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Project **Insurance contracts**

Topic **Policyholder behaviour**

STAFF NOTE: this paper reissues Agenda Paper 5D of the April 2009 IASB meeting and FASB Memorandum 20 of the May 6, 2009 FASB Meeting.

Purpose of this paper

1. The purpose of this paper is to provide material for a preliminary discussion on future insurance contract premium payments (and other cash flows resulting from those premiums, eg benefits and claims).

   a. Should insurance contract recurring payments—i.e., those premiums that will occur as long as the policyholder does not cancel the existing contract—be included in the measurement of the insurance contract liability?

   b. If so, how should the distinction between (1) recurring premium payments related to existing contracts and (2) premium payments related to new insurance contracts be determined—that is, how should the boundary for an existing contract be determined?

2. This paper does not ask the boards to make a choice between the alternatives, nor does it seek any other Board decisions; this will be part of a future Board meeting.

3. This paper does not discuss:

   a. the level of aggregation of insurance contracts (eg a portfolio or a book of business) used for measuring an insurance contract liability.

This paper has been prepared by the technical staff of the IASB for the purposes of discussion at a public meeting of the IASB.

The views expressed in this paper are those of the staff preparing the paper and do not purport to represent the views of any individual members of the Board or the IASB.

Decisions made by the Board are reported in IASB *Update*.

Official pronouncements of the IASB are published only after the Board has completed its full due process, including appropriate public consultation and formal voting procedures.

b. policyholder participation (policyholder dividends)—although this topic shares some similarities with the topic discussed in this paper, we will address policyholder participation separately.

c. Other elements of the contract cash flows.

Background

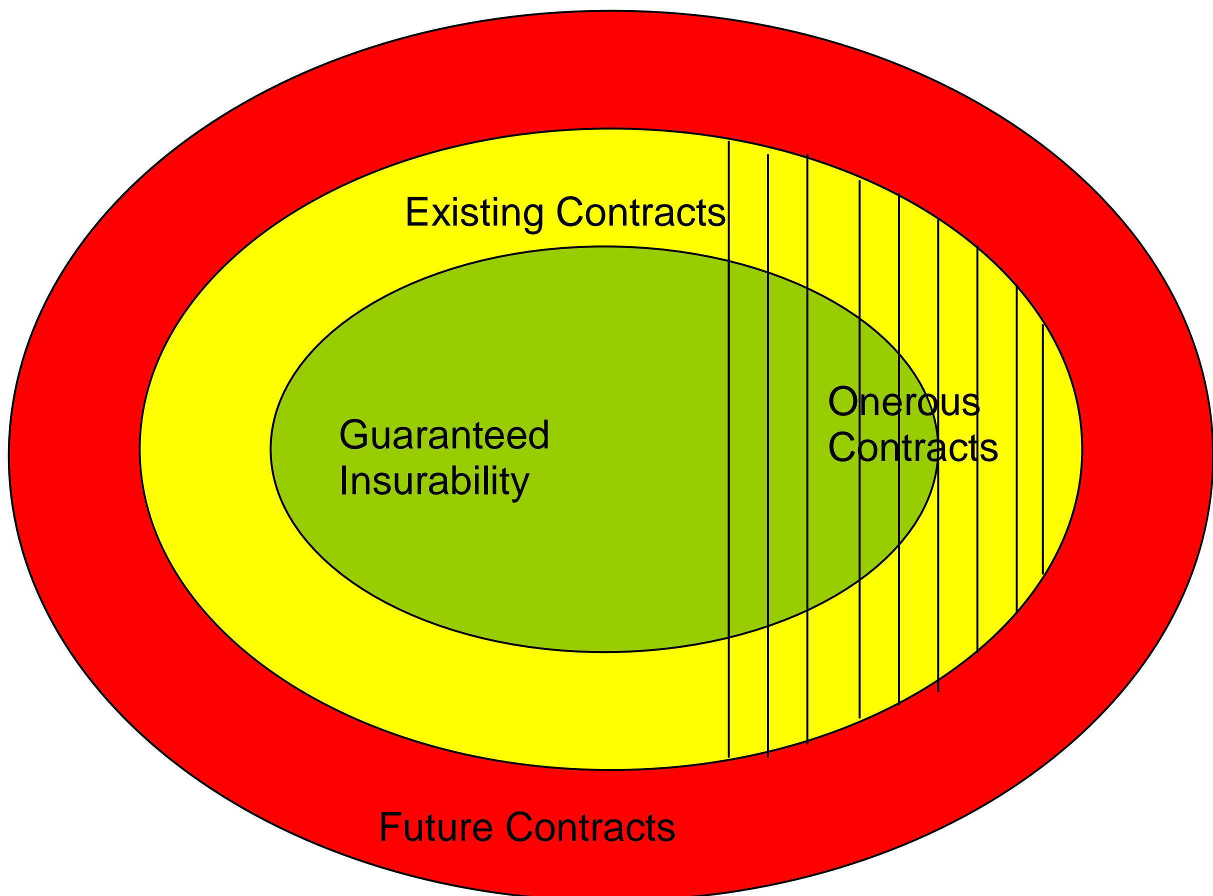
4. IASB's Discussion Paper, *Preliminary Views on Insurance Contracts*, identified including contract premium payments and resulting cash flows (benefits and claims) as a significant insurance contract accounting and measurement issue. The issue was also addressed by respondents to the Discussion Paper who were generally critical of the IASB's proposals concerning the treatment of recurring premium payments.

