

Statutory Issue Paper No. 59

Credit Life and Accident and Health Insurance Contracts

STATUS

Finalized March 16, 1998

Original SSAP and Current Authoritative Guidance: SSAP No. 59

Type of Issue:

Common Area

SUMMARY OF ISSUE

1. Current statutory accounting guidance on policy reserves for credit life and accident and health insurance contracts, as defined in *Issue Paper No. 50—Classifications and Definitions of Insurance or Managed Care Contracts In Force* (Issue Paper No. 50), is addressed in Chapter 10, Aggregate Reserves for Life and Annuity Contracts and Chapter 13, Aggregate Reserves for Accident and Health Policies of the Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies (Life/A&H Accounting Practices and Procedures Manual). That guidance addresses policy reserves related to all credit life and accident and health insurance contracts. Under current statutory accounting, credit life policy reserves may be based on either a gross unearned premium reserve or a mortality reserve. Credit accident and health policy reserves are established through a gross unearned premium reserve computed under various methods or an actuarial reserve not less than the gross unearned premium reserve.

2. GAAP requires insurance contracts to be classified as short-duration or long-duration contracts. Long-duration contracts include contracts, such as whole-life, guaranteed renewable term life, endowment, annuity, and title insurance contracts, that are expected to remain in force for an extended period. Other insurance contracts are generally considered short-duration contracts and include most property and liability insurance contracts as well as credit life and accident and health insurance contracts. Premiums from short-duration contracts ordinarily are recognized as revenue over the period of the contract in proportion to the amount of insurance protection provided. Claim costs, including estimates of costs for claims relating to insured events that have occurred but have not been reported to the insurer, are recognized when insured events occur.

3. The purpose of this issue paper is to establish statutory accounting principles for credit life and accident and health insurance contract premium recognition and policy reserves that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts). Credit life and accident and health insurance contracts will be referred to collectively as “credit insurance” for purposes of this issue paper.

SUMMARY CONCLUSION

Definitions

4. Credit insurance is generally issued in connection with the issuance of credit to an individual by a bank, retailer, finance company, or other similar organization. This type of insurance most often protects the creditor to the extent of the unpaid balance of the loan. Contracts sold in connection with loans or other credit transactions, not exceeding a stated duration shall be reported as credit insurance. Mortgage guaranty insurance is addressed in *Issue Paper No. 88—Mortgage Guaranty Insurance*. Credit policies are generally limited to issues of 120 months or less in most states. Credit insurance is sold as either an individual or group policy and may provide for single or joint life coverage.

5. Credit life insurance, generally in the form of decreasing term insurance, is issued on the lives of debtors to cover payment of loan balances in case of death. Credit accident and health insurance is insurance on a debtor to either provide indemnity for payments becoming due on a specific loan or other credit transaction while the debtor is disabled.
6. Premiums for credit insurance contracts shall be defined as the contractually determined amount charged by the insurance company to the policyholder for the effective period of the contract.

Income Recognition and Policy Reserves

7. Consistent with *Issue Paper No. 51—Life Contracts* (Issue Paper No. 51), premiums shall be recognized in the summary of operations as income on the gross basis (amount charged to the policyholder) when due from policyholders under the terms of the insurance contract.
8. Policy reserves are established through either a gross unearned premium reserve or a mortality/morbidity reserve. The gross unearned premium reserve represents the estimated amount of premium for insurance coverage that has not yet expired. The mortality/morbidity reserve represents the estimated amount of future anticipated benefits, discounted at valuation interest and mortality/morbidity, to be incurred on policies in force. Policy reserves meet the definition of liabilities as defined in *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*.
9. When the level of insurance risk is constant during the contract period, policy reserves shall be recognized over the period of risk using either the daily pro-rata or monthly pro-rata methods as described in *Issue Paper No. 53—Property and Casualty Contracts - Premiums* (Issue Paper No. 53). Policy reserves for contracts where the level of insurance risk is not constant throughout the contract period shall be recognized over the period of risk in proportion to the amount of insurance protection provided. Various methods may be used to accomplish this as discussed in paragraphs 21 to 23. The reporting entity shall select the method that most closely reflects the pattern of insurance protection provided.
10. For credit accident and health contracts, the policy reserve recorded shall not be less than the gross unearned premium reserve. In addition, for all credit contracts in the aggregate, if the premium refund liability exceeds the aggregate recorded reserve, an additional liability shall be established. This premium refund (excess) liability may include consideration of commission, premium tax and other expenses recoverable.
11. The difference between the policy reserves at the beginning and end of the reporting period shall be reflected as the change in reserves or change in unearned premium, as appropriate, in the summary of operations, except for any difference due to a change in valuation basis. A change in valuation basis shall be accounted for consistent with paragraph 24 of Issue Paper No. 51.
12. When the anticipated benefits, expected dividends to policyholders and maintenance cost exceed the recorded policy reserve, a premium deficiency reserve shall be recognized by recording an additional liability for the excess deficiency with a corresponding charge to operations. Commission and other acquisition costs need not be considered in the premium deficiency analysis since they have previously been expensed.

