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Project **Insurance contracts**

Topic **Policyholder Behaviour and Contract Boundaries**

Purpose of this paper

1. In its April 2009 meeting, the IASB had a preliminary discussion on future insurance contract premium receipts (ie policyholder behaviour and the related issue of contract boundaries). In its May 6, 2009 meeting, the FASB discussed the same topic.

2. The purpose of this paper is to provide staff analysis and recommendations on this topic. It supplements the discussions included in the paper used for the preliminary discussion[1]. We therefore reissue that paper as agenda paper 16B.

3. When drafting this paper, the staff considered the Revenue Recognition Team's paper on Contract Boundaries that also will be discussed in May 2009 by the boards[2].

4. This paper does not address whether an insurer should account for insurance contracts as a single (net) asset or liability rather than account for future cash outflows as a liability and future cash inflows as an asset.

[1] See IASB agenda paper 5D, April 2009. See FASB memorandum 20, May 6, 2009.
[2] See IASB agenda paper 6A, May 2009.

Summary of staff recommendations

5. The staff recommends the following:

   (a) A measurement of an insurance contract includes the expected (ie probability-weighted) cash flows (future premiums and other cash flows resulting from those premiums, eg benefits and claims) resulting from that contract, including those cash flows whose amount or timing depends on whether policyholders exercise options (such as renewal and cancellation options) in existing contracts.

   (b) The staff should develop a definition for which cash flows arise from an existing insurance contract. The definition should be based on the insurer's ability to cancel, or change the pricing or other terms, of the contract.

Background

6. For some insurance contracts, the insurer must accept recurring premiums from a policyholder at rates determined by the contract and must keep the policy in force as long as the policyholder keeps paying the recurring premiums until the contract period ends, the policyholder stops making payments, or the policyholder dies. In short, the insurer must accept the premium payments from the policyholder and continue providing insurance coverage.

7. The right of the policyholder to continue coverage is, particularly for long-duration contracts, effected by a series of renewal and cancellation options written by the insurer for the benefit of the policyholder (the holder of the options). Some think of this as a promise of insurance coverage for a fixed period and an option for future insurance coverage at a constrained price.

8. Two issues arise from these contractual renewal and cancellation options:

   (a) How should the insurer account for the future premiums (and other cash flows resulting from those premiums, eg policyholder benefits) that depend on whether the policyholder exercises the renewal and cancellation options?

   (b) How to determine the boundary that establishes which cash flows result from an existing contract (ie which options are part of the existing contract) rather than from a possible future contract. This boundary would define which cash flows would be included in the measurement.

Accounting for future premiums that depend on options

9. The insurer has effectively written an option for the policyholder. The option compels the insurer to accept the policyholder's premiums (as determined by the insurance contract) and continue the insurance coverage. The insurer has a premium for the current year and a series of written options into the future years.[3]

10. We identified three approaches to accounting for renewal options, which are basically consistent with the approaches the Revenue Recognition team explored in its paper on Contract Boundaries. Those are:

    (a) Ignore the option.

    (b) Measure the option.

    (c) Look through the option (ie treating cash flow subject to renewal and cancellation options as part of the existing contract).

11. The renewal and cancellation options in insurance contracts can have a significant value, particularly in cases where contracts are or are likely to become onerous (eg due to a decline in health of a policy holder). Put otherwise, those options are too significant to be ignored. Therefore, the staff does not view (a) (ignore the option) as providing decision-useful information. Thus, the two approaches to be considered are (b) (measuring the option) and (c) (looking through the option).

12. The Revenue Recognition paper on Contract Boundaries includes an analysis on measuring written renewal and cancellation options in a contract with customers; we refer to that paper for a discussion on measuring such an option. That paper on Contract Boundaries argues that:

    (a) Estimating the standalone selling price (ie measuring the option) comes with significant practical difficulties.

    (b) An approach that treats cash flows subject to renewal and cancellation options as part of an existing contract results in financial statements that are highly similar to those that would result from measuring the option.

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[3] At the end of agenda paper 6A for this meeting, the Revenue Recognition Team contrasts renewal options to sales incentives (paragraphs 53-55) and asks the boards how these two types of options differ. In our analysis of insurance contracts, we consider the ability of the policyholder to cancel or continue a current contractual coverage to be a contractual written option rather than a sales incentive provided by the insurer for future insurance business.