5. For example, consider a twenty-year term life contract with a yearly premium payment. The terms of the contract, including the yearly premium amount, are fixed. If the policyholder stops paying the premium during the life of the contract, he/she loses the coverage provided by balance of the contract. The insurer cannot compel the policyholder to pay the premiums. However, the insurer expects many policyholders to continue paying the premiums to keep the contract in force—which is sometimes encouraged by the insurer through incentives, such as a low surrender value in early years, or a period of enhanced crediting rates. If the policyholder decides to continue paying the premiums, the insurer is obligated to accept those premiums and continue the contractual insurance coverage.

6. The measurement of the insurance contract liability is comprised of several components (the three building blocks)—the contract cash flows, a margin or margins, and the time value of money (discount). In turn, the contract cash flows are made up of the present value of expected future cash flows which likely would include expected (a) benefit and claim payments, (b) policyholder dividends (not addressed in this paper), (c) recurring premiums from renewal and cancellation options (d) other contract options and guarantees (also not addressed in this paper). Recurring premiums (a cash inflow) are a deduction from the other cash flow components (cash outflows) and, therefore, reduce the recognized contract liability.

7. The graphic below depicts the universe of insurance contracts and divides them first into existing contracts and future contracts. There is no disagreement that future contracts do not enter into the current contract liability measurement (although they may be relevant in determining a customer relationship intangible asset). The yellow and green areas represent existing contracts which the illustration divides into two segments: (a) contracts that compel the insurer to accept future premiums (b) contracts that guarantee continuing insurability if the policyholder continues to pay premiums (a sub-set of the contracts in (a)), and (c) other contracts that have neither of these characteristics (ie the policyholder cannot compel the insurer to accept future premiums).

The Discussion Paper Approach



8. The Discussion Paper considered onerous contracts and contracts that guarantee insurability as two types of contracts with recurring premiums that should be included

in the measurement of the insurance contract liability. The onerous contracts are shown by the shaded area of the yellow and green segments. Note that some contracts will have both of these characteristics (there is an overlap).

9. The Discussion Paper included recurring premiums from onerous contracts directly in the measurement of the liability. These recurring premiums are paid by policyholders who will, as a group, receive more in benefit payments as a result of paying their premiums than the amount of those recurring premiums. If those groups of policyholders and contracts were separately identifiable, the recording of the recurring payment would be accompanied by the recognition of a larger insurance benefit accrual.

10. For some of the contracts that are not onerous, policyholders have a contractual right to pay premiums to continue their insurance coverage and, perhaps more importantly, to retain the right to continue paying future premiums and continue receiving coverage. The insurance contract requires the insurer to accept the recurring premiums and maintain the coverage for the policyholders for the life of the contract. However, in most cases, the insurer cannot compel the insured to pay the recurring premium. If the recurring premium is not paid, the policy and therefore the coverage lapse.