DISCUSSION

13. This issue paper expands on current statutory guidance by requiring that policy reserves on credit insurance contracts be recognized over the exposure period of the contract in proportion to the amount of insurance protection provided. Under current statutory accounting, credit life policy reserves may be based on either a gross unearned premium reserve or a mortality reserve. Credit accident and health policy reserves are established through a gross unearned premium reserve computed under various methods. Additionally, this issue paper modifies current statutory accounting by requiring the recognition of a premium deficiency in circumstances described in the preceding paragraph. Current statutory

guidance does not specifically address premium deficiency reserves. These changes were made to improve consistency in accounting and reporting for credit insurance contracts.

GAAP Literature

14. Consistent with Issue Papers Nos. 50, 51 and *Issue Paper No. 54 - Individual and Group Accident and Health Contracts* (Issue Paper No. 54), *FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises* (FAS 60), *FASB Statement No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments* (FAS 97) and *FASB Statement 120, Accounting and Reporting by Mutual Life Assurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts* (FAS 120), are rejected for the reasons set forth in those issue papers. However, the GAAP concept of recognizing policy reserves over the period of risk in proportion to the amount of insurance protection provided has been considered in this issue paper.

Characteristics of Credit Life and Accident and Health Insurance Contracts

15. Accounting for credit life and accident and health insurance is significantly affected by the premium mode and the nature of the risks assumed. Both of these factors shall be considered in determining the most appropriate method in which to recognize the policy reserve over the exposure period of the contract in proportion to the amount of insurance protection provided.

16. The premium mode may be either a single premium or a monthly premium based on the outstanding loan balance. Under single premium credit insurance, the premium rate is applied to the initial amount of insurance and generally is included in the debt. The single premium is generally remitted to the insurer at the time the loan is made. Premiums which are collected monthly based on the insurance protection provided are generally the monthly outstanding balance type. Outstanding balance rates, used generally for group coverage, are determined by multiplying a monthly rate times the amount of outstanding insured indebtedness.

17. The nature of the risks assumed are impacted by the loan conditions as well as the type of coverage or benefits provided. Loan conditions include the loan term, amount, payment pattern, and interest rate. Coverage or benefit types for credit life insurance policies are generally either gross coverage, net payoff coverage, level coverage, or a combination of insurance plans. Gross coverage insures the gross indebtedness of a loan in the form of decreasing term insurance and is used for closed end loans such as installment loans. Net payoff coverage provides decreasing term insurance protection where the death benefit is equal to the scheduled amount due under a debt obligation at any time. This normally includes the outstanding principal and insurance premiums, plus any accrued interest since the last payment. Net payoff coverage is generally used for open end loans in which the monthly payment is not fixed (e.g., lines of credit, home equity loans, and variable rate loans). Level coverage is generally used for single payment closed-end loans and provides for the full payment of the loan at maturity using level term insurance as the plan of insurance. Balloon loans provide for monthly installment payments, plus a lump sum payment at maturity (the balloon). Frequently the installment portion of the loan is covered by decreasing term insurance, while the balloon is covered by level term insurance. Other times, decreasing term coverage is provided as a single policy (certificate) where the last month of the coverage decreases by an amount, or balloon, much greater than the regular monthly installment payment.

