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F.12 Covering Hybrid Insurance and Pension Products

Prepared by the Financial and Payments Systems Task Team (FITT)

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F.12 Covering Hybrid Insurance and Pension Products[1]

The recommended recording of insurance and pension products differs substantially depending on whether they are classified as life insurance and annuities, non-life insurance or pensions. This guidance note (GN) examines possible alternatives to the classification of the following two products in macroeconomic statistics: (1) hybrid insurance products, and (2) employer-independent pensions.

Issue 1: The Balance of Payments and International Investment Position Manual, sixth edition *(*BPM6*) and the* System of National Accounts 2008 *(*2008 SNA*) highlight that nonlife insurance is distinguished from life insurance in that it pays benefits only if an insured event occurs. However, in practice a large range of insurance products exist that combine nonlife insurance with financial investment elements which make them similar to life insurance. This GN examines the options to better account for the classification of such hybrid insurance products.*

Issue 2: Pension products provide a stream of payments to households in retirement. Households' social pension contributions are deducted from primary income, similar to taxes, in the calculation of disposable income of households. This GN argues that the core features of pensions in the system of accounts are that accumulated contributions are set aside for retirement income, and, for pensions provided by the autonomous pension fund sub-sector (S129), that they are subject to regulation or supervision as pension schemes/funds. The GN considers options to amend the classification of pensions in social insurance to incorporate these core features, thereby extending the scope of S129 pension schemes/funds to include employer-independent schemes/funds.

SECTION I: THE ISSUES

BACKGROUND

1. **The *Balance of Payments and International Investment Position Manual, sixth edition* (*BPM6*) and the *System of National Accounts 2008* (*2008 SNA*) discuss the treatment of two primary types of insurance products: life insurance (and annuities) and nonlife insurance.** Types of nonlife insurance include accident and health; term life; marine, aviation, and other transport; fire and other property damage; pecuniary loss; general liability; and credit insurance (*BPM6*, paragraph A6c.7). On the other hand, *life insurance involves a stream of payments by the policyholder in return for a lump sum at the end of the policy* (*BPM6*, paragraph A6c.29). The *BPM6* states that life insurance includes a large saving component, whereas the objective of nonlife insurance is largely to pool risk (*BPM6*, paragraph A6c.3).

2. **Moreover, the *BPM6* highlights that nonlife insurance is distinguished from life insurance in that it pays benefits only if an insured event occurs (*BPM6*, paragraph A6c.11).** Because life insurance includes a policyholders' saving component, it is recorded as other investment in the balance of payments financial account, and funds are regarded as financial assets managed by insurance corporations on policyholders' behalf. On the other hand, nonlife insurance generally does not have a

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policyholders' saving component (i.e., insurance premiums once paid to the insurer will not be returned to the policyholders if the insured event does not occur). Therefore, nonlife insurance claims (excluding reserves against outstanding insurance claims) and net premiums are regarded as transfers and are recorded in the secondary income account under current transfers.

3. **Similarly, in the *2008 SNA*, life insurance is defined as an activity whereby a policyholder makes regular payments to an insurer in return for which the insurer guarantees to pay the policyholder (or in some cases another nominated person) an agreed sum, or an annuity, at a given date or earlier if the policyholder dies beforehand (*2008 SNA*, paragraph 17.6).** Nonlife insurance is defined as an activity similar to life insurance except that it covers all other risks, accidents, sickness, fire, etc. Further, the *2008 SNA* states that in the case of nonlife insurance, insurance payouts to policyholders are made only if the event insured against occurs, while life insurance policies are a type of saving scheme (*2008 SNA*, paragraphs 6.177 and 6.192). Therefore, in the case of nonlife insurance, claims and net premiums are recorded as current transfers, while in the case of life insurance products cash flows are recorded as transactions in financial assets in the financial account (e.g., *2008 SNA*, paragraph 8.74).

4. **In the *BPM6* and the *2008 SNA*, however, term life insurance is included in nonlife insurance, because benefits are payable only on the death or incapacity of the insured.** Nonlife insurance is distinguished from life insurance in that it pays benefits only if an insured event occurs (*BPM6*, paragraph A6c.11). In the *2008 SNA*, term life insurance is regarded as nonlife insurance since it provides a benefit in the case of death within a given period but in no other circumstances (*2008 SNA*, paragraph 17.6).

