IASB/FASB Meeting
Week commencing 21 March 2011

IASB Agenda reference **12C**

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Staff Paper

Project **Insurance contracts**

Topic **Contract boundary**

What is this paper about?

1. Paragraphs 26 to 29 of the IASB's exposure draft (ED) *Insurance Contracts* and paragraphs 46 to 49 of the FASB's discussion paper (DP) *Preliminary Views on Insurance Contracts* propose that the measurement of an insurance contract would reflect all cash flows arising within the boundary of that contract. Conversely, cash flows arising beyond the boundary of existing contracts would be treated as arising from a future contract. An extract from the basis for conclusions relating to contract boundaries is reproduced in Appendix A.
2. Some question whether the proposed contract boundary has been drawn in the right place. In particular, they are concerned that including cash flows beyond the end of the contract's stated coverage period (renewal date) but within the contract boundary would affect the contract's eligibility for the modified approach for short-duration contracts. Some also express concerns that estimates of those additional cash flows may be highly uncertain for some insurance contracts, particularly some types of health insurance.

This paper has been prepared by the technical staff of the IFRS Foundation and the FASB for discussion at a public meeting of the FASB or the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the FASB or the IASB.

Comments made in relation to the application of U.S. GAAP or IFRSs do not purport to be acceptable or unacceptable application of U.S. GAAP or IFRSs.

The tentative decisions made by the FASB or the IASB at public meetings are reported in FASB *Action Alert* or in IASB *Update*. Official pronouncements of the FASB or the IASB are published only after each board has completed its full due process, including appropriate public consultation and formal voting procedures.

Staff recommendation

3. This paper recommends that:

   (a) Contract renewals should be treated as a new contract:

      (i) when the insurer is no longer required to provide coverage; or

      (ii) when the existing contract does not confer on the policyholder any substantive rights.

   (b) A contract does not confer on the policyholder any substantive rights when the insurer has the right or the practical ability to reassess the risk of the particular policyholder and, as a result, can set a price that fully reflects that risk.
   Some staff recommend a modification to this conclusion for contracts for which the pricing of the premiums does not include risks relating to future periods: no substantive rights are conferred on the policyholder when the insurer has the right or the practical ability to reassess the risk of the **portfolio** the contract belongs to and, as a result, can set a price that fully reflects the risk of that portfolio.

   (c) All renewal rights should be considered in determining the contract boundary whether arising from contract, law or regulation.

4. Appendix C describes how these recommendations would apply to example product characteristics.

5. This paper does not address:

   (a) contract boundary issues relating to reinsurance (for both the reinsurer and the cedant), which will be considered together with other reinsurance issues in a future meeting.

   (b) the recognition date of insurance contracts which is discussed in paper 3I.

(c) the eligibility criteria for the modified measurement approach, which will be considered in a future meeting, together with other issues relating to the modified measurement approach.

Background

Relevant questions in the invitation to comment

6. Question 9 of the IASB's ED asked respondents:

> Do you agree with the proposed boundary principle and do you think insurers would be able to apply it consistently in practice? Why or why not? If not, what would you recommend and why?

7. This paper does not address Question 23 of the FASB's DP which asked respondents about the implications of the recent US healthcare reform for the application of the proposed contract boundary principles.

Input from comment letter, outreach activities and field tests

8. Paragraph 27 of the ED and paragraph 46 of the DP[1] states that the boundary of an insurance contract would be the point at which an insurer either:

   (a) is no longer required to provide coverage, or

   (b) has the right or the practical ability to reassess the risk of the particular policyholder and, as a result, can set a price that fully reflects that risk.

9. Almost all respondents believe that a contract boundary exists at the point where the insurer is no longer required to provide coverage (the condition described in paragraph 27(a) of the ED).

10. Respondents generally also agree that a contract boundary exists at the point where the insurer has the right or practical ability to reassess risk and to reset the price accordingly. More specifically, many respondents agreed with the particular

[1] For brevity we will from this point refer only to the paragraph number in the ED.

proposal in paragraph 27(b) of the ED that this boundary should be the point where the insurer can reassess the risk for the **particular** policyholder and can set a price that **fully** reflects that risk.

