

IAA PAPER
FEATURES OF INSURANCE CONTRACTS
(IASC Insurance Issues Paper, Sub-Issue 1A, Paragraphs 17 & 25)

The important distinguishing characteristics of insurance contracts are quite relevant to much of the discussion regarding insurance standards for insurance contracts. The IASC Insurance Issues Paper (the IASC Paper) devotes a considerable amount of space distinguishing insurance from other financial instruments and near-financial instruments. If no significant differences in contract terms exist between financial instruments, it is difficult to justify different accounting treatment among them.

Regulatory definitions can not practically be used for this purpose, both because of the wide diversity in definitions of insurance used around the world and because they were not developed for the purpose of distinguishing recognition and measurement among financial instruments. Nevertheless, some distinction is required.

Paragraph 17 of the IASC Paper states that the transfer of risk is the single distinguishing element of insurance contracts. In order to make this definition operable, the IASC Paper carves out both contracts transferring price only related risk (e.g., derivatives) and employee benefit plans (covered elsewhere). Insurable interest, an often-used distinguishing characteristic for certain types of insurance contracts as pointed out in paragraph 23 of the IASC Paper, although relevant to certain public policy related issues, does not significantly affect the value of the liability of insurance contracts. Note that the elimination of insurable interest as a requirement indicates the close relationship between gambling contracts and insurance contracts for measurement purposes.

The IAA accepts the definition described in the IASC Paper as a useful starting point to distinguish insurance contracts from other financial instruments. The carve-outs identified made for practical reasons are reasonable for the purposes of setting standards at the current time. It is also important to note that accounting standards for insurance should be as consistent as possible and practical for near-insurance contracts (e.g., annuities with no material risk transfer and non-cash benefit insurance contracts).

It is also important to recognize several of the key external factors that affect the performance of and obligations relating to these contracts. These include the lack of availability of a ready market for the insurer's liability and the regulatory environment and policyholder expectations resulting from the nature of the insurer's obligations.

Features of insurance contracts

In general, an insurance contract contains an agreement by the insurer to provide, in exchange for a set of insurance premiums, agreed upon benefits to a beneficiary of the contract upon occurrence of specified uncertain or contingent future events affecting the life or property of the insured party, i.e., a transfer of such risks.

In exploring the significant features of most insurance contracts, we believe it is appropriate to discuss this risk transfer feature in more detail and to discuss the accessibility to this risk transfer.

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a) What risk is transferred – Uncertainty with respect to the timing and size of the benefits to be provided

The timing of the benefits to be provided by the insurer depends on the terms specified in the contract conditions. Events covered may include death (e.g., term insurance), surviving to a maturity date (e.g., pure endowment), surviving during the covered period (e.g., annuity), becoming and remaining disabled (e.g., waiver of premium or workers compensation), or suffering an accident (e.g., liability or property damage). Usually the insurance contract contains guarantees as to the charges for uncertain events such as mortality over a long period. Due to this long-term or non-level nature of the insurer's obligations, including the probability of loss over the course of the exposure period and its expected costs, the premiums may contain a savings element, an accumulation of a portion of early premiums used to supplement the expected inadequacies of later premiums. Relating to this savings element, a minimum investment return can be guaranteed. In addition to these guarantees, policyholders often have the right to a form of profit-sharing.

b) The willingness or ability of the party responsible for the payment of premiums or continuation of the contract

The willingness to pay premiums or to continue the contract is reflected in the risk of cancellation, lapse, or paid-up options available prior to the end of the contract term. This reduces or cancels the insurer's obligations in line with a decline in premium or revenue. The existence of surrender values may result in cash outflows - the timing, but not necessarily the amounts of which, are determined at the option of the owner of the contract. The payment of insurance premiums depends on such factors as (1) contract conditions, such as "being alive" and "not being disabled", (2) the willingness or financial ability to pay ("being solvent" status of the risk subject) or (3) the resolution of disputes over the contract conditions or fairness.