11. The question is which items that flow from the contract should be measured as part of the contract:

a. It is uncontroversial to include in the contractual cash flows recurring premiums whose payment can be compelled by the insurer [we therefore do not discuss these premiums any further in this paper].

b. It also seems uncontroversial to include in the measurement of the liability recurring premiums from contracts that have become onerous as part of the contract, even when an insurer cannot compel those premium payments.

b. It arguably is less obvious whether to include future recurring premium payments that are not onerous and whose payment cannot be compelled by the insurer.

The Discussion Paper Approach

12. In the Discussion Paper the IASB expressed the preliminary view that recurring premium payments from onerous contracts and contracts that guarantee insurability would be included in the measurement of the insurance liability. Of course, the expected benefit and claim cash flows that accompany the recurring premiums also would be included in the measurement of the contract liability.

12. However, the IASB decided that recurring premiums paid by policyholders who renewed their contracts to guarantee their continued insurability and future coverage were not a contractual cash flow (the policyholder could not be compelled to pay the premiums) but instead result from a customer relationship intangible asset (based on the existing contractual relationship with the policyholder). Internally developed customer relationship intangible assets are rarely—if ever—recognized. To be recognized these intangibles generally need to be acquired from third parties. Nevertheless, the IASB concluded that existing insurance contracts are closely associated with the part of the customer relationship that relates to the expected policyholder exercise of existing contractual options. In the IASB's preliminary view expressed in the Discussion Paper, this close association justified recognition of the customer intangible (although the IASB noted that it did not intend to extend that conclusion to contracts other than insurance contracts). Accordingly, the future recurring premiums of customers paying for guaranteed insurability were included as a customer relationship intangible asset rather than a contractual cash flow. Nevertheless, the IASB proposed to measure the customer intangible as a part of the insurance liability because of the interrelationship of the recurring premium payments with the benefit and claims cash flows and the resulting inability to separate the measurement of the intangible asset from the liability on a non-arbitrary basis. Thus, the practical effect was that the liability measurement under the Discussion Paper proposals included the shaded area of the yellow segment and both the shaded and non-shaded areas of the green segment.

13. The two previous paragraphs show that the Discussion Paper applied two different tests:

a. For contracts that result in net cash outflows (eg the policyholders who have become, or will become unhealthy before future premiums are due,

the shaded areas of the yellow and green segments), an onerous contract test.

b. For contracts that result in net cash inflows (the policyholders who remain, and will remain, healthy, before future premiums are due, the non-shaded area of the green segment) – the guaranteed insurability test, which is narrower than onerous contract test.

14. Because of the distinction in the Discussion Paper between the onerous and guaranteed insurability tests, an insurer would have been required to separate the contracts into two buckets. Arguably, the resulting measurement is not the measurement of any real world economic phenomenon.

Comments on guaranteed insurability from respondents to the Discussion Paper

15. Many respondents opposed the guaranteed insurability test for recurring premium payments. They commented as follows:

a. Once a contract meets the recognition criteria, an insurer should recognise that contract as a single asset or liability, without dividing the contract into components for separate recognition.

b. A measurement that excludes the inbound cash flows would not be current exit value, because market participants would consider all the inbound cash flows in determining an acceptable price for a transfer of the insurer's rights and obligations under the contract.

c. The guaranteed insurability test would be difficult and burdensome.

d. The guaranteed insurability test relies on a distinction that insurers would not find useful internally. It excludes net cash inflows that most respondents regard as part of the cash flows from the contract. Particular problems may arise for more flexible contract designs that enable participants to vary or suspend premiums.

e. A few respondents felt the guaranteed insurability test might include too many cash inflows. These respondents fell into the following categories:

(1) Health insurers currently using an annual accounting model for multi-year contracts with features such as annual rate-setting constrained by government, portability of coverage to other insurers, and restrictions on setting differential rates for different policyholders or on rejecting new policyholders.

(2) Non-insurers concerned about the implications for other contracts if non-enforceable cash flows are included.

16. The responses were based on the current exit value model (similar to fair value) proposed in the Discussion Paper. Although fulfilment value models are now being considered, the comments likely would still be made.

17. Respondents generally agreed that the objective should be to measure existing contracts, without considering cash flows from possible future contracts (for example, modified, exchanged, re-underwritten, or re-priced contracts). However, respondents did not generally suggest how to distinguish existing contracts from possible future contracts, though some acknowledged that this distinction may be difficult to make and could need further work. See the discussion in paragraphs 25-35 on boundary issues.

