

Life Insurance Accounting

Contract classification

The accounting treatment of the life insurance business varies depending on the nature of the contract.

The majority of the business of AMP Life and a substantial part for NMLA relates to wealth management products such as savings, superannuation and allocated pensions/annuities where there is no insurance risk and no discretion over the vesting of policyholder benefits (ie non-participating). These contracts are classified as "investment contracts" and are accounted for at fair value under the Australian equivalents to International Financial Reporting Standards (AIFRS) for Financial Instruments and Revenue.

AMP Life and NMLA also issue contracts that either:

- transfer significant insurance risk from the policyholder such as death, disability or longevity, or
- provide discretionary participating benefits.

These contracts are classified as "life insurance contracts" and are accounted for using Margin on Services (MoS).

Investment contracts

Life investment contracts may consist of a financial instrument and an investment management services element, both of which are measured at fair value. Apart from fixed term annuity policies, the resulting liability to policyholders is tightly linked to the performance and value of the assets (after income tax) that back those liabilities. The fair value of such liabilities is therefore the same as the fair value of those assets, after income tax on the basis charged to policyholders.

Fees and other charges passed to the shareholder are reported as revenue.

For fixed term annuity policies, the financial instruments element is the fair value of the fixed term annuity payments, which is their present value at a fair value discount rate. The fair value of the associated management services element is the net present value at a fair value discount rate of all costs associated with the provision of services and any profit margins thereon.

For the North Guarantee product, fair value of the embedded derivative is determined by stochastic modelling.

Life insurance contracts

MoS is the financial reporting methodology developed to report on the life insurance business of Australian companies. It continues to apply to life insurance contracts issued by Australian companies or their subsidiaries.

Under MoS, the profits that are expected to be earned on life insurance contracts emerge over the life of the business as services are provided and income received, hence the name Margin on Services.

Detailed description of MoS

MoS policy liabilities are ordinarily determined using a projection method, whereby estimates of policy cashflows (premiums, benefits, costs and profit margins to be released in future periods) are projected into the future. The policy liability is calculated as the net present value of these projected cashflows.

The policy liabilities have two components:

- the best estimate liabilities (to cover future benefits and costs, and allowing for future premiums)
- the value of future profit margins (based on the appropriate profit carrier).

A risk-free discount rate is used unless policyholder benefits are linked to performance of assets backing the contract, in which case the discount rate is the expected future earnings rate on those assets.

No profit is normally recognised on inception of new business after allowing for acquisition costs.

Instead, profit margins on new business (after allowing for the recoverability of acquisition costs) enhance the existing value of future profit margins, to be released over the future life of the business. For risk insurance this results in a negative policy liability, often referred to as the implicit DAC.

The expected profit margins are related to a profit carrier, which best reflects the provision of services under the contract and emerges as a proportion of that profit carrier.

MoS policy liabilities are calculated using best estimate assumptions about future conditions. In the case of maintenance costs, the assumption must be sufficient to cover the budgeted costs in the following year.

If actual experience differs from that expected, the financial effects of these differences are recognised as experience profits or losses in addition to the expected profits.

The best estimate assumptions are reviewed and revised as necessary at each reporting date. Changes generally do not affect policy liabilities and reported profit; their effect is absorbed in the value of future profit margins, to emerge in the future.

The exception is market related changes in the investment earning assumption for non-participating business. In this case, the policy liabilities are altered and, to the extent that such change is not matched by a similar movement in the value of assets, a profit or loss emerges.

Where future losses are expected, they must be recognised immediately. If a favourable change in assumptions subsequently occurs, or if profitable new business is written, previously recognised losses may be reversed.

An accumulation method may be used if it produces results that are not materially different from those produced by a projection method. A modified accumulation method is used for some discretionary participating contracts, where the policy liability is the accumulation of amounts invested by the policyholder, less fees specified in the policy, plus investment earnings and vested benefits, adjusted to allow for the fact that the crediting rates are determined by reference to investment income over a period greater than one year. This accumulation may be adjusted to the extent that acquisition costs are to be recovered from future margins between fees and costs.

A similar approach is used for group risk business except that the basic accumulation is the amount of the unearned premium plus unreported claims at the valuation date.