Statutory Issue Paper No. 49

Policy Loans

STATUS
Finalized March 16, 1998

Original SSAP and Current Authoritative Guidance: SSAP No. 49

Type of Issue:
Life Specific

SUMMARY OF ISSUE

1. Current statutory accounting guidance for policy loans is provided in the Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies (Life/A&H Accounting Practices and Procedures Manual). GAAP guidance is limited but is provided in the AICPA Audit and Accounting Guide: Stock Life Insurance Companies. Current statutory and GAAP guidance are consistent.

2. The purpose of this issue paper is to establish statutory accounting principles for policy loans that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

3. A policy (or contract) loan shall be defined as a loan to a policyholder, under the provisions of an insurance contract, that is secured by the cash surrender value or collateral assignment of the related policy or contract. Policy loans shall include:

   a. Cash loans, including loans resulting from early payment benefits or accelerated payment benefits, on contracts when the terms of the contract specify that such payments are policy loans secured by the policy and

   b. Automatic premium loans, which are loans made in accordance with policy provisions whereby delinquent premium payments are automatically paid from the cash value at the end of the established grace period for premium payments.

4. Policy loans meet the definition of assets defined in *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets* and meet the criteria for admitted assets, except as specified in paragraphs 6 and 7 of this issue paper. Policy loans are readily available to satisfy policyholder obligations as the terms of the policy loan allow the reporting entity to offset an outstanding policy loan balance against the cash surrender value of the policy.

5. Policy loans shall be carried at the unpaid balance of the loan. The unpaid balance of the loan shall include any unpaid principal plus any accrued interest which is 90 days or more past due.

6. If the unpaid balance of the loan exceeds the cash surrender value or policy reserves established for the policy, the policy generally shall lapse. Cash surrender value shall be defined as the cash value of the basic policy plus cash value of any policy accumulations such as paid-up additions. The excess of the unpaid balance of the loan over the cash surrender value shall be evaluated for collectibility. If the amount is considered uncollectible, it shall be written off as a reduction of investment income in the statement of operations during the period it is determined to be uncollectible. Except for collateral

assignment loans, all other amounts in excess of the cash surrender value shall be considered nonadmitted assets. The change in this nonadmitted asset shall be recorded as an unrealized capital gain or loss as applicable.

7. A loan resulting from early payment benefits or accelerated payment benefits and secured by an assignment of the policy to the reporting entity as collateral for the loan shall be an admitted asset, except that any loan (including accrued interest) in excess of the policy reserve for that policy shall be nonadmitted. Upon death, the entire death benefit is recorded as a death benefit expense. The policy proceeds shall be used to repay the loan. Any proceeds in excess of that needed to repay the loan are payable to the named beneficiary.

8. Interest income on policy loans shall be recorded as earned and included in investment income consistent with *Issue Paper No. 34—Investment Income Due and Accrued*. For interest received before it is earned, unearned interest income shall be recorded as a liability in accordance with *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets.*

9. Accrued interest income on policy loans that is past due 90 days or more shall be reclassified from Investment Income Due and Accrued and included in the unpaid balance of the policy loan as defined in paragraph 5 above.

DISCUSSION

10. The statutory principles described in the conclusion above are consistent with current statutory guidance except for the following:

a. The definition of policy loans includes certain early payment benefits or accelerated payment benefits that by the terms of the applicable policy are policy loans. Existing statutory guidance does not specifically address such loans in the guidance on policy loans. The accounting treatment adopted in paragraph 7 above allows a loan resulting from an early payment benefit or an accelerated payment benefit to be an admitted asset if the loan amount plus accrued interest is less than the policy reserve and the loan is secured by the full assignment of the policy benefits to the reporting entity.

b. Past due interest has been defined in paragraph 9 as accrued interest that is past due 90 days or more.

c. Under current statutory guidance, the excess of the unpaid balance of the loan over the cash surrender value is a nonadmitted asset. The statutory accounting principle in paragraph 6 above requires different accounting treatment for uncollectible and collectible unpaid balances in excess of the cash surrender value.

11. The statutory accounting principles described in the conclusion above are consistent with the conservatism and recognition concepts in the Statement of Concepts. Pertinent excerpts follow:

> Conservatism
>
> Conservative valuation procedures provide protection to policyholders against adverse fluctuations in financial condition or operating results. Statutory accounting should be reasonably conservative over the span of economic cycles and in recognition of the primary responsibility to regulate for financial solvency. Valuation procedures should, to the extent possible, prevent sharp fluctuations in surplus.