5. **In some countries, however, there seem to be hybrid insurance products that are a mixture of the two primary types**—life insurance (insurance whose financial claims arise regardless of an event occurrence—i.e., insurance with a saving component), and nonlife insurance (insurance whose financial claims arise only if an event occurs). In the *BPM6* and the *2008 SNA*, there seems to be no clear reference to the treatment of these products.

6. **Issue 2 of this note considers how to record autonomous pension schemes that provide similar benefits as employment-related pension schemes but are employer-independent.** A clarification of how to deal with employer-independent schemes is needed because they exist in several countries (e.g., in Germany and Spain for self-employed professionals).

7. **For a scheme to qualify as a social insurance pension scheme, it needs to provide social benefits which are conditional on participation in the scheme and mandatory participation or employer involvement (*2008 SNA,* paragraph 17.88).** Social benefits in the relevant introductory paragraphs of the *2008 SNA* do not require employer involvement (paragraphs 8.87 and17.79). However, the more detailed text indicates that social insurance schemes are employment related (e.g., paragraph 17.91).

8. **The recording of employer-independent pensions provided by autonomous pension schemes or funds for self-employed professionals would thus require amendment of the conditions to qualify as pensions in social insurance.** In countries with qualifying employer-independent schemes, including such schemes would affect not only the financial accounts, but also the non-financial accounts. In particular, the extension would affect households' social contributions

and benefits in the secondary distribution of income account, the adjustment for the change in pension entitlement in the use of disposable income account, household disposable income and savings.

9. **This GN discusses the two hybrid or borderline cases as introduced above.** The GN discusses the underlying issues and presents some alternatives.

ISSUES FOR DISCUSSION

Issue 1: Hybrid Life/Non-Life Insurance Products

10. **The following insurance products are extremely difficult to classify in terms of the recording of funds and the type of insurance provided.**

- Funded insurance: These are generally long-term polices that involve some payout by the insurer at maturity. Some policies are combined with fire insurance, personal accident insurance, etc. That is, these insurance products combine nonlife insurance and saving elements.
- Education endowment insurance: These are policies that allow policyholders (parents) to save money for their children's education. Should the policyholder die during the premium payment period, no further premiums need to be paid, but the policy continues, and payouts are made at maturity to pay for tuition. Moreover, policies often include riders such as medical care or death benefits for the child and/or medical security for the parents. As a result, education endowment insurance can be regarded as a mixture of life insurance, which has a saving element, and nonlife insurance.
- Health insurance with a “no claim” bonus: Policyholders receive a bonus if they do not make a claim within a certain period. While these policies are classified as nonlife insurance products and do not contain a saving element, policyholders receive a certain sum of money even if the insured event does not occur.
- “Hybrid“ long-term care insurance: This type of insurance comprises traditional long-term care insurance, where payouts are made when long-term care expenses occur, but also includes a part with death benefits, which decrease in line with payments for long-term care made. In other words, unpaid benefits or previously established minimum benefits will be paid out even in cases where long-term care did not occur.

11. **Hybrid insurance products could be classified in the same way as term life insurance (nonlife insurance is distinguished from life insurance in that it pays benefits only if an insured event occurs (*BPM6*, paragraph A6c.11)), depending on the main characteristics of the product (meaning the way premiums are mainly used).** That is, funded insurance, education endowment insurance, and hybrid long-term care insurance can be classified together as life insurance, since premiums are mainly used for payouts at maturity and only the investment income portion is used for insurance claim payouts for insured events. Health insurance with a “no claim” bonus can be regarded as medical insurance that provides payouts if an insured event occurs. Unlike the other insurance products, the majority of premiums is spent on insurance claims; moreover, “no claim” bonuses are relatively small in comparison to premiums paid and can be regarded as a discount on premiums, so that health insurance with a “no claim” bonus can be classified as nonlife insurance.

12. **In theory, one could envision a policy where half of the premiums paid are allocated to claim payouts for insured events and the other half are allocated to payouts at maturity.** In that case, however, payouts at maturity would be much smaller than the total amount of premiums paid (for example, 60 percent), so that such a product would not be attractive for policyholders, and we were not able to find such a product in practice.

