

IAA PAPER
INSURANCE CONTRACT RENEWALS
(IASC Insurance Issues Paper Paragraphs 191 - 192)

Background

Three elements mentioned in paragraphs 191 and 192 of the IASC Insurance Issues Paper (the IASC Paper) provide an appropriate framework to examine the issue of the determination of the proper period over which the liability of an insurance contract (this does not apply to the liability for insurance claims) should be recognized:

1. The contractually defined coverage period for the current contract,
2. Subsequent contracts of essentially the same type that will replace the current contract, and
3. Subsequent sales of related or non-related products to the same contract-owner.

In addition, incorporated as part of the bundle of options included in many insurance contracts during their current contract term are (1) a one-time or continuous series of options available to the contract-owner to discontinue premiums or exercise other voluntary forms of termination and (2) a one-time or continuous series of options available to the insurer to terminate the contract or to continue it only on the basis of revised terms that could include different premiums, interest rates, charges or credits.

Thus, the concept of the closed book approach referred to in the IASC Paper does not adequately capture the range and complexity of the options included within many insurance contracts. Both actuaries and the market typically reflect the effect of the expected utilization of these options in the measurement of the liability for insurance obligations associated with currently inforce contracts. Further, the IASC Paper inadequately addresses the similarity of the effects of options to terminate the contract before the end of the contract period, and the options to continue the contract, on essentially the same terms, at the end of the current contract period. The IASC Paper appears to assume the special case in which during the remaining contractually guaranteed period, termination can only be initiated by the contract-owner (and not the insurer).

To assess the reasonableness of the possible alternative approaches to reflecting renewals, we reviewed paragraphs 60 and 61 of the IASC Framework that state:

“An essential characteristic of a liability is that the enterprise has a present obligation. An obligation is a duty or responsibility to act or perform in a certain way. Obligations may be legally enforceable as a consequence of a binding contract or statutory requirement. ... Obligations also arise, however, from normal business practice, custom and a desire to maintain good business relations or act in an equitable manner. ... A distinction needs to be drawn between a present obligation and a future commitment. An obligation normally arises only when ... the enterprise enters into an irrevocable agreement....”

In considering the intent of the closed book approach, there is little controversy with respect to whether future additional contracts issued to current inforce contract-owners

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should be provided for in the liability of inforce contracts. We agree with the strong consensus that they should not be reflected. Views are more varied in respect of continuation of existing contracts beyond their current contract period. Due to the existence of multiple options, both stated in the contract and reflective of normal business practice, the duration of the end of the contract for this purpose is not necessarily clear. Possibilities include the period through (1) the contract expiry date, (2) the earliest date that the contract-owner or insurer can voluntarily terminate the contract, or (3) the period over which expected cash flows related to the contract or its continuance are expected (with or without a guarantee of re-entry into the insurance pool of which the insured was a part). An actuary can estimate the expected value associated with any of these sets of dating rules. A case could be made for each of them.

Should form or substance rule? Is there a substantive difference between a termination option, a premium continuance option, and a renewal option? How much weight should be placed, in a fair value environment, upon exit price that normally reflects the anticipated probabilities of termination, continuation and renewal of existing contracts? Does this exit price result from the contracts or customer relationships? Does the expectation of renewal by the contract-owners, reinforced by a highly regulated industry, affect the extent of recognition?

Elsewhere, the IAA has noted that the contractual right to remain in an insurance pool is a significant feature of an insurance contract; to hold that business practice and exit price can be more important may appear somewhat inconsistent with this feature. These questions should be addressed in order to resolve this issue. See our paper entitled "FEATURES OF INSURANCE CONTRACTS" for further details regarding such features.

Discussion of the Issue

With this background in mind, the following addresses the question of whether future renewal periods should be reflected in the calculation of the liability of an insurance contract, or indeed whether anything beyond the first opportunity of the insurer to terminate the contract should be reflected. The issue can usefully be illustrated by a few examples.

1. A number of contracts have cancellation options prior to contract renewal, e.g., multi-year (such as three or five year) property/casualty insurance or reinsurance contracts. One example is multi-year (up to ten years) fire insurance contracts issued in Japan. Many other contracts can be cancelled during this period by either party at any time (or at least at periodic intervals), though in most cases such cancellation would likely be rare. Substantively, there is no material difference between such contracts and those that are structured as a series of separate one-year contracts. The insurance industry has been and will likely "take advantage" of differences in the effect of accounting rules that ignore economic reality but rely instead on form if a possible advantage exists, i.e., through accounting arbitrage.

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2. In some countries, a number of contracts are formally structured as one-year contracts, due to regulatory requirements or historical precedent, with renewal features in which the contracts can be terminated; one example is certain mail order annuity or automobile or health insurance contracts in which high annual persistency (e.g., ninety percent) is expected and is priced for (i.e., reflected in both entry and exit prices), even though the option of non-renewal exists. In fact, reflecting the relatively large initial acquisition cost and margins in future premiums out of which this cost is anticipated to be recovered, it is in the best interest of the insurer to renew these contracts. Such expected persistency may be higher than in many contracts where renewal is solely at the discretion of the contract-owner. Not to reflect expected contract terms results in a large loss at issue, with profits reported in subsequent periods. This lack of recognition would be inconsistent with exit and entry values, as well as with internal methods by which such business is managed.

In fact, a wide range of contract renewal features exists in insurance contracts around the world (see examples provided in IAA comments regarding Sub-issue 1K of the IASC Paper) incorporating each of the features described above. At the extremes, the answers are obvious – where the renewal process is outside the control of the insurer (access to the insurance pool), expected voluntary contract continuance (contract persistency) should be reflected. However, the right to renew the contract is inherent in most such contracts and insurers typically operate in a manner both to encourage and to manage such a process in an efficient manner.