Recognition

The ability to meet policyholder obligations is predicated on the existence of readily marketable assets available when both current and future obligations are due. Assets having economic value other than those which can be used to fulfill policyholder obligations, or those assets which may be unavailable due to encumbrances or other third party interests should not be recognized on the balance sheet but rather should be charged against surplus when acquired or when availability otherwise becomes questionable.

Revenue should be recognized only as the earnings process of the underlying underwriting or investment business is completed. Accounting treatments which tend to defer expense recognition do not generally represent acceptable SAP treatment.

Drafting Notes/Comments
None

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting
12. The Life/A&H Accounting Practices and Procedures Manual provides the following guidance in Chapter 7, Policy Loans:

In most states, the right to make a loan is among the standard provisions that are included in cash value life insurance policies. The policy usually provides:

1. That the company will advance on the security of the policy an amount which, with interest to either the next policy anniversary or premium due date, will not exceed the guaranteed cash value of the policy on that date;

2. That any outstanding loan and interest will be deducted from the proceeds;

3. That interest will be payable annually at either a fixed rate that is specified on the policy or at a variable rate with a description of how the rate is determined;

4. That interest that is not paid when due shall be added to the loan and shall bear interest at the same rate;

5. That if the total indebtedness equals or exceeds the cash value, the policy shall terminate; and,

6. That the policy owner may repay the loan either in whole or in part at any time while the policy is in force.

In most states, the maximum interest rate on policy loans has been established by statute, although in several states the rate is determined by state insurance departments. Also, some companies have introduced variable interest rates which will reduce the variance in rates between policy loans and other borrowings.

<u>Cash Loans</u>

The request for a cash loan generally will originate with the policy owner in the form of an application for a cash loan. The insured will also be required to sign a loan agreement which specifies the original amount of the loan and may recite all the conditions of the loan. Other parties may also be required to sign the agreement because of contract limitations as to control or because of prior assignment. The agreement to make a cash loan may be made as a special endorsement on the check that the policy owner receives.

Automatic Premium Loans

An automatic premium loan (APL) is one which is made in accordance with the provision in some policies for automatically paying a delinquent premium from the cash value at the end of the grace period. A special loan agreement is not required because the policy owner previously requested the APL option. In some states the policy owner must specifically elect this provision for it to be effective.

The purpose of the APL provision is that, in the event of inadvertent nonpayment of premium or temporary inability to pay the premium, the policy is kept in full force. If the policy were allowed to lapse and the nonforfeiture options of reduced paid-up or extended term insurance were effective, the policy owner would then be required to comply with the reinstatement procedures, such as furnishing evidence of insurability.

Valuation

Policy loans are reported as admitted assets in the statutory financial statement. They are carried at the unpaid balance of the loan provided the unpaid balance does not exceed either the cash surrender value of the policy or the policy reserves. The cash surrender value generally consists of the cash value of the basic policy plus cash value of any policy accumulations such as paid-up additions.

In cases where the policy indebtedness exceeds the cash surrender value, the excess is a nonadmitted asset. The change in this nonadmitted asset is reflected as an unrealized capital gain or loss as applicable.

Interest

Interest on a policy loan may be payable at either the beginning or end of the policy loan interest period. Where it is payable at the beginning of the period, appropriate balance sheet provision should be established for any unearned policy loan interest. Where it is payable at the end of the period, appropriate provision should be established for any accrued interest. Interest earned is reported as investment income.

The calculation of investment income from a company's policy loans requires a determination of unearned or accrued interest. These are included in their respective accounts in the balance sheet as unearned or accrued investment income and not with the balance of policy loans. The calculation of accrued and unearned interest usually is made on a policy-by-policy basis, or for policies grouped by interest rate and policy anniversary or interest paid- to-date.

Past-due interest normally is capitalized as an addition to the loan balance with the interest recorded as received.

13. The Life/A&H Accounting Practices and Procedures Manual provides the following guidance in Chapter 19, Investment Income and Net Realized Gains:

Gross Investment Income

Investment income arises from interest on bonds, dividends on stock, interest on mortgage loans and policy loans, rent on real estate, and other miscellaneous sources. Such income is on a gross basis and does not reflect investment expenses, taxes, depreciation, depletion or interest on borrowed money. Gross investment income is composed of income collected during the period, the change in income due and accrued and the change in income unearned and nonadmitted.

14. The NAIC Annual Statement Instructions provide the following guidance related to Policy Loans:

EXHIBIT 4 - UNREALIZED CAPITAL GAINS AND (LOSSES) ON INVESTMENTS

Line 5 - Premium Notes, Policy Loans and Liens

Include: In Column 3, the net change in the excess of premium notes, policy loans and other policy assets over net value and other policy liabilities on individual policies. (See Exhibit 14, Line 9.)