Could Recurring Premiums be seen as part of the contractual cash flows?

18. Recurring premiums are an essential element of most long term insurance contracts. One could argue that including all expected future premiums on existing contracts provides a better depiction of the contract liability. In that case, recurring premiums would be regarded an integral part of the contract and not a customer relationship intangible (which may exist separately from recurring premiums of potential new contracts with the existing policyholders).

19. This view is built on the notion that all elements that flow from the existing contract should be considered in the measurement of the contractual cash flows. Determining the duration of the existing contract is a key issue in determining the relevant flows. This issue will be discussed in paragraphs 25-35 on boundaries.

20. Contractual cash flow candidates are:

Contractual Cash Flow Candidates

Inbound	Outbound
-Single premium -Initial premium -**Recurring premium** -Pour in premiums (e.g., voluntary deposits into universal life type accounts).	-Benefit and claims payments -Dividends to policyholders -Options and guarantees

Note: The focus of this paper is recurring premiums. Other items will be discussed at future meetings.

The Lease Discussion Paper—a Precedent

21. The recently issued Discussion Paper, *Leases: Preliminary Views*, appears to offer support for looking at recurring premiums as part of the contractual cash flows. In this Discussion Paper, the lease contract is designated as a single unit with a right-to-use asset and a lease obligation (liability). All the terms of the lease (eg options to extend the lease, contingent rents, guaranteed residual values) are considered part of the lease agreement and are valued as part of the lease obligation which is simply the present value of all of the estimated cash flows (the two boards parted ways on measuring the various options and how to recognize changes in estimates). The lease term specified is the most likely lease term.

22. Combining all potential asset and liability components into a single asset and a single liability and using a single lease term methodology greatly simplifies the accounting for leases. Even though the Boards split on measurement approaches for various options, etc., each Board was consistent in its single asset-single liability approach for those elements of the right-to-use asset and the lease obligation.

23. The preliminary views' model for accounting for a lease contract considers all contractual terms as linked to the single contract asset and liability (including options held by the lessee which are included in the lease obligation based on the lessee's judgment concerning the most likely outcome). Although the decision regarding recurring premium payments is in control of the policyholder, the insurer has the information to make the measurement judgment regarding those recurring premiums based on its experience with policyholders over time.

24. Like the leases approach, the contract approach for insurance would result in measuring a single asset or liability rather than a mix of contractual cash flows and a customer intangible. The boards have so far only discussed lessee accounting; for lessee accounting the board took the position that measurement of the lease contract from the lessee's view should look at a single asset and a single liability. The Discussion Paper on leases discussed the lease accounting model from the customer's perspective. The boards will discuss lessor accounting at a later stage. If the boards approach lessor accounting as a mirror-image of lessee accounting, the lessor accounting also would not split the cash flows into contractual cash flows and a customer intangible.

The Boundary Issue

25. As mentioned earlier boundaries are necessary to define where the existing contract ends and a new or replacement contract begins (even under the Discussion Paper approach one needs to determine where an existing contracts ends, for example to determine the extent of onerous contracts to consider). If one wants to look at an insurance contract as one single liability, one arguably has to give substance to how to define the items that are part of the contract. In other words, so long as selected constraints are in effect the contract is considered to be the existing and not a replacement or new contract. So far, we have identified two sets of constraints (ie tests):

a. the guaranteed insurability test (from the Discussion Paper)

b. constraints on re-pricing and re-underwriting (suggested by some constituents).

26. In addition, note that expected (ie probability-weighted) policy terminations would be taken into account in the cash flow measurement using assumptions regarding contract persistency rates (or its complement—lapse rates).

Guaranteed Insurability

27. One way to define the cash flows that are part of the contract is to apply a test based on guaranteed insurability. The IASB defined guaranteed insurability in the Discussion Paper as a right that permits continued coverage without reconfirmation of the policyholder’s risk and at a price that is contractually constrained. The Discussion Paper viewed an insurance contract as divided into components; it tacitly made the decision that when guaranteed insurability ceased to exist, the related customer intangible would no longer be included in the measurement of the liability. Although the Discussion Paper used the guaranteed insurability test in a context of a boundary for the customer intangible, this test can be applied equally for determining which cash flows are part of the contract. When the guaranteed insurability criterion was is longer met, the future premiums will no longer be part of the contractual cash flow; the existing contract is deemed to be replaced by a new contract. All cash flows that pass the guaranteed insurability test remain in the measurement of the contractual liability.