13. **Given the considerations above, there are various options regarding how to deal with such hybrid insurance products.**

Option 1: Introduce a new category for hybrid insurance products and distinguish among the following categories—life insurance: insurance with a saving component; nonlife insurance: insurance where claims (benefits) are paid to policyholders only if the insured event occurs (*2008 SNA* paragraph 6.177); and other insurance products: insurance products that are difficult to classify into the two primary types of insurance products.

Option 2: Keep the current categories—life insurance/nonlife insurance. That is, products with a saving component are classified as the former, and products where claims are paid only if the insured event occurs are classified as the latter. Hybrid products would be allocated to one category or the other depending on which features are predominant.

Option 3: Revise the categories life insurance/nonlife insurance into insurance with a "saving component" and insurance where premiums are "lost" in case covered events do not occur and change the terms and descriptions in the statistical standards. Hybrid products would be allocated to one category or the other depending on which features (insurance with a "saving component" or insurance where premiums are "lost") are predominant.

Issue 2: Employer-Independent Pensions Provided by Autonomous Pension Schemes or Funds

14. **The *2008 SNA* defines social insurance schemes as schemes where the employer or government may oblige or encourage insurance scheme members to take out insurance against certain eventualities or circumstances (*2008 SNA,* paragraph 8.74).** All social insurance schemes are founded on an employment relationship even if the participants are self-employed or currently unemployed (*2008 SNA,* paragraph 8.76). Furthermore, pension entitlements are described as claims against employers or funds designated by employers (*2008 SNA,* paragraph 11.107; and *BPM6,* paragraph 5.66).

15. **In several countries (e.g., Germany, Spain)[2] there are autonomous pension schemes covering self-employed persons that are designed to provide retirement income in a similar fashion as employer-related pension schemes.** These schemes are typically encouraged by government through fiscal incentives and similarly regulated as employer-related pension schemes to ensure that the accumulated funds are used for post-retirement income. If the regulations prevent the withdrawal of the accumulated funds before a certain retirement age is reached and require the scheme

[2] In Germany, contribution to professional associations' autonomous pension funds is mandatory for certain employed and self-employed professionals. In Spain, schemes exist for certain groups of professionals, membership is voluntary, but the accumulated contributions are subject to the same regulations as for employer-related pension schemes.

to set aside the accumulated funds, it seems appropriate to record such schemes as pension schemes in social insurance.

16. **Households are treated in the financial accounts as owning pension entitlements (AF.63).** In the non-financial accounts, pension contributions are seen as uses in the secondary distribution of income account, and they can be made by employers and households. Households' pension contributions (D.613) are deducted from primary income, similar to taxes, in the calculation of disposable income of households, as the net contributions are not available for consumption. An adjustment (D.8) is needed in the use of disposable income account to equate consumption and saving with disposable income.

17. **The criterion whether the accumulated funds are shielded from early withdrawals, may be considered more important than the requirement of employer involvement.** One may argue that the reason for the special treatment of pensions is the existence of regulations designed to ensure that the accumulated contributions are set aside for retirement income. Individual products which may be provided by autonomous pension schemes or funds to provide retirement income may be classified as social insurance if they are subject to similar regulations and supervision as employer-related pension schemes.

18. **Employer-independent pension schemes may be obliged or encouraged by government for certain groups (e.g., employees of a group of enterprises, employees of a branch or industry, and persons having the same profession) for which participation may or may not be mandatory.** Several comments from FITT and CATT members emphasize *mandatory participation* as an important characteristic of social insurance pension schemes. However, government may want to also **encourage** individuals who are not part of a well-defined group to participate in pension schemes. For example, governments may want to foster regulated pension products which are open to employees without long-term employment contracts and to the self-employed individuals who are not members of a profession. The pan-European personal pension product regulation is an example of a recent government initiative to encourage retirement savings through voluntary and flexible schemes, which at the same time limits early withdrawals. The comments requiring mandatory participation are captured by Option 2 presented below.

19. **Related to mandatory participation, redistribution is a characteristic of social insurance schemes emphasized by FITT members.** However, in the case of pensions, social redistribution does not always take place—for instance, there is no redistribution in the case of defined contribution schemes. Redistribution is thus not proposed as a criterion to classify employer-independent schemes.