EXHIBIT 13 - ASSETS

Lines 5 & 6 - Policy Loans and Premium Notes

Include: In Column 3 premium notes, policy loans, and other policy assets in excess of net value and of other policy liabilities on individual policies.

Exclude: Interest due and accrued (include in Line 16).

Premium extension agreements (include in Line 14).

Policy liens under reinsurance agreements.

Line 5 plus Line 6, Column 3 should agree with Exhibit 14, Line 9, Column 2.

EXHIBIT 14 - ANALYSIS OF NON-ADMITTED ASSETS AND RELATED ITEMS

Line 9 - Premium Notes, etc., in Excess of Net Value and Other Policy Liabilities on Individual Policies

The change for the year should be included in Exhibit 4, Column 3, Line 5.

Generally Accepted Accounting Principles

15. The *AICPA Audit and Accounting Guide: Stock Life Insurance Companies* provides the following guidance in Chapter 4, Investment Operations:

Policy Loans*

4.13 Life insurance companies generally must permit borrowing against the cash values of policies. Policy loans are carried at their unpaid balances including accumulated interest but not in excess of cash surrender values or in excess of policy reserves. Many policy contracts require the company to initiate an "automatic premium loan" to pay delinquent premiums.

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* *FASB Statement No. 114*, *Accounting by Creditors for Impairment of a Loan*, addresses the accounting by creditors for impairment of certain loans. It is applicable to all creditors and to all loans, uncollateralized as well as collateralized, except large groups of smaller-balance homogeneous loans that are collectively evaluated for impairment, loans that are measured at fair value or at the lower of cost or fair value, leases, and debt securities as defined in FASB Statement No. 115. It applies to all loans that are restructured in a troubled debt restructuring involving a modification of terms.

It requires that impaired loans that are within its scope be measured based on the present value of expected future cash flows discounted at the loan's effective interest rate or, as a practical expedient, at the loans' observable market price or the fair value of the collateral if the loan is collateral dependent.

The Statement amends *FASB Statement No. 5, Accounting for Contingencies*, to clarify that a creditor should evaluate the collectibility of both contractual interest and contractual principal of all receivables when assessing the need for a loss accrual. The Statement also amends *FASB Statement No. 15, Accounting by Debtors and Creditors for Troubled Debt Restructurings*, to require a creditor to measure all loans that are restructured in a trouble debt restructuring involving a modification of terms in accordance with the Statement.

The Statement applies to financial statements for fiscal years beginning after December 15, 1994. Earlier application is encouraged.

The Glossary provides the following definitions:

> Automatic premium loan - A loan made under a provision in a life insurance policy that a premium not paid by the end of the grace period will be automatically paid from the proceeds of a policy loan made by the company if there is sufficient loan value.
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> Policy loan - A loan made by a life insurance company to a policyholder on the security of the cash surrender value of his policy.

OTHER SOURCES OF INFORMATION

16. NAIC Technical Resource Group Proposed Draft Life Codification provides the following guidance in Chapter 20, Policy and Contract Benefits, related to early payment benefits or accelerated payment benefits:

> Early Payment or Accelerated Payment Benefits
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> When an insurer offers the insured/policyowner an option to receive benefit payments early, typically when the insured is diagnosed with a terminal illness, accounting for the payments must be consistent with the terms of the contract. Either the loan method or policy reduction method shall be used to account for the payments.
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>> Loan Method:
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>> When the terms of the contract recognize payments to be a loan on the policy with the policy serving as collateral, and interest is charged on the loan amount, all payments are reported as policy loans and included as an admitted asset of the insurer. Interest and fees (if any) are recorded when earned. Upon death or lapse (policy loan plus accrued interest equals the face amount), the policy is accounted for as a claim payment.
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>> Policy Reduction Method:
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>> When the payments result in a reduction in the amount of insurance, the payments are recorded as benefit payments with a corresponding release of a pro-rata portion of the policy reserve.

RELEVANT LITERATURE

Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets*
- *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*
- *Issue Paper No. 34—Investment Income Due and Accrued*
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 7, Policy Loans, and Chapter 19, Investment Income and Net Realized Gains
- NAIC Annual Statement Instructions, Exhibit 4, Unrealized Capital Gains and Losses on Investments, Exhibit 13, Assets, Exhibit 14 - Analysis of Non-Admitted Assets and Related Items

Generally Accepted Accounting Principles
- *AICPA Audit and Accounting Guide: Stock Life Insurance Companies, Chapter* 4, *Investment Operations*

State Regulations
- No additional guidance obtained from state statutes or regulations.

Other Sources of Information
- NAIC Technical Resource Group Proposed Draft Life Codification, Chapter 20, Policy and Contract Benefits