11. Most also agreed that insurers would be able to apply the contract boundary principle consistently in practice.

12. A few respondents stated explicitly that if the boards changed the boundary to the point where the insurer can reassess the risk for the portfolio, rather than for the particular policyholder, the modified approach for short-duration contract might be used for contracts generally thought of as having a long duration. For example, for some life insurance contracts:

    (a) the policyholder may have the right to renew without providing evidence of insurability or health status; but

    (b) the insurer may be able to adjust the premium for the contract to reflect changes in generic factors that affect the portfolio of contracts. Such generic factors could include increasing administration fees in line with inflation or increasing mortality charges to reflect changes in expectations of general mortality.

13. However, some respondents are concerned about how the contract boundary applies to contracts for which the pricing:

    (a) is assessed only at the portfolio level eg because regulation obliges the insurer to renew contracts and restricts the insurer's ability to reprice them; and

    (b) considers only the current renewal period and resets the level of premiums each period, based on the portfolio level.

14. Many insurers currently account for such contracts using an unearned premium approach and believe that an annual basis of accounting faithfully represents their business because they price, manage and account for these contracts as annual contracts. However, these contracts may not be eligible for the modified approach

for short-duration contracts if the contract boundary proposals in the ED and DP were to be applied. Applying the building block approach to such contracts would require them to estimate cash inflows and outflows they consider to be uncertain when they believe that the outflows arising from coverage in future periods will be largely or wholly covered by related future premiums. Furthermore, they believe developing new systems to treat such contracts as long duration would be costly and they state that the resulting information would not provide significant benefits to users because the insurer would typically aim, and be permitted, to reset rates periodically for changes in costs.

15. This issue is of particular relevance to health insurers, whose concerns are explained in further detail in Appendix B, but a few respondents expressed similar concerns for products such as compulsory car or compulsory third-party liability insurance, lender mortgage insurance and builders' warranty insurance. Underlying those concerns is the view that short duration accounting is currently used for these contracts and it could be difficult for the insurer to estimate the future cash flows that would arise in these contracts. (As always in this project, we need to exercise caution when we use names for particular products, because similar names are sometimes used for products with different features.)

16. The concerns expressed about these contracts were as follows:

    (a) The contract boundary proposal in the ED and DP would mean that the contract boundary extends to the period covered by the renewal rights rather than the original contract term. Examples of such renewal rights are the right to renew without re-underwriting or the right to guaranteed insurability.

    (b) In many countries, legal or regulatory restrictions prevent an insurer from repricing contracts to reflect the risk of particular policyholders (for example their health status), but permit the insurer to reprice the contracts periodically to reflect the risk in the portfolio as a whole. Some

believe that such legal or regulatory restrictions should be disregarded in determining the contract boundary in these situations.

(c) In some countries, an insurer is required to accept all policyholders without assessing their particular risk and is required to set uniform charges for all policyholders (existing and new) meeting particular criteria. In such cases, at the time of renewal, existing policyholders are in the same position as new policyholders. Some believe it would be appropriate to treat the renewal as a new contract.

(d) The test proposed in paragraph 27(b) of the ED requires an assessment at the level of the particular policyholder, rather than the portfolio. This is inconsistent with the way these contracts are priced and managed, and with the unit of account used for most other aspects of the proposed measurement model.

17. Some suggest alternative wording to address their concerns. The alternatives proposed tend to have one or more of the following features:

(a) they would describe the boundary of the contracts as the point where the insurer has the right or practical ability to set a price that fully reflects the risk of a group of contracts, eg a portfolio or cohort.

(b) they would not consider restrictions imposed by regulation or law in assessing whether the insurer has the right or practical ability to set a price for the contract.

(c) they would describe the boundary of the contract as the point where existing policyholders have the same right as new policyholders.