18. Credit accident and health insurance policies provide generally a monthly benefit payable as long as the insured remains disabled, or until the scheduled maturity of the loan, if earlier. Since the benefit is the full monthly payment of the loan, including interest charges, the coverage is gross coverage. In some cases, a lump sum, total and permanent disability coverage is offered. This coverage provides for the full payment of the loan balance if the insured is totally and permanently disabled.

Income Recognition and Policy Reserves

19. This issue paper requires gross premiums from credit insurance contracts to be recognized when due and for policy reserves to be recognized over the exposure period of the contract in proportion to the amount of insurance protection provided. To the extent the methods discussed below do not reflect the pattern of insurance protection provided, the insurer should modify or develop, if necessary, a method that recognizes net income from the policy over the exposure period of the contract in proportion to the amount of insurance protection provided.

20. Monthly outstanding balance credit policies are generally collected at the beginning of each month. Consequently, premium is generally earned at the end of the month and a gross unearned premium is only needed to the extent policies are issued during the month. When policies are issued throughout the month, a gross unearned premium reserve should be established based on the remaining proportionate amount of insurance protection to be provided using either the daily pro-rata or monthly pro-rata methods as described in Issue Paper No. 53.

21. Single premium credit life policy reserves shall be based on either a gross unearned premium reserve based on a refund formula, or a reserve based on assumed risks using mortality factors. In practice, various methods exist and are currently used to estimate the amount of gross unearned premiums applicable to the unexpired portion of the policies in force. For decreasing gross coverage, the gross unearned premium may be estimated using a Rule of 78's method; for decreasing net payoff coverage, either the Rule of 78's or the single-premium method is used; and for level coverage, the pro-rata method is generally used. The reporting entity shall select a method that reflects the pattern of insurance protection provided.

22. Policy reserves for credit A&H policies shall be based on a gross unearned premium reserve using either the pro rata, Rule of 78's, or actuarial methods. The actuarial reserve is the single premium for the debt's remaining term and amount. Most states require insurers to record a gross unearned premium reserve using the Rule of 78's method. In practice, a mean gross unearned premium reserve (average of the Rule of 78's and the pro rata methods) is often recorded. The reporting entity shall select a method that most closely reflects the pattern of insurance protection provided.

23. Recognizing net income in proportion to the amount of insurance protection provided is consistent with the recognition concept in the Statement of Concepts. The recognition concepts states, *"revenue should be recognized only as the earnings process of the underlying underwriting or investment business is completed."* Therefore, as the period that is protected expires, the underlying underwriting process is completed and the net income should be recognized.

Drafting Notes/Comments

- Issue Paper No. 50 addresses Classifications and Definitions of Insurance Contracts In Force.
- Issue Paper No. 51 addresses Life Contracts.
- Issue Paper No. 53 addresses Property and Casualty Contracts – Premiums.
- Issue Paper No. 54 addresses Individual and Group Accident and Health Contracts.
- Issue Paper No. 55 addresses Unpaid Claims, Losses and Loss Adjustment Expenses.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE (only pertinent excerpts are included below)**Statutory Accounting**

24. The Life/A&H Accounting Practices and Procedures Manual provides the following guidance with respect to credit life insurance policies:

CHAPTER 10
AGGREGATE RESERVES FOR LIFE AND ANNUITY CONTRACTS

Life Insurance

The fourth line of life insurance is credit. Credit insurance may be either individual or group. All life and all accident and health insurance that is sold in connection with loans or other credit transactions not exceeding a stated duration is to be reported as credit insurance.

Types of Reserves

Reserves for credit insurance to a great extent depend on the premium payment plan which may be either a single premium or a monthly premium based on the outstanding loan balance. If the premium is included as part of the finance charge, and included with the total principal and interest to be paid, it is single premium credit insurance. The single premium is remitted to the insurer at the time the loan is made. State regulations may prohibit remittance of a single premium on a monthly basis by a creditor.