Most insurance contracts can generally be characterized as containing several main features. Nevertheless, as the types of available insurance contracts are quite diverse, few features are shared by every insurance contract. Moreover, few types of insurance contracts contain all of these insurance-related features. The IAA believes that it is the combination of several of these features that can provide useful insight to the development of accounting standards for insurance contracts, even though they are not directly considered in the definition of insurance. Note that although individually these features are not unique to insurance, in the aggregate, they may justify different accounting treatment than is afforded other financial instruments. A few of these incorporate features of the external insurance environment that should be considered along with the features of the insurance contract.

1. The **transfer of risk** distinguishes insurance from certain other financial instruments and provisions by which an enterprise deals with or manages the insurance-related exposure. This risk often attaches to risks attached to the insured subject, i.e., is a "personal" risk.

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2. **Pooling of risks.** Two aspects of risk pooling can be distinguished:
- a. **Contract-owner view.** Due to the inability of an individual/enterprise to deal effectively with her/his own risk as to the frequency, timing and/or the severity of pertinent contingent events, pooling of reasonably homogeneous risks is needed. In this way, the individual contract-owner is able to spread her/his risk by transferring it to a pool of similar risks.
 - b. **Insurer view.** The insurer has the ability to manage these risks through a number of risk management techniques, including the pooling of similar risks (usually similar in terms of the characteristics of the risk subjects, but this pooling could occur over time as well) or securitization of the risks (this has been done only in a limited set of circumstances to date).

For both the contract-owner and the insurer, this pooling of risks is beneficial and overall both obtain the benefits of this pooling when the contract is **continued**.

3. **Guarantees of a long-term nature, including guaranteed insurability,** exist in many insurance contracts, regarding such contract elements such as minimum credited interest rates, maximum premiums, and maximum expense, surrender, or mortality charges. Guaranteed insurability results from the valuable benefits associated with being a member of an insurance pool. The costs to the insurer may not be level during the period of the contract, in many cases resulting in a savings element that is inextricably combined with the pure risk element.
4. **A bundle of real and financial options that can be quite complicated and difficult to separate,** available to both the contract-owner and the insurer. These consist of rights provided under the contract, including the right to pay premiums and the risks of cancellation, non-renewal, lapse, use of paid-up options. There are also a number of near-rights that may be considered. For example, in many insurance contracts, even though the right of termination may exist at expiry of the current contract term, a high percentage of contracts are continued through renewal. This complexity that otherwise would result in higher transaction costs, can be reduced as a result of bundling them together in a single contract.
5. **Entry and re-entry restrictions** may be continued in an insurance contract. Because of the potential for anti-selection (moral hazard), criteria are often developed (generally in addition to the credit risk of the contract-holder) to minimize the associated additional costs. For example, if an insurance contract is terminated, the acquisition of a replacement contract may require new underwriting.
6. **A continuous option to terminate** the contract, although it may be restricted as to who can terminate it and when it can be terminated. This may consist of a continuous series of renewal options available at specified dates. A near-right that is included with many contracts at their expiry is that they will usually be automatically

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continued, usually with the same premium structure but sometimes at a different premium level sometimes restricted as a result of contract or regulatory rules.

7. The purchase of an insurance contract is generally made under the perception that the insurer will fulfill certain promises or implied promises of certain insurance contracts, often referred to as **policyholder expectations**. These expectations, often long-term in duration, are supported by the regulation of the insurance industry in the public interest. Some of these expectations include the equitable treatment with respect to participation in the profits generated by participating (with-profits) contracts and other non-guaranteed elements and the continuation of a customer relationship with respect to the exposures being insured.
8. **The insurer may be constrained to utilize certain of its options** on the basis of a class of insureds, rather than the individual insured. These constraints may be imposed as a result of the nature of the law or regulation affecting such contracts.
9. Certain aspects of both insurance contracts and insurance companies are highly **regulated**, due to the perceived public interest inherent in the contracts, resulting from the long-term guarantees of the contracts, the imbalance in information regarding the nature of insurance, and the imbalance of control over the implementation of certain contract provisions between the contract-owner and the insurer.
10. The probabilities of the utilization of these options and the cost associated with them are considered in determination of both **entry and exit prices** as viewed by the insurer. The reasons why insurers enter into these contracts include an expected reward for risk undertaken and opportunities for profit related to these risks. In order to quantify them, probabilities relating to the expected frequency, amount and timing of the associated cash flows are considered, as well as the uncertainty and volatility associated with these cash flows.
11. The **exit value provided to the contract-owner** (e.g., for some life insurance contracts the cash value; for some property/casualty insurance contracts the “unearned premium”) is **not necessarily related to the economic value of the contract** at the time of exit. In addition, contract-owner exit values do not correspond with the exit value to the insurer that reflects the price a willing buyer of its business, rather than the exit value to the consumer.
12. During the course of the contract, one or more **relevant contingent events** (relevant to the risk transferred) **may occur that result in a payment of a contract benefit** and will constitute a claim against the insurer. Such a claim, although defined in the contract, may be disputed, resulting in the need for claims management in order to assure adherence to the terms of the contract, while at the same time to minimize the costs covered.