18. Some observe that the proposed contract boundary is different from the boundary proposed in Solvency II and that different boundaries would increase compliance costs. However, some have also suggested that the Solvency II boundary be changed to be consistent with the proposals in the ED/DP.

19. A few respondents raised other concerns about the proposal in paragraph 27(b) of the ED. These are discussed in paragraphs 45-53.

Staff analysis and recommendation

20. The staff has analysed the concerns summarised in paragraphs 8-18 as follows:

    (a) how renewal rights affect the determination of when an insurer is no longer required to provide coverage.

    (b) whether a contract renewal should be treated as a new contract when the existing contract does not confer on the policyholder any substantive rights.

    (c) whether 'setting a price that fully reflect the risk' should be determined at a contract or a portfolio level.

    (d) whether restrictions imposed by regulation or law should be treated differently from restrictions imposed by contract.

Renewal rights

21. In some cases, insurers may be prohibited from refusing to insure existing policyholders. In other words, some contracts contain renewal rights for policyholders. These rights may be conferred by the contract or, particularly in areas related to public policy, by regulation or law. Such rights are prevalent in health insurance. For example, health insurers commonly are unable to cancel coverage for any individual or group based on pre-existing medical conditions and may be required to renew the policy regardless of changes in the health of the policyholder.

22. Under the contract boundary principle proposed in the ED and DP, such contracts would not qualify for the modified approach for short duration contracts. This is because the coverage period of such contracts extends beyond the nominal term of one year to include the periods for which the insurer is required to renew the contract. Accordingly, the cash flows included in the measurement of the contract include all future cashflows, including premiums and claims, arising from renewals until the policyholder is no longer expected to renew. The insurer would no longer be required to provide coverage if the policyholder does not renew.

23. As noted in paragraph 9, almost all agree with the proposal in the ED/DP that a contract boundary exists at the point where the insurer is no longer required to provide coverage under the existing contract and the staff does not propose to consider this further.

Setting a price that fully reflects risk

Substantive rights in an existing contract

24. As noted in paragraph 10, most respondents agree that the point at which the insurer has the right or practical ability to reassess risk and reset prices should determine the contract boundary. However, some questioned how those criteria should be applied.

25. In most cases, renewal rights are attached to constraints about the price that can be charged on renewal, for example constraints that prevent an insurer from pricing the renewed contract in a way that fully reflects the risk of the contract. Those constraints are a necessary condition to make guaranteed insurability a substantive right for the policyholder. (Guaranteed insurability will not benefit the policyholder if the insurer could just raise the premium to exceed what any rational policyholder would pay for the contract.) Accordingly, the ED proposed that cash flows would be outside the contract boundary when the insurer has the ability to set a price that fully reflects the risk in the contract.

26. Some agree that this point is an appropriate contract boundary but believe that the underlying principle is that a contract renewal with the same terms that would be available to new policyholders should be treated as a new contract, because the existing contract does not confer on the existing policyholder any further substantive rights. Under this approach, renewals subject to restrictions on the insurer’s ability to reprice the contract would not be included within the contract boundary of the existing contract as long as those same restrictions would apply to a new contract.

27. For example, in some jurisdictions, policyholders have a right to transfer insurance coverage (for instance health insurance coverage) from one insurer to the next without a change in premium. As another example, in some jurisdictions, an insurer is obliged to accept new policyholders without assessing their individual risk, but instead assess risk based on standard demographic data. If the insurer

was prohibited from repricing renewals to reflect the risk of the particular policyholder, but could reprice with reference to those standard demographic tables, the existing policyholders would not have any rights in addition to those of new policyholders. However, such renewals would be regarded as within the contract boundary under the proposals in the ED because the insurer does not have the right or practical ability to reassess the risk of the particular policyholder and set a price that fully reflects that risk.

28. In assessing whether there are restrictions on an insurer's ability to reprice for risk, it is worth remembering that insurance contracts are priced based on groupings of risk, for example:

    (a) Life insurance rates are based on the policyholder's age at issue, gender, pre-existing conditions, smoker or non-smoker, etc.