13. Based on the characteristics of renewal and cancellation option in insurance contracts, we conclude that measuring such options would come with practical difficulties similar to those mentioned in the Revenue Recognition paper on Contract Boundaries —for example, requiring factors such as the current market price, the exercise (strike) price, the time until the option expires, and the volatility of price from the option writing date to the option exercise/expiration date. Other than the time element, each of these factors would be difficult to measure, especially if there is no market for the options.

14. Staff also believes that for insurance contracts looking through an option should not result in an answer that differs significantly from measuring an option. In both approaches an insurer would consider the expected cash flows from both favourable outcomes (eg the policyholder of a life insurance contract stays healthy) and unfavourable outcomes (eg the policyholder becomes unhealthy) from that option.

15. Staff notes that renewal and cancellation options in an insurance contract could result in a net asset for that contract (when favourable outcomes outweigh the unfavourable outcomes). As a result, the measurement reflects cross-subsidies from the contracts with net favourable cash flows (net cash inflows) to the contracts that generate net unfavourable cash flows (net cash outflows). Otherwise the insurer would have to book a loss from an onerous contract each time an individual policyholder becomes (or could become) unhealthy, even when there are sufficient expected net cash-inflows from contracts of policyholders who remain healthy throughout the life of the contract. This in our view would:

    (a) produce information that is not decision-useful because it is inconsistent with the inherent pooling that makes insurance viable.

    (b) not be implementable in a reliable manner.

    (c) be costly and impracticable to implement [we presume that under an approach that measures the option, the value of the option would be updated in each reporting period].

16. Thus, staff concludes that a measurement of an insurance contract should include the expected (ie probability-weighted) cash flows (future premiums and other cash flows resulting from those premiums, eg benefits and claims) resulting from

that contract, including those cash flows whose amount or timing depends on whether policyholders exercise options (such as renewal and cancellation options) in existing contracts. Put otherwise, the measurement of an insurance contract should look through renewal and cancellation options.

Comparison with the approach proposed in the Discussion Paper

17. For those premiums that the insurer cannot compel, the discussion paper included two different tests that bounded the future premiums:

    (a) an onerous test for a contract that is, or has become, onerous; the insurer would include those future premiums (and other cash flows resulting from those premiums) that would result in a net increase in the liability.

    (b) a guaranteed insurability test for a contract that is not onerous: the insurer would include those premiums (and other cash flows resulting from those premiums) that permit the policyholder to continue its coverage without reconfirmation of risk and at a price that is contractually constrained. Those additional cash flows would be regarded as arising from a customer relationship (rather than from the contract itself) but, rather than being recognised and measured separately, they would be included in the measurement of the insurance liability.

18. However, fully separating the existing contracts into buckets for those that are or will become onerous, those that are providing guaranteed insurability, and other seems virtually impossible. Cross-subsidization of net cash flow from onerous contracts with those from contracts that are not onerous is a fundamental aspect of insurance. Moreover, arguably the resulting measurement is not a representation of an economic phenomenon. Recognizing cash flows from both types of contracts as contract cash flows provides a better reflection of the economics of an insurance contract. Staff concludes that defining one single test for the boundaries of an existing contract is preferable to an approach that requires one test for an onerous contract and a different test for a contract that is not onerous.

Question for the boards
Do you agree with staff recommendation in paragraph 16 to look through the option? [We note that this recommendation is consistent with the recommendation staff made in the Revenue Recognition paper on Contract Boundaries.] Thus, staff concludes that a measurement of an insurance contract should include the expected (ie probability-weighted) cash flows (future premiums and other cash flows resulting from those premiums, eg benefits and claims) resulting from that contract, including those cash flows whose amount or timing depends on whether policyholders exercise options (such as renewal and cancellation options) in existing contracts. If not, what approach would you prefer?

Question for the boards
Do you agree with staff recommendation that recurring premiums that flow from looking through an option contained in an existing contract should be considered as contractual cash flows rather than a customer intangible asset?

Boundaries of an existing contract

19. Respondents to the discussion paper agreed that premiums from future contracts should not be included in the measurement of the insurance liability. It is necessary to define where the existing contract ends and a new or replacement contract ends. More specifically, to define which renewal and cancellation options are part of an existing contract.

