.
36. Could traditional contracts be reverse engineered and this model applied? Probably, but the explicit charges and credits of an account-driven contract would have to be invented. The process would have to start with creation of a notional account balance, and cash surrender value would not be that amount because of surrender charges. Remember, cash surrender value is net of implicit surrender penalties. It would then create notional interest credits, mortality and expense charges and surrender penalties. In contrast, the building block approach can be applied to both account-driven and traditional contracts – the difference being that account-driven contracts present a larger number of potential outcomes.

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37. *The individual contract charges and credits don't matter as much as they seem to.* Heresy, right? Bear with us.
38. The staff has heard actuaries claim that the individual elements of an account-driven contract do not matter. They assert that they can make up for a better-than-usual interest credit with a higher-than-usual mortality fees. In their view, the process is no different than a grocer who loses money on bananas but makes it up on bread and milk. The staff has never given a lot of credence to those claims.
39. However, the staff also understands that the contract is the nexus of individual charges and credits. The economic behaviours of the policyholder and insurer come from the value that they place on the package, because they cannot realise the pieces individually. We understand that an insurer testing for, say, the effect of a 250 basis point change in interest rates, must necessarily look at how the change affects all of the contract cash flows. It does not limit the analysis to the interest crediting rate, because a policyholder who surrenders also loses the insurance coverage and other policy options, and probably pays surrender penalties. In our view, the various charges and credits are important because of the way they change the risk profile, and thus the value, of a book of account-driven contracts. An individual element in an account-driven contract, though, is not the same as that element as a standalone contract. We are persuaded by those observers who note that the combination of elements in the contract do not behave the same as a synthetic combination of independent items. In our view, that argues for application of the building block approach to the entire contract.
40. We understand that some staff members may be developing an alternative view.
41. *The model is inconsistent with existing measurement conventions in both IFRS and US GAAP.* With the exception of demand deposits of financial institutions, that is. In the staff's view, the account balance is one possibility for how an uncertain liability will be settled. FASB Concepts Statement 7, the FASB or the developing IASB guidance on fair value, the joint revenue recognition project, as we understand it and IAS 37 would all consider the range of expected outcomes.

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But wait a minute

42. The Statement 97 model could be summarised as a liability based on the account balance, with revenue and expenses recognised as they are realised. Could we construct a measurement model based on the account balance, increased or decreased by the value of each option embedded in the contract? Statement 97 version 2.0, if you will.
43. Conceptually, yes, we could. There is a body of literature that attempts to measure individual options in insurance contracts. (Reading list available on request.) However, many of those papers focus on the valuation of individual options, with an inherent assumption that the others are either well behaved or measured using actuarial techniques. Few suggest a generalised, closed form, approach for all life insurance contracts.
44. The biggest problems in an option-pricing approach are:
 - (a) The number of options inherent in a life insurance or annuity contract. For example, a policyholder might be able to surrender the contract for cash, apply the surrender value to the purchase of paid-up life coverage, or withdraw a portion of the balance while leaving the account in place;
 - (b) The fact that the value of the options is path-dependent; and
 - (c) The interdependence of the options to one another. At a minimum, this creates the same ordering problem that the IASB encountered in bifurcating components of a convertible bond. If we knew the fair value of the contract as a whole, it would not equal the sum of the values of the account balance and the independent values of the several options.
45. In the staff's view, the building block approach developed in this project is a generalised measurement that can be applied to both premium-driven and account-driven contracts. While an alternative measurement might be developed for account-driven contracts, we do not see the alternative as one that can be generalised or that can be applied by a variety of insurance enterprises in a variety of jurisdictions for a variety of insurance contracts. We therefore

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recommend that the Boards not pursue an alternative measurement basis for this class of contracts.

46. The building-block approach does not ignore the role of the account balance in measuring the total contract liability. In the case of index-linked contracts, for example, the first assumption in the approach would be, “Assume that the amount of the policyholder’s account balance is always equal to the fair value of the index. Make all other assumptions consistent with that first assumption.”

Question for the boards

In this paper, the staff recommends that an insurer’s liability for account-driven contracts be measured using the same building-block approach adopted in this project for other insurance contracts.

Do you agree with the staff recommendation?