    (b) Auto insurance rates are based on jurisdictional location, age, gender and prior driving record

    (c) Health insurance is based on similar concepts in some situations, but in other situations these concepts (eg age and pre-existing conditions) do not affect pricing which is equalised across policyholders with different risk profiles, perhaps because of legal requirements.

29. In conclusion, the staff agrees with the view that renewal terms should be included within the boundary of the existing insurance contract if those renewal terms confer an advantage on the existing policyholder and create an additional risk for the insurer. This is consistent with paragraph BC57 which explains that a contract binds an insurer by requiring it to provide the policyholder with something of value. If the same terms are available to new policyholders, then the insurer has not provided the policyholder with anything of value.

Contract vs portfolio level

30. In some cases, an insurer may not be able to set a price for a particular contract that fully reflects the risks for the contract. However, it may be able to set the

price for the portfolio in a way that fully reflects the risks for the portfolio the contract belongs to.

31. For example, consider a contract in which the insurer is required to renew without reassessing the risk in the contract. If the policyholder's particular risk has increased, the value of the contract to the insurer has decreased. However, if the contract was considered as part of a portfolio of similar contracts and the insurer could increase the premiums for the portfolio as a whole to reflect all the changes in risks for the contracts in the portfolio, there would be no decrease in value of the portfolio. In effect, the insurer would spread the increase in premiums for any one contract across the whole portfolio.

32. Accordingly, as noted in paragraph 14, some argue that it would be appropriate to disregard the restrictions on the insurer's ability to reassess the risk of the particular policyholder, because there are no restrictions on the insurer's ability to reassess the risk of the portfolio as a whole. As a result, the insurer can set a price that fully reflects the risk when considered at the portfolio level.

33. The main consequence of performing this assessment at the portfolio rather than particular policyholder level would be to shorten the contract boundary for the contracts described in paragraph 30. Such contracts might therefore become eligible for the modified approach.

34. Some argue that it would be consistent with measuring insurance contracts at a portfolio level to determine whether an insurer is bound to a portfolio of contracts, rather than to a particular contract. However, in the staff's view, this argument is not valid. The portfolio is the unit of account for the *measurement* of insurance contracts. Determining the contract boundary is a *recognition* issue and recognition can only be performed at a contract level because the rights and obligations arise at the contract level.

35. Another argument for assessing at a portfolio level the ability of the insurer to set a price that fully reflects risk is to be consistent with the reasoning in paragraph BC57 of the Basis for Conclusions. BC57 explains that an insurer is bound to an

insurance contract because it is required to provide the policyholder with something of value. On a portfolio basis, the insurer has not given up anything of value.

36. However, some state that assessing whether the insurer has the ability to set a price that fully reflects risk at a portfolio level would have unintended consequences for many contracts that are currently treated as long duration. For example, in some cases, life contracts include provision for the insurer and the policyholder to share future increases in charges, such as expenses and mortality (even though life insurers rarely exercise this option). Hence the contract would allow the insurer to increase the price across an entire portfolio for increases in, for instance, expenses or increased mortality in the portfolio, but would not allow the insurer to reassess the risk of the particular policyholder. Those with this view are concerned that:

    (a) when a contract boundary is drawn earlier than the point at which the insurer's obligations cease, it is inevitable that existing obligations will not be recognised. If this is the case there is a risk that the profit recognised in the year will be too high, because it will not include the cost of meeting the future obligations. For example, if a term insurance contract with level premiums was accounted for on an annual basis then it would be reported as extremely profitable in the early years but loss-making in the later years.

    (b) the insurer may incur acquisition costs based on the expectation that the contract will be long duration. In some cases, such acquisition costs may exceed the first year's premium. When a contract boundary is drawn earlier than the point for which the insurer prices, the insurer may report a large loss at inception and increased profitability over subsequent years.