If the premium is collected monthly for the amount of indemnity, the indemnity generally is the outstanding balance type. Reserves for credit life insurance on which premiums are remitted monthly are, in most cases, pro rata unearned premium.

Reserves for single premium credit life may be computed by any of several methods. One method is unearned premium reserves based on the refund formula, usually called Sum of the Digits method or the "Rule of 78's" method. The "Rule of 78's" method assumes that refunds may be made to all insureds. Another method of computation establishes reserves in accordance with the assumed risks. This assumes that refunds will be made as they are experienced in the normal course of business, but not necessarily for all policies. Based on this method, reserves for single premium credit life insurance are established using mortality factors.

25. The Life/A&H Accounting Practices and Procedures Manual provides the following guidance with respect to credit accident and health insurance policies:

CHAPTER 13
AGGREGATE RESERVES FOR ACCIDENT AND HEALTH POLICIES

Credit Insurance

Credit accident and health insurance is insurance on a debtor to provide indemnity for payments becoming due on a specific loan or other credit transaction while the debtor is disabled as defined in the policy. Credit policies are limited to issues of 120 months or less in most states. Some states limit such policies to 60 months.

Credit accident and health insurance is sold as either individual or group coverage, and the reserves are included in the annual statement. Because of the significant growth in recent years of credit insurance coverages of 120 months or less are now reported as a separate line of business in the annual statement.

The premium payment methods of credit insurance may be single premium or monthly premium on the outstanding balance. Outstanding balance rates, used only for group coverage, are determined by multiplying a monthly rate times the amount of outstanding insured indebtedness.

The premium so determined is remitted on each monthly due date to the insurer by the group creditor. Under single premium credit insurance, the premium rate is applied to the initial amount of insurance and generally is included in the debt. Creditors usually remit the single premium for each new insured once a month.

Although credit insurance may be written on an individual or a group basis, the major portion of credit insurance that is written today is group. The two types differ only in form, not in substance. Consequently, they are treated here as one, unless otherwise noted.

Legal Requirements for Reserves

The reserve for single premium credit accident and health insurance is the unearned premium. Three methods are used to calculate unearned premiums: pro rata, "Rule of 78's," and actuarial. The actuarial reserve is the single premium for the debt's remaining term and amount; it is the most accurate method. Pro rata allocates the single premium proportionately to the remaining term, while "Rule of 78's" does it by using the ratio of the sum of the digits for the remaining term of the sum of the digits for the initial term. The "Rule of 78's" may substantially underreserve relative to the actuarial reserve.

Quite a few states prescribe minimum reserve standards in their credit insurance regulations. Typically, the requirement for credit A & H is either the gross unearned premium, or the actuarial reserve, but not less than the gross unearned premium. On outstanding balance group credit insurance, the gross unearned premium is generally calculated using the methods described above for other group accident and health policies.

Most companies calculate unearned premium reserves for single premium credit accident and health insurance as average factors. On the actuarial basis, the factor is the average of the single premium rates for the remaining number of months and the remaining number of months less one month. Similarly, companies that use the "Rule of 78's" will apply an average of 78's factors. These factors are applied to the single premium and are a function of the original term of the insurance and the number of months remaining in that term. The factor used to compute the reserve will be the average of the "Rule of 78's" factor for the number of months remaining, and the 78's factor for one less than the number of months remaining. This half-month assumption in both methods assumes that debtors become insured uniformly throughout each month.

Generally Accepted Accounting Principles

26. FAS 60, as amended by FAS 120, provides the following guidance:

3. Premiums from short-duration insurance contracts, such as most property and liability insurance contracts, are intended to cover expected claim¹ costs resulting from insured events that occur during a fixed period of short duration. The insurance enterprise ordinarily has the ability to cancel the contract or to revise the premium at the beginning of each contract period to cover future insured events. Therefore, premiums from short-duration contracts ordinarily are earned and recognized as revenue evenly as insurance protection is provided.

