

# IAA PAPER

## *MINIMUM LIABILITY FLOOR*

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### **Introduction**

Paragraph 425 of the main text of the IASC Insurance Issues Paper (the IASC Paper) sets out the Steering Committee’s tentative view as follows:

“In the Steering Committee’s view, a prospective (policyholder benefit) approach is consistent with its view of a life insurance contract as a single set of interrelated assets and liabilities. However, the amount recorded as a liability should not be less than the amount that would result from applying a retrospective (policyholder deposit) approach...”

The introduction of the minimum liability (‘the liability floor’) based on a retrospective approach has a number of drawbacks in the context of the proposed accounting model taken as a whole. This note seeks to examine whether the floor is an essential feature of the accounting model for life insurance activities.

The main argument for the introduction of the liability floor is set out in paragraph 426(b):

“the liability recognised in a policyholder-deposit model – the policyholder’s account balance – is a financial liability that is typically payable to policyholders on demand (although it may be subject to surrender charges or penalties). When considered in a traditional context, the balance of this financial liability represents a minimum measurement of the liability.”

The crux of this argument is that the policyholder can demand the payment of the liability floor and hence “controls” the contract in the sense that “controls” is used in defining an asset or liability. We note that a policyholder’s ability to surrender his or her policy does not make it rational to do so. We consider this further in paragraphs [27] to [31] below.

However, this argument for the liability floor is rooted firmly in the consideration of an individual policy and an individual policyholder. This is in conflict with the general stance taken elsewhere in the IASC Paper, notably in paragraph 190, that the unit of account should be the portfolio of policies. This inconsistency is examined further below.

### **The drawbacks of the introduction of a liability floor**

In the context of a prospective accounting model that takes the accounting unit to be a portfolio of policies and which excludes the use of deferred acquisition cost assets, the drawbacks of introducing the liability floor are:

1. For newly written portfolios of contracts, large negative earnings will be recorded even for the most profitable contracts. This is because the floor effectively prevents the recognition of margins in future premiums to recover initial costs. In traditional accounting models that implicitly or explicitly recognize a floor, a deferred acquisition cost asset is almost always available to offset this distortion (attached is a

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graph of comparative earnings for a five year term assurance which illustrates this point);

2. The alternative approaches for determining the liability lead to discontinuity in earnings. For example, for a regular premium case, the existence of a floor results in a significant loss in the first year, followed by increased earnings in the second and subsequent periods, until the prospective provisions exceed the retrospective. At this point, the earnings revert to the steady pattern, which might be viewed as being more in line with management's operation of the business;
3. For some types of contracts, cash surrender values are determined at the discretion of the insurer. For example, in the U.K. the cash surrender values can be altered at any time over the duration of the policy. The effect of reducing the surrender value, in any year when the floor has an effect, would be to increase the reported profit. This would be the case even if no policyholder actually took the reduced surrender value. Such a situation would not be unusual in the U.K. as surrender values are often subject to short term adjustment to reflect sharp movements in markets – for example when equity markets fell in the early 1990's; and
4. The determination and comparison of two values for a liability makes the calculations of the liabilities complicated to perform.

While none of these points justify moving away from a correct accounting treatment, they suggest that a further examination of the requirement for a 'floor' is worthwhile.

#### **The liability for a portfolio of policies rather than for an individual policy**

The IASC Paper recognizes in a number of places, notably in paragraph 190, the Steering Committee's view that the unit of account should be a group of contracts that have substantially the same contractual terms and are priced on the basis of the same assumptions. (This paper refers to such a group of contracts as a portfolio.) It is therefore important that the accounting model, and in particular the floor, is consistent with the operations of a portfolio of contracts.

When considering the operations of a portfolio, it is useful to understand that insurers view portfolios as being made up, conceptually, of different subgroups of contracts, each of which will remain in force for a different duration and will exit in a different manner. Statistical analysis will indicate the proportions of the portfolio that each subgroup represents but it cannot indicate which individual plans can be allocated to each subgroup. Thus the subgroups cannot be distinguished from the portfolio.

The process of developing sufficient statistical information to allow a portfolio to be segmented into these notional subgroups is the essence of creating an insurable portfolio. Once it is possible to develop the structure of the subgroups then it is possible to estimate the risks in the portfolio using the best current credible information.

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If the risks are estimated using the best current credible information, it is possible to find an appropriate premium that is sufficient, when taken with the other premiums payable, to provide the portfolio as a whole with adequate resources to meet the range of expected potential payments over the range of different dates. Thus, in pricing and managing a portfolio of policies, the insurer recognizes that a certain proportion of policies will become claims or lapses each year and that many policies will not complete the full term.

The “adequate resources” referred to in the previous paragraph are often described as the realistic liabilities and are consistent with a prospective accounting model.

Importantly, the ‘realistic liability’ recognizes the ability of individual policyholders to lapse their policies but also recognizes that, taken across the portfolio as a whole, only a proportion of policyholders will do this in any year. Thus, the ‘realistic liability’ recognizes that, while policyholders may control their individual contracts, no policyholder controls the portfolio taken as a whole.

Instead, it is the insurer that controls the portfolio. The insurer can sell on the portfolio, either by legally transferring the portfolio or by quota-share reinsurance. While in some cases for statutory reasons insurers have to inform policyholders of the sale of a book of business, for the majority of cases, the policyholders are not consulted and cannot block the sale.