37. Some suggest an additional factor to be considered is how the insurer prices the portfolio. In other words, some suggest that where the insurer has the ability to

increase the premiums on a portfolio basis each year to reflect all the risks in the portfolio, it might be possible to distinguish two cases:

(a) Case 1: the insurer prices the premiums for the portfolio on an annual basis regardless of any renewal rights that particular policyholders might have. For example, in some health insurance contracts, the insurer may be restricted from increasing the premium for particular policyholders based on their individual risk. However, each year, the insurer would set the premiums for the portfolio as a whole to reflect all the risks in the portfolio. Accordingly, the insurer sets the annual premiums without reference to the risks in future periods and those future risks would be reflected in the future premiums for those future periods.

(b) Case 2: the insurer prices the premiums on the basis that the contracts in the portfolio are long-term contracts. This may include features such as fixed premiums over the contract term. In such cases, the insurer sets the annual premiums for the portfolio based on its expectations of risks for the expected contract term. Accordingly, the insurer sets the annual premiums based on its expectations for the whole of the expected contract term. Future risks would therefore be reflected in the premiums for the current period.

38. The staff considered whether this difference in pricing structure reflects an underlying economic difference in the contracts or the environment in which those contracts operate. In the staff's view, when future risks are included in current year's premiums, the insurer would receive higher premiums in the early years in relation to the risk followed by lower premiums in relation to the risk in later years. Thus, those contracts have a financing element. The insurer regards the contract as long duration partly because of the financing element. Similarly, the contracts for which future risks are not included in the current year's premiums have no financing element.

39. One approach would be to set the boundary of the contract at the point where the insurer has the right or practical ability to reassess the risk of the portfolio the contract belongs to only for those contracts for which the pricing of the premiums does not include risks relating to future periods. This would not create some of the problems listed in paragraph 36. However, in the staff's view, one concern underlying the objections to the contract boundary principle is not the principle itself, but that some insurers think that a premium allocation approach is more appropriate for these contracts because they believe they will always recover any future increases in costs by future increases in the overall premium levels. Thus, their aim is that these contracts should be eligible for the modified approach, which uses a premium allocation approach (see paragraph 14). The staff notes that a commonly heard concern is that contracts that have no financing element should be eligible for the modified approach. If the boards were, somehow, to address these concerns through changes to the eligibility criteria for the modified approach, the staff believes there would be little opposition to the contract boundary principle, although some may still have concerns for the following reasons.

40. Even within the modified approach, widening the contract boundary increases the need to estimate future cash flows. This is one concern raised by, for example, health insurers. If the contract boundary includes future years, the modified approach would require a health insurer to estimate the total premiums within the boundary of the contract, and those premiums would depend on future pricing decisions, which would in turn depend on estimates of future health care costs. That process would require more judgement and estimation than simply measuring the contract on the basis of the premiums for the current year.

41. On balance, some staff place most weight on the argument that recognition can only be performed at the contract level (see paragraph 34). In these staff's view, the determination of contract boundary relates to the determination of whether and when particular contracts exist to be measured. Although the insurer may not have given up something of value when the contracts are measured at a portfolio

level, each contract nonetheless grants a right to the policyholder (ie to renew at constrained prices) and that creates an obligation for the insurer. The staff believes it appropriate to reflect the existence of those obligations in determining the contract boundary.

42. Other staff agree with that conclusion when the pricing of risks at a portfolio level includes risks relating to future periods, because those staff see these contracts as containing a financing element. However, where the pricing of risks at a portfolio level does not include risks relating to future periods, those staff believe that the contract does not contain a financing element. Therefore, in the view of those staff, the contract boundary principle should be modified for those contracts for which the pricing of the premiums at a portfolio level does not include risks relating to future periods. The boundary of these contracts should be the point where the insurer has the right or practical ability to reassess the risk of the portfolio the contract belongs to and, as a result, can set a price that fully reflects the risk of that portfolio.

Question 1: Contract renewals
Do the boards agree that a contract renewal should be treated as a new contract when: (a) the insurer is no longer required to provide coverage; or (b) the existing contract does not confer on the policyholder any substantive rights?