¹ Terms defined in the glossary (Appendix A) are in boldface type the first time they appear in this Statement.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

General Principles

7. Insurance contracts, for purposes of this Statement, shall be classified as short-duration or long-duration contracts depending on whether the contracts are expected to remain in force³ for an extended period. The factors that shall be considered in determining whether a particular contract can be expected to remain in force for an extended period are:

³ *In force* refers to the period of coverage, that is, the period during which the occurrence of insured events can result in liabilities of the insurance enterprise.

- a. Short-duration contract. The contract provides insurance protection for a fixed period of short duration and enables the insurer to cancel the contract or to adjust the provisions of the contract at the end of any contract period, such as adjusting the amount of premiums charged or coverage provided.
 - b. Long-duration contract. The contract generally is not subject to unilateral changes in its provisions, such as a noncancelable or guaranteed renewable contract, and requires the performance of various functions and services (including insurance protection) for an extended period.
8. Examples of short-duration contracts include most property and liability insurance contracts and certain term life insurance contracts, such as credit life insurance. Examples of long-duration contracts include whole-life contracts, guaranteed renewable term life contracts, endowment contracts, annuity contracts, and title insurance contracts. Accident and health insurance contracts may be short-duration or long-duration depending on whether the contracts are expected to remain in force for an extended period. For example, individual and group insurance contracts that are noncancelable or guaranteed renewable (renewable at the option of the insured), or collectively renewable (individual contracts within a group are not cancelable), ordinarily are long-duration contracts.
9. Premiums from short-duration insurance contracts ordinarily shall be recognized as revenue over the period of the contract in proportion to the amount of insurance protection provided. A liability for unpaid claims (including estimates of costs for claims relating to insured events that have occurred but have not been reported to the insurer) and a liability for claim adjustment expenses shall be accrued when insured events occur.

Premium Revenue Recognition

Short-Duration Contracts

13. Premiums from short-duration contracts ordinarily shall be recognized as revenue over the period of the contract in proportion to the amount of insurance protection provided. For those few types of contracts for which the period of risk differs significantly from the contract period, premiums shall be recognized as revenue over the period of risk in proportion to the amount of insurance protection provided. That generally results in premiums being recognized as revenue evenly over the contract period (or the period of risk, if different), except for those few cases in which the amount of insurance protection declines according to a predetermined schedule.

27. The AICPA Audit and Accounting Guide: Stock Life Insurance Companies provides the following guidance:

Term Contracts

8.18 A wide variety of term insurance contracts are issued. The clearly predominant service provided by many such term contracts is protection. Examples of term contracts where the predominant service is protection, include credit life insurance and other types of single or limited payment contracts of a relatively short duration. Gross premium revenues on such contracts should be recognized in proportion to the amounts of insurance in force. Expressed otherwise, written premiums should be recognized as earned during each year that a policy is in force in proportion to the ratio of the amount of insurance in force each year to the total of the annual amounts in force over the life of the policy.

8.23 The accounting for accident and health insurance policies, which are expected to be in force for a reasonable period of time and for which elements of expense or benefit costs are not level, should follow the same principle of accounting as followed for whole-life insurance. Accordingly, premium revenues should be recognized over the premium-paying period. For other kinds of health insurance, gross premiums should be recognized as revenues on a pro rata basis over the period covered by the premium except in those cases of credit accident and health where the coverage decreases by passage of time. For the latter type contracts, gross premiums should be recognized as revenues over the stated period of the contract in reasonable relationship to the anticipated claims.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 10, Aggregate Reserves for Life and Annuity Contracts, and Chapter 13, Aggregate Reserves for Accident and Health Policies
- *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*
- *Issue Paper No. 50—Classifications and Definitions of Insurance or Managed Care Contracts In Force*
- *Issue Paper No. 51—Life Contracts*
- *Issue Paper No. 53—Property and Casualty Contracts - Premiums*
- *Issue Paper No. 88—Mortgage Guaranty Insurance*

Generally Accepted Accounting Principles

- *FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises*
- *FASB Statement No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*
- *FASB Statement No. 120, Accounting and Reporting by Mutual Life Assurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts*
- AICPA Audit and Accounting Guide: Stock Life Insurance Companies

State Regulations

- No additional guidance obtained from state statutes or regulations.