20. **Two options are envisaged to clarify the treatment of autonomous employer-independent pension schemes or funds on the basis of the elements identified in the discussion above: (i) their mandatory nature; and (ii) the fact that they are based on contributions set aside for retirement, and the resulting funds are regulated in a similar way to employer-related schemes to ensure the use of the funds for retirement.** Options 2 and 3 propose amending the definition of pensions in social insurance to include autonomous employer-independent schemes or funds, based on these two elements and imply a widening of the pension concept. Option 1 suggests keeping the current definition of pensions in social insurance and exploring whether it can be aligned with international accounting standards such as IPSAS 39, following a FITT comment. Employer-independent schemes may be recorded in an extended version of the Supplementary Table on Pensions in Social Insurance (*2008 SNA*

Table 17.10), such as the proposed Table on household retirement resources. Option 1 has the advantage that the non-financial accounts are not affected.

Option 1: Keep the narrow definition of social insurance pension schemes as employer-related schemes only and explore whether it can be aligned with international accounting standards. *2008 SNA* Pension Table 17.10 may be extended to include a column for non-social insurance pension entitlements.

Option 2: Clarify that autonomous, employer-independent schemes or funds can also qualify as social insurance pensions, and specify the criteria as follows:

- participation in the schemes is mandatory for certain groups, and
- accumulated contributions are set aside for retirement income and are subject to regulation or supervision in line with or similar to employer-related pension schemes/funds.

Option 3: Clarify that autonomous, employer-independent schemes or funds can also qualify as social insurance pensions, and specify the criterion as follows:

- accumulated contributions are set aside for retirement income and are subject to regulation or supervision in line with or similar to employer-related pension schemes/funds.

SECTION II: OUTCOMES

Recommendation for Issue 1: Hybrid Life/ Non-Life Insurance Products

21. **The authors of this GN recommend Option 2.** The *BPM6* and *2008 SNA* classify insurance products based on whether the benefits are payable only if an insured event occurs or not. Hybrid insurance products could be classified into one of the two categories of life (financial account) or nonlife insurance (current transfers) by applying the same criteria to the main characteristics of the product, such as how products are structured, and premiums are spent.

22. **In the BPM, a certain portion of premiums are considered to represent the value of insurance services provided (*BPM6*, paragraph A6c.15, A6c.16, and A6c.31).** The service elements should be recorded in the same manner for each insurance product that is classified in either life or nonlife insurance.

23. **This option would entail little change in practice** as currently all insurance products classified as "life insurance" have a saving component and the cases where they also include for instance some fire and personal accident insurance products together with a saving component are likely to be negligible.

24. **The following chart may be helpful for compilers in classifying insurance products under Option 2.**

Table 1. Classification of Life/Nonlife Insurance Products

<table>
<tr><td colspan="2" rowspan="2"></td><td colspan="2">General category</td></tr>
<tr><td>Life insurance</td><td>Nonlife insurance</td></tr>
<tr><td rowspan="6">Definitions in the manuals</td><td rowspan="3">Insurance providing payouts (based on financial claims) regardless of whether an event occurs (Financial account)

<Life insurance></td><td>Life insurance</td><td>Fire insurance (with saving component)
Personal accident insurance (with saving component)</td></tr>
<tr><td colspan="2">Education endowment insurance</td></tr>
<tr><td colspan="2">Hybrid long-term care insurance</td></tr>
<tr><td rowspan="3">Insurance providing payouts (based on financial claims) only if an insured event occurs (Current transfers)

<Nonlife insurance></td><td rowspan="3">Term life insurance</td><td>Fire insurance
Personal accident insurance</td></tr>
<tr><td>Marine, aviation, and other transport insurance</td></tr>
<tr><td>Health insurance
Etc.</td></tr>
</table>

Note: The blue boxes denote treatments already reflected in the BPM6.

25. **On the contrary, Option 1—creating a new category—does not appear to be desirable.** In addition, even if a new category was created, it would be similarly difficult to establish universal rules to determine whether premiums and claims linked to hybrid insurance products should be recorded under current transfers or the financial account. There would also be difficulties in calculation of service elements of hybrid insurance products. Given the additional burden on compilers and respondents this would create, introducing a new category does not appear appropriate from a cost-benefit perspective.