Question 2: Level at which contract boundary is determined
Do the boards agree that a contract does not confer on the policyholder any substantive rights when the insurer has the right or the practical ability to reassess the risk of the **particular policyholder** and, as a result, can set a price that fully reflects that risk? If the boards do not support the above recommendation, the staff suggests that the boards modify the contract boundary principle as follows:

For contracts for which the pricing of the premiums does not include risks relating to future periods, no substantive rights are conferred on the policyholder when the insurer has the right or the practical ability to reassess the risk of the **portfolio** the contract belongs to and, as a result, can set a price that fully reflects the risk of that **portfolio**.

The effect of restrictions imposed by regulation or law

43. Some seek to draw a distinction between renewal rights that arise from contract and those that arise from regulation or legislation. They suggest that renewal rights that do not arise from a contract should not be considered in determining the contract boundary because they are beyond the control of the insurer. However, in the staff's view, a contract can only exist within the context of its legal and regulatory environment. Therefore, the terms of the contract implicitly include the terms conferred by law or regulation and there is no basis to differentiate based on where those terms are actually expressed.

44. Accordingly, the staff thinks that *all* renewal rights should be considered in determining the contract boundary. This would mean the contract boundary for an annual contract that includes a right to renewal would be greater than 12 months.

Question 3: Rights arising from contract, law or regulation
Do the boards agree that all renewal rights should be considered in determining the contract boundary, whether arising from contract, law or regulation?

Other contract boundary related matters

45. Paragraphs 46-53 address other matters relating to contract boundary that were raised in the comment letters, during outreach or in the field test.

46. ***Repricing over an extended period:*** In some cases, the insurers may be able to reflect the risk in the pricing over a specified period, eg over 3 years. Some question whether this gives the insurer the "ability to set a price that fully reflects

the risk". In the staff's view, the boundary of the contract would extend to cover the time period over which an insurer may fully reflect the risk of the contract.

47. ***No expectation of repricing fully for risk:*** A few respondents question whether an insurer's right to reprice a contract should be ignored if, in practice, the insurer expects not to reprice **fully** for the risk. In the staff's view, the existence of rights does not depend on whether the insurer intends to use those rights. However, the staff notes that paragraph 27(b) requires an insurer to "ignore restrictions that have no commercial substance (ie no discernible effect on the economics of the contract)".

48. ***Ability to exit the market:*** Some question whether an insurers' ability to avoid renewal rights by exiting from a particular market (usually by abandoning a licence) should be considered in determining whether the insurer is required to provide coverage. To the extent that this is a viable option for the insurer (eg because it operates in many markets and one market is not significant to its overall operations), the staff believes that it might be appropriate for the boundary to reflect the insurer's ability to exit from the market.

49. ***Adjustment of benefits rather than premiums:*** Some note that an insurer may be able to reflect risk fully by adjusting the level of benefits paid to existing policyholders, rather than by adjusting the price of the contract. In the staff's view resetting the level of benefits for existing policyholders is equivalent to resetting the premiums and the contract boundary considerations would apply analogously in these situations.

50. ***Contract modifications and contract riders:*** Some have asked for additional guidance on contract modifications and contract riders (ie an additional set of terms attached to a contract at inception or subsequently) and on whether they result in a replacement contract or a continuation of the existing contract. In the staff's view, if such modifications are within the terms of the contract, the estimate of cash flows would reflect the probability of modification and the cash flows that

arise from modification. If a contract modification or rider arises separately from the original contract, it would be treated as a separate contract.

51. ***Voluntary contributions:*** Some questioned whether voluntary contributions, such as discretionary payments for universal life contracts, would be included within the contract boundary. They note that the amount of such discretionary payments may be hard to estimate. In the staff's view, this is a similar issue to that for contract modifications and riders, and similar considerations apply. Thus, if the policyholder makes the payments because of a substantive right in the existing contract, the estimate of cash flows would reflect the probability of voluntary contributions arising from the contract. If the policyholder decides to make an additional payment on the same terms as new policyholders, the payment arises from a new contract.