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13. **Assets**, sometimes substantial, **may accumulate** because of differences in timing of revenues and benefit payments and in certain cases as a result of non-level expected costs of the contract. This constitutes a **savings element** that is inextricably combined with the pure insurance element.
14. Many insurance contracts **participate in the profits generated by an insurance contract**. These may take the form of dividends or a profit-sharing arrangement, sometimes by percentage.
15. **Markets** for insurance liabilities are usually **incomplete**, either non-existent or relatively inactive or non-liquid. Market prices that are available may serve only as a crude guide to market value. Such prices often provide for other, sometimes intangible factors, such as control of a company or the value of a distribution system or potential new sources business.

Potential implications of these features

A number of implications for the recognition and measurement of insurance liabilities result from these features of insurance. They include the following that are discussed further within the IAA's comments on the IASC Paper and in several separate IAA papers dealing with related key issues.

1. **Unbundling** of the elements of insurance contracts. Conceptually there may be a temptation to attempt to unbundle all of the elements of insurance contracts in order to avoid accounting arbitrage both among insurance contracts and between insurance contracts and other contracts that include similar features. However, in most cases the bundle of options, rights and obligations included in these contracts are intertwined and are non-separable. In addition, the effect of the options may be correlated, to the point that the sum of the values of the separate options is not equal to value of the sum of the aggregate of the options. Where all such elements are valued in a consistent fair value manner, the issue of unbundling becomes irrelevant, as long as the fair values are determined on a consistent basis. In addition, because of their inter-connection, the sequence of valuing them may affect their value. See our response to Sub-issue 1E of the IASC Paper.

Nevertheless, some sets of options may be separable, sometimes as a result of being contractually separate through the use of a rider. Examples could include the accumulation of dividend deposits and riders that are voluntarily added by an insured that could be sold separately at comparable prices.

2. The lack of an efficient or active market results in the need to **estimate expected future cash flows and resulting risks** in the measurement of the liabilities associated with insurance contracts. Estimation of the probabilities associated with these future cash flows **on a prospective basis** is necessary, consistent with the view of a market for these liabilities if a market was available. In addition, an evaluation of the

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uncertainties associated with these probabilities is also necessary. These uncertainties lead to reflection in adjustments for risk demanded by willing parties participating in a market for taking on these risks. Stochastic models can be useful in this evaluation process.

3. A **minimum floor for the liability** is inappropriate, being incompatible with the application of a prospective valuation, which implies estimates of probabilities will be made representing the likelihood of surrender.
4. Both the contract-owner and the insurer obtain access to the benefits of the pooling of risk when the contract is continued. Even though there may also exist a continuous option to terminate, consistent with the IASC Framework, estimated **probabilities of continuation of the contract** should be reflected in the measurement of liabilities of insurance contracts. The development of policyholder expectations and the influence of regulatory constraints contribute to making this measurement principle apply equally to the continuation of the contract and during the current contract term.
5. There are two **exit prices** – those of the contract-holder as the retail client of the insurer and those associated with another insurer as a possible party to which the insurance contract or parts of the contract (e.g., the insurance exposure) can be transferred or exchanged. A market for the latter does not always exist. The latter exit value is the one most appropriate to be used to measure the insurer's liability related to the insurance contract.
6. Due to the risks involved and the long-term nature of insurance contracts, a minimum **level of capital is required**. This level, sometimes dictated by law or regulation, should relate to the insurer's expected risks.

31 May 2000