An example of an insurance contract in which a continuous option to discontinue by the contract-owner is included is the typical whole life insurance contract. However, if this option is exercised, access to the insurance pool is forfeited. Similarly, certain contract features provide a contractual right to change the current contract into another. In such cases, the probability that this will occur can be estimated (such as convertible term insurance in which a percentage of such term insurance policies can be expected to convert without evidence of insurability into a range of permanent life insurance contracts).

At the other extreme is a one-year contract wherein the contract-owner is separately solicited and underwritten annually. In this case, a significant percentage of contracts may not be renewed, although average non-renewal rates are typically small unless the premium has been increased significantly. In such cases, it certainly would not be appropriate to assume one hundred percent renewals; but even here the probability of renewals can usually be estimated with a reasonable degree of accuracy. Note that in such cases, it may be appropriate to establish a provision for the deterioration of contingent risk experience (e.g., mortality or automobile liability experience) on those contracts that are renewed, particularly if the renewal qualification requirements are lower than those imposed to enter the insurance pool initially.

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If annual loss and expense experience is expected to be level by contract duration, the financial effect of alternative recognition treatment may be small. However, if experience is expected to be non-level (e.g., claim experience for automobile insurance, mail order sales, or life or health insurance, or the expense of acquiring the contracts), a substantive difference could result. In such cases, both entry and exit prices would reflect these non-level costs. Why should not the value of liabilities?

A substantive issue, rather than the form of renewability or right to cancel provided, is whether the contract imposes the requirement to provide evidence of insurability (continuous right to re-enter into the insurance pool) or the extent to which business practice results in a very small percentage of non-renewals (say, less than two percent). The expectation of substantially similar obligations continuing in substantively the same form may be an appropriate criterion against which prior experience can be validated. The ability or expectation to remain in the insurance pool is the principal factor that should govern the expectation of the continuation of the current contract. In sum, most insurance contract renewals result “*from normal business practice, custom and a desire to maintain good business relations or act in an equitable manner.*” (IASC Framework)

In a fair value accounting regime, it should be recognized that most, if not all, exchanges of insurance contracts between willing parties (assuming that the right to renew is exchanged as well) would incorporate estimates of insurance contract renewals. In most cases, relevant historical experience for similar contracts previously issued is reflected, unless serious dislocations are anticipated, such as in the distribution system that produced the block. Not to reflect future renewals in the valuation of the liabilities would be inconsistent with the intent of fair values and would ignore market realities.

Contract-owners enter into many insurance contracts with the expectation that they will continue the contracts that they purchased. The percentage of non-renewals by the insurer is usually very small, partly due to the highly regulated nature of insurance, and partly due to the value of an insurance pool in the view of the insurer.

In addition, the market usually expects a high percent of renewal business, reflecting historical experience. It expects the insurer to be a going concern and does not expect it to go out of business.

The Steering Committee position that the unit of measurement for liabilities is the pool of contracts rather than the specific individual contract that may not be renewed is relevant. While a case could be made that an individual contract could be non-renewed, the fact that the measurement basis is groups of contracts leads to the conclusion that renewals should be recognized. Market expectations should be relatively close to company expectations with respect to percent of renewals of a group of contracts.

Although we believe that the value of a customer relationship with regard to possible add-on sales is an intangible that should not be recognized, a renewal of an existing contract does not constitute an intangible. This belief is validated through similar

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contract persistency experience often achieved with respect to pools of insurance contracts, with a cancellation feature or renewal feature included. Potential changes in premium rates at the times premiums are due at the insurer's option would generally be more important in expected contract persistency than would the existence of cancellation options.

In addition, we are concerned that accounting rules (along with local product approval and regulatory reserving requirements) may influence product design, possibly to the detriment of solvency, contract flexibility, or the best interest of contract-owners. Whenever a fixed period limit is set at which accounting treatment changes, such as 12 months, contract designs may be modified to take advantage of the rules rather than to respond to natural competitive pressures. To optimize comparability of substantially similar contracts (those with a near term contract expiry compared with those of longer duration which include rights to terminate), we believe it would be appropriate to recognize the estimated probabilities of the renewal of in force contracts.

We recognize that a semi-closed book approach is advocated by some (non-recognition of either the right to terminate during the course of a contract or the right to renew a contract at contract expiry). In both those cases, the estimated probability of continuance can be estimated and should be recognized.

Summary

In summary, it would be appropriate to recognize contract renewals if business practice is to do so and contract continuation can be estimated, because:

1. There is no substantive difference between contract termination during a contract period and its expiry. Similarly, there is no substantive difference between the utilization of the option to continue a contract during its period and renewal of a contract at the end of the current period.
2. The market recognizes the value of expected renewals in an exchange between willing parties. The continuance in substantively the same form can easily be distinguished from add-on sales.
3. Imposition of a rule not to recognize contract renewals that results in substantive differences in accounting treatment will result in changes in contract forms to take advantage of such differences.
4. In a regulated industry in which significant contract-owner expectations exist, probabilities of non-renewal resulting from actions by an insurer may not be materially different than those of termination resulting from the application of contract termination provision at a similar period measured from original contract issue.

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5. Many insurance contracts are designed, sold, and managed taking into account the probabilities of renewal. Not to reflect such probabilities does not reflect market realities.

As a result of these reasons, the IAA is in favor of a closed-book approach, with the closed book including the effect of expected continuance of existing contracts, but excluding the effect of contracts that are not a continuation of existing contracts.

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