20. Some constituents (including preparers and some regulators) have provided input to define such a boundary, we mention two proposals specifically:

    (a) limit the future premium to the earlier of

        (i) the contractual termination date as extended by any unilateral option available to the policyholder, or

        (ii) the insurer having a unilateral right to cancel or freely re-underwrite the policy, or

        (iii) both the insurer and policyholder being jointly involved in making a bilateral decision regarding continuation of the policy.

    (b) limit the future premiums to the shorter of the contract's life and the point, if any, at which the policy can be freely re-priced by the insurer at the individual policy level (ie up until the insurer has the ability both to reassess the risk profile of the individual policyholder and change the price for an individual without contractual constraint).

21. Staff sees the insurer's ability to cancel or change that individual contract as a useful starting point for exploring the boundaries of existing contracts for accounting purposes. So far, staff has not identified any other approaches that are worth exploring.

22. However, staff acknowledges that defining the boundaries needs further consideration. For example, one has to determine how to apply this approach to contracts where the insurer has some, but limited, ability to change the pricing for benefits provided by the contract. As an indication of some of the matters that we might need to consider in this context, appendix A provides excerpts from AICPA Statement of Position 05-1, *Accounting by Insurance Enterprises for Deferred Acquisition Costs in Connection With Modifications or Exchanges of Insurance Contracts*. (Those excerpts were written with a slightly different focus, namely to identify whether modifications to the terms of a contract create a new contract.)

23. The staff also wants to look further into some specific issues (eg. group plans, health insurance contracts, universal life contracts).

24. Thus, the staff does not present specific proposals at this meeting. The staff will return to the Boards with further thoughts on the boundary matter at a later date. The staff will also seek further input from respondents and feedback from the Working Group on this matter.

Question for the boards
Staff regards the insurer's ability to cancel or change the pricing or other terms of a contract as an useful starting point for developing boundary between existing contracts and new contracts. Have you identified any other approaches the staff should consider?

APPENDIX A

A-1. Paragraphs 8-14 of AICPA Statement of Position 05-1, *Accounting by Insurance Enterprises for Deferred Acquisition Costs in Connection With Modifications or Exchanges of Insurance Contracts,* follow:

> **Internal Replacements**
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> 8. An internal replacement is a modification in product benefits, features, rights, or coverages that occurs by the legal extinguishment of one contract and the issuance of another contract (a contract exchange), or by amendment, endorsement, or rider to a contract, or by the election of a benefit, feature, right, or coverage within a contract.
>
> 9. Modifications (other than partial withdrawals, surrenders or reductions in coverage that are addressed in paragraph .10 of this SOP) that result from the election by the contract holder of a benefit, feature, right, or coverage that was within the original contract are not internal replacements subject to this guidance as long as all of the following conditions are met:
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> a. The election is made in accordance with terms fixed or specified within narrow ranges in the original contract.
>
> b. The election of the benefit, feature, right, or coverage is not subject to any underwriting.
>
> c. The insurance enterprise cannot decline to provide the coverage or adjust the pricing of the benefit, feature, right, or coverage.
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> d. The benefit, feature, right, or coverage had been accounted for since the inception of the contract, for example, the option to elect the feature is an embedded option within the contract that is required to be accounted for under FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities,* as amended, (or would have been accounted for under FASB Statement No. 133 if the "grandfathering" provisions of the Statement, for embedded derivatives, had not been elected) or the existence of the option to elect a feature was assessed in the classification of and accounting for of the contract, such as the classification of the contract as an insurance contract under SOP 03-1, *Accounting and Reporting by Insurance Enterprises for Certain Nontraditional Long-Duration Contracts and for Separate Accounts* [section 10,870].
>
> The annuitization phase of a contract is separate and distinct from and cannot be accounted for as a continuation of the accumulation phase, even if annuitization is in accordance with terms fixed in the original contract.
>
> 10. Partial withdrawals, surrenders, or reductions in coverage (for example, reduced face amount on a life insurance contract or higher deductibles on a property casualty contract), as allowed by terms that are fixed and specified at contract inception either in the contract or other

information available to the contract holder or, if required by state law or regulation, at terms in effect when the reduction is made for that benefit, feature, right, or coverage, whether or not surrender charges or other termination charges are assessed, are not internal replacements subject to this guidance, as long as there are no reunderwriting or other modifications to the contract, at that time, that would require evaluation under paragraph .15 of this SOP.