If the principles underlying the ‘realistic liability’ approach, and by implication the prospective accounting model, are accepted, then the necessity for a liability floor drops away. This is because the approach is based on the operation of the portfolio that can be viewed as being controlled by the insurer rather than by the individual policyholder.

Further, the prospective accounting model, while giving some weight to the current cash value to the policyholder, only gives it weight in proportion to the number of policyholders expected to exercise the option. This reflects the underlying operations of the insurer and as such gives more meaningful disclosure.

#### **The portfolio of policies as an asset**

While the necessity for a liability floor may fall away if the above arguments are accepted, the drawbacks noted in drawbacks (1) and (2) noted above remain unless it is accepted that the liability can not just fall to zero but can become negative. Stated another way, the portfolio needs to be capable of being regarded as an asset as well as a liability.

**From a fair value viewpoint**, the rationale for a portfolio of policies representing an asset is based on observable market values. It is clear from transactions relating to recently written blocks of business that purchasers are willing to pay in excess of the associated assets for portfolios of policies which in aggregate are expected to generate positive cash flows. It has been argued that these market transactions are not reflecting the policyholder’s option to lapse his or her policy. However, the exercise of such an

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option is not a willing buyer/ willing seller transaction with a third party as envisaged by the definition of fair value.

**From a ‘non-fair value’ asset/liability viewpoint**, the rationale for accepting that a portfolio can represent an asset is again based on the concept of a portfolio being made up of different subgroups of plans, each of which will remain in force for a different duration and will exit in a different manner.

Each subgroup represents an asset or a liability based on a comparison of the expected income from future premiums with the expected outgo from claims, surrender values and expenses. Some subgroups will run many years into the future and premiums will exceed claims. These subgroups will represent assets. Some subgroups will exit as claims or surrenders after a few years and will represent liabilities. For a recently written portfolio, the aggregate of the subgroups will represent an asset. It is not possible to segregate the subgroups between assets and liabilities because it is not possible to say which policies fall into which sub-groups. Thus the portfolio as a whole must be taken to represent an asset.

Once the portfolio has been in force for some years, the balance between the positive and negative subgroups changes and the portfolio as a whole becomes a liability.

The IAA recognizes the validity of these arguments and in consequence is of the opinion that portfolios of policies can represent assets as well as liabilities.

Although it recognizes that the portfolios can be assets or liabilities, the IAA would nonetheless argue that all portfolios should be shown together in one entry in the balance sheet. This is preferred, as it will provide the clearest picture to the user of the accounts. As the majority of portfolios will usually represent liabilities, we suggest that the aggregate of positive and negative liabilities are presented on the liability side of the balance sheet regardless of whether the aggregate is positive or negative. This suggestion assumes that the results of the current review of performance reporting retain the same basic layout. This presentation has the advantage that it reflects current practice.

**The policyholder's option not to renew**

The counter-argument raised to taking a portfolio of policies as an asset is that there is no reason to expect a rational policyholder to pay further premiums if the present value of the premiums to be paid exceeds the expected value of the benefits that the policyholder will receive.

Responding to this, we note that the fundamental reason for a person to take out or to continue with a policy is that the benefit of the life cover to the policyholder is greater than the cost of the cover to the insurer. This is because the policyholder is more risk averse than the insurer, the insurer being able to benefit from the pooling of risks. Therefore a rational policyholder may well be happy to pay future premiums even when the value of those premiums exceed the expected cost of the benefits to the insurer.

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Indeed, for level premium life policies, the time when the policyholder is most disadvantaged by profit margins in future premiums is at the outset of the policy. By taking out a policy, the policyholder demonstrates tangibly that the benefit of the life cover is worth more than the premiums payable. Thereafter, the value of the life cover rises relative to the cost of the premiums and the rational policyholder increasingly values the policies.

It is worth noting that the different perception of the value of a policy as between the policyholder and the insurer is a fundamental feature of insurance contracts, which is not present in other portfolios of financial instruments such as bank deposits. If it is accepted that a rational policyholder will wish to maintain life cover, there remains the possibility that the same rational policyholder in a rational market will seek another insurer offering a keener price. However, it only makes economic sense for a policyholder to surrender a contract and move to another insurer if the profit margins in future premiums under the existing plan exceed:

1. The acquisition costs of the new contract; plus
2. Any explicit or implicit surrender penalties, which would include not returning any reserves built up under term assurance and similar contracts; plus
3. The value of any rights that a policyholder has accrued since inception (for example the right to be underwritten at standard premium rates despite a deterioration in health); plus
4. Any loss of security involved in changing to an insurer with a lower credit rating.

Given that margins in future premiums can be at least equal to the items (a), (b), (c) and (d) above before a policyholder will surrender, a practical minimum liability is at least a negative value of the acquisition cost of a similar portfolio of contracts. This might be better re-expressed as the portfolio can be taken as an asset at least equal to the acquisition costs and in many circumstances more.

#### **Conclusions**

The introduction of a liability floor brings with it some distinct drawbacks. The pricing and management of portfolios of policies, as opposed to individual contracts, indicate that a liability floor is not necessary for the development of a robust accounting model. The Steering Committee should reject the adoption of a mixed prospective/retrospective basis and choose instead to adopt only the prospective basis.

The adoption of a prospective basis should include the recognition that a portfolio of policies can represent either a liability or an asset to an insurer.

31 May 2000



### Term Assurance - Comparison of Earnings