Constraints to re-underwriting and re-pricing

28. Another way to define the items that are part of the contract is to apply a test based on the insurer's unrestricted ability to re-underwrite and re-price an individual insurance contract. In some contracts the insurer's ability to effectively rewrite the contract will happen contractually after a specified number of years. The words "individual insurance contract" above are important in that the ability of the insurer to modify a group or book of contracts would often be more limited (practically if not by statute or regulation) and likely to be subject to some form of negotiation rather than a unilateral action by the insurer. Also, even though a group of contracts may include some onerous contracts, the whole group of contracts might still be profitable. As a business matter, the insurer might be less likely to force a change on a group that included a limited number of onerous contracts.

29. Some respondents see such a test as a way to identify the boundary of the contract—that is, when the existing contract terminates and a new (replacement) contract begins. If the ability of the insurer to modify the contract is less than unrestricted, a question arises about what or which modifications (or the ability of the insurer to make such modifications) to the contract would lead to the conclusion that the existing contract is replaced by a "new" contract.

30. A contract that becomes subject to unrestricted re-underwriting and re-pricing can result in a significantly changed (new) contract based on the new information available to the underwriter at the time of the re-pricing. For example, assume that contract is or will soon become onerous due to the policyholder's health. The insurer will obtain new information regarding the policyholder's current health condition from the re-underwriting process. The result is likely to be higher premiums, reduced benefits, or a contract cancellation (assuming these are all permitted actions based on a policyholder's declining health). In this case an insurer's unrestricted ability to re-underwrite and re-price, the contract will have effectively resulted in a substantially different (new) contract or in the extreme case no contract at all.

31. Thus, the unrestricted ability of the insurer re-underwrite and re-price individual contracts will provide the insurer with the ability to modify price, coverage, and other terms—the ability to rewrite the contract. Whether exercised or not, this ability

effectively puts an existing insurance contract in a new environment which changes the substance of the contractual arrangement even if no changes currently are made in the price, coverage, or terms of the contract. The change in the insurer's authority alone has created the new arrangement. Without the new unrestricted authority the insurer would not be able to rewrite the terms of the contract and an insured with either an onerous contract or in need of the guaranteed insurability would not be put in the position of being unlikely or unable to find a new insurer.

32. Accordingly, the unrestricted ability or re-underwrite and re-price an insurance contract provides a tool for an insurer to rewrite insurance contracts. The issue is whether some less significant changes in the insurer's authority could result in a modified contract that also could be considered "new" for the purposes of establishing a boundary in an insurance accounting context.

Specific issues

33. The following are examples of contracts where the outcome of both the guaranteed insurability test and a test based on the unrestricted ability to re-underwrite and re-price individual contracts may not be obvious:

a. Group health plans. Does the insurer have a single contract with the employer or separate contracts with each employee?

b. Health insurance contracts. In some jurisdictions, these contracts are multi-year contracts, but have been treated for accounting as annual contracts. In part, this may be due to government restrictions on re-pricing and on selection of policyholders.

c. Universal life contracts. If a contract permits additional voluntary premiums, are they part of that contract or a separate transaction?

d. Bonus-malus systems in car insurance. Policyholders pay lower premiums if they have had no accidents in prior years. Are the resulting discounts inducements to renew with the same insurer, or a means of providing more accurate risk classification in future periods? Moreover, in some cases, policyholders may be able to carry those discounts over to other providers.

Revenue Recognition

34. The discussion paper *Preliminary Views on Revenue Recognition in Contracts with Customers* did not address the issues of renewals and cancellations. These issues are similar to the issue of policyholder behaviour (recurring premiums) discussed in this paper. The revenue recognition project will bring these issues to the boards at future meetings.

35. However, one item of note is that the discussion paper on revenue recognition requires the performance obligations (liabilities) to be set equal to the customer consideration (at least in part to avoid a gain or loss at inception). So far, the boards' have reached a similar conclusion in the insurance contracts project in prohibiting a gain at the inception of an insurance contract.

36. QUESTIONS FOR THE BOARD'S CONSIDERATION

a. Do you have any questions or comments?