26. **Finally, while Option 3 might be appropriate in terms of how such products are recorded in the balance of payments and national accounts, information on what type of insurance products these categories comprise would be lost.** Since most insurance products with financial claims regardless of an event occurrence would correspond to what we now call life insurance products, it seems preferable to keep the category "life insurance." In this context, term life insurance would of course be classified as nonlife insurance.

27. **However, based on the considerations above, one option could be adding an explanation regarding the nature of the insurance to the current terms in the manuals.** For example, the categories could be changed to "Life insurance (insurance whose financial claims arise regardless of an event occurrence)" and "Nonlife insurance (insurance whose financial claims arise only if an event occurs)."

28. **In sum, the authors of the GN propose revising the standards by adding a statement highlighting that hybrid insurance products are classified based on the predominant nature of the policy.**

Recommendation for Issue 2: Employer-Independent Pension Schemes

29. **The authors of this GN favor Option 3 as the criterion that the accumulated contributions that are set aside for retirement income and are subject to regulation is considered as sufficient to justify the recording of the contribution as social contributions,** which, similar to (e.g.) taxes, reduce disposable income. The coverage of employer-independent schemes may require the development of new data sources. However, the restriction to schemes/funds which are subject to pension fund regulation and supervision should facilitate the identification of the relevant schemes and data providers.

30. **It is acknowledged that Option 2 has the advantage of simplicity** and would amend the current SNA definition to explicitly state the conditions for the recording of employer-independent schemes as social insurance schemes pension.

31. **However, it seems analytically not meaningful to restrict pension schemes in such a way (specific groups and mandatory membership).** The pension scheme definition should also be widened to cover autonomous schemes/funds for which similar regulation exist ensuring that the accumulated savings provide retirement income, and therefore having the same economic purpose and effects as employer-related pension schemes.

32. **Consultation on the first draft of this GN generated nine comments from FITT members and four comments from CATT members. The reflection of the comments in this draft are briefly summarized below.**

33. **As for <u>Issue 1 (hybrid insurance products)</u>, 10 members out of 13 expressed support for Option 2, which the authors have recommended.** One member expressed preference for modified Option 2—separate a hybrid product into life and nonlife component—and another member supported Option 3. The other member seemed to agree with the suggestion in the GN, not showing clear preference for Issue 1. Some FITT and CATT members are in favor of adding the expression as referred in paragraph 27. In the updated *BPM6* and *2008 SNA*, the terms of categories could be changed to "Life insurance (insurance whose financial claims arise regardless of an event occurrence)" and "Nonlife insurance (insurance whose financial claims arise only if an event occurs)." In addition, *BPM6*, paragraph A6c.11 and *2008 SNA*, paragraph 17.6 would need to be made consistent.

34. **For <u>Issue 2 (pension products)</u>, eight members supported Option 3, which the authors have recommended.** Two members supported Option 2, and the other 3 members made objection to Option 3 without preferring an alternative option. The proposal of a FITT member to make the reference to pension regulations more explicit, was implemented following the argument that this would help compilers to base their decisions on simpler elements, rather than exploring the financial aspects of the insurance supply. The common criterion of Options 2 and 3 were thus amended and aligned with the general direction of comments received. Furthermore, following comments regarding the distinction between annuities offered by insurance corporations, it is now clarified that the proposed extension of the pension concept considers only autonomous pension schemes/funds.

35. **The comments emphasizing mandatory participation as an important characteristic of pension schemes are considered in Section 2 (paragraph 18) and reflected in Option 2.** The social redistribution aspect of social insurance is considered in Section 2 (paragraph 19), but not found to be decisive in the case of pensions.

36. **The comments suggesting an alignment of the pension definition of the SNA with IPSAS 39** are considered in Section 2 (paragraph 20) and captured in Option 1.

Questions for Discussion:

1) *What option do the Committees favor for the classification of hybrid insurance products (Option 1, Option 2, or Option 3)?*
2) *What option do the Committees favor for the classification of autonomous, employer-independent pension schemes (Option 1, Option 2, or Option 3)?*
3) *Do the Committees have any other comments/suggestions on the issues discussed in the GN?*