Integrated and Nonintegrated Contract Features

11. For long-duration contracts, integrated contract features are those for which the benefits provided by the feature can be determined only in conjunction with the account value or other contract holder balances related to the base contract, and nonintegrated contract features are those for which the determination of benefits provided by the feature is not related to or dependent on the account value or other contract holder balances of the base contract. Underwriting and pricing for nonintegrated contract features typically are executed separately from other components of the contract, and it is inherent in this concept that the premium charged is not in excess of an amount that is commensurate with the incremental insurance coverage provided.

12. For short-duration contracts, nonintegrated contract features are those that provide coverage that is underwritten and priced only for that incremental insurance coverage, and do not result in the explicit or implicit reunderwriting or repricing of other components of the contract. It is inherent in this concept that the premium charged is not in excess of an amount that is commensurate with the incremental insurance coverage provided. Additional coverage provided by a nonintegrated contract feature would be considered nonintegrated even though the entire coverage provided by the short-duration contract may be subject to only one deductible or limit in the event of an insured loss. For short-duration contracts, integrated contract features are those where there is explicit or implicit reunderwriting or repricing of existing components of the base contract.

Contract Modifications Involving Nonintegrated Contract Features

13. If a contract feature or coverage is nonintegrated, the addition or election of that feature or coverage, in and of itself, does not change the existing base contract and, as a result, further evaluation of the base contract under paragraph .15 of this SOP is not required. The nonintegrated contract feature or coverage should be accounted for in a manner similar to a separately issued contract. Subsequent modifications made only to the nonintegrated contract feature or coverage should be evaluated under paragraphs .09 through .15 of this SOP separately from the base contract, and any deferred acquisition costs related to the nonintegrated contract feature or coverage accounted for accordingly. Subsequent termination of a nonintegrated contract feature or coverage should be accounted for as an extinguishment of only the balances related to the nonintegrated contract feature or coverage.

Contract Modifications Involving Integrated Contract Features

14. For contract modifications involving integrated contract features or coverages (other than those contract modifications described in paragraphs .09 and .10 of this SOP), the insurance enterprise should review the conditions set forth in paragraph .15 of this SOP to determine whether the contract has changed substantially as a result of the modification. A contract modification meeting all of the conditions in paragraph .15 of this SOP results in a replacement contract that is substantially unchanged from the replaced contract, and should be accounted for as a continuation of the replaced contract in accordance with paragraphs .16 through .24 of this SOP. A contract modification that fails any of the conditions in paragraph .15 of this SOP results in a replacement contract that is substantially changed from the replaced contract, and should be accounted for as an extinguishment of the replaced contract in accordance with paragraph .25 of this SOP.

Determining Substantial Changes

15. An internal replacement (other than those not subject to the SOP as described in paragraphs .09 and .10 of this SOP) is determined to involve contracts that are substantially unchanged only if all the following conditions exist:

a. The insured event, risk, or period of coverage of the contract has not changed, as noted by no significant changes in the kind and degree of mortality risk, morbidity risk, or other insurance risk, if any.

b. The nature of the investment return rights (for example, whether amounts are determined by formulae specified by the contract, pass through of actual performance of referenced investments, or at the discretion of the insurer), if any, between the insurance enterprise and the contract holder has not changed.

c. No additional deposit, premium, or charge relating to the original benefit or coverage, in excess of amounts specified or allowed in the original contract, is required to effect the transaction; or if there is a reduction in the original benefit or coverage, the deposit, premiums, or charges are reduced by an amount at least equal to the corresponding reduction in benefits or coverage.

d. Other than distributions to the contract holder or contract designee or charges related to newly purchased or elected benefits or coverages, there is no net reduction in the contract holder’s account value or, for contracts not having an explicit or implicit account value, the cash surrender value, if any.

e. There is no change in the participation or dividend features of the contract, if any.

f. There is no change to the amortization method or revenue classification of the contract.

If any of the conditions above are not met, an internal replacement is determined to involve a replacement contract that is substantially changed from the replaced contract.