52. ***Group plans:*** It is unclear to some whether under a group contract the policyholder is the employer, or the individual members of the plan. For such contracts, an insurer may be able to reprice at the plan level, rather than at the particular policyholder level. In the staff's view, determining who is the policyholder would depend on the facts and circumstances of each contract. In some cases, the contract is one contract with the employer and the contract compensates the employer for payments it may be required to make to employees. In others, the group contract consists of separate contracts with each employee.

53. ***Whether the boundary should depend on both coverage and ability to reprice:*** A few suggested that both conditions in determining the boundary of the contract should be present, namely not required to provide coverage as well as the ability to reprice the risk, and not only one of the requirements. The staff notes that paragraph BC59 of the Basis for Conclusions states that: "two tests will often give the same result in practice, but the first test is written in a manner that may be more intuitive for single premium contracts and the second test is written in a manner that may be more intuitive for recurring premium contracts". Therefore the staff believes that the two conditions would either both be met, or neither be met.

54. The staff proposes to address the issues in paragraph 45 – 53 in drafting.

Effect on other areas of the insurance contract project

55. The determination of the contract boundary helps to define the contracts that would be eligible for the modified approach. Some entities believe that the modified approach is more appropriate to contracts for which there is limited investment return, and for which the premiums are priced with reference only to the risks insured. If the requirements relating to the modified approach were amended, it might affect the contract boundary as follows:

    (a) If the modified approach were to apply to risk-based, rather than investment-based business, many health insurance contracts would become eligible.

    (b) if the modified approach were to be permitted rather than required, it would reduce the extent to which some insurers would have to apply two models.

56. The extent to which unbundling arises as a possible issue may depend to some extent on how widely the contract boundaries are drawn.

Appendix A – Basis for Conclusions on Exposure Draft

This appendix reproduces the Basis for Conclusions relating to contract boundary

BC53 To identify the future cash flows that will arise as the insurer fulfils its obligations, it is necessary to distinguish whether future premiums (and resulting benefits and claims) arise from:

(a) existing contracts (which are included in the measurement of the contract) or

(b) future contracts (which are not included in the measurement of the existing contract).

In other words, it is necessary to draw a contract boundary.

BC54 The essence of a contract is that it binds one or both of the parties. If both parties are bound equally, the boundaries of the contract are generally clear. Similarly, if neither party is bound, it is clear that no genuine contract exists. However, it may be more difficult to determine where the boundaries lie if the contract binds one party more tightly than the other party. The Board focused on common contracts that bind the insurer but not the policyholder, by requiring the insurer to continue to accept premiums but permitting the policyholder to stop paying premiums, although possibly for a penalty.

BC55 Clearly, the point at which the insurer is no longer required to provide coverage and the policyholder has no right of renewal is one point on the boundary of the existing contract. Beyond that point, neither party is bound.

BC56 Similarly, at the point at which the insurer has the right (conferred by the contract) or the practical ability (eg through access to claims information) to reassess the risk presented by a policyholder and, as a result, can set a price that fully reflects that risk, the insurer is no longer bound by the existing contract. Thus, any cash flows arising beyond that point occur beyond the boundaries of

the existing contract and should be related to a future contract, not to the existing contract.

BC57 A contract may permit an insurer to reprice a contract on the basis of general market experience (eg mortality experience) but without permitting the insurer to reassess the individual policyholder's risk profile (eg the policyholder's health). In this case, the insurance contract binds the insurer by requiring it to provide the policyholder with something of value (ie continuing insurance coverage without the need to undergo re-underwriting). Therefore, the Board concluded that if the insurer can reprice an existing contract, but cannot at that time reassess the individual policyholder's risk profile, that point lies within the boundary of the existing contract. Thus, the cash flows resulting from that repricing are regarded as arising within the boundaries of the existing contract.

BC58 An insurer may have the right or the practical ability to reassess the risk presented by a policyholder, but not have the right to set a price that fully reflects that risk. In that case, the Board concluded that the contract still binds the insurer. Thus, that point would not lie on the boundary of the existing contract, unless the restriction on the insurer's ability to reprice the contract is so loose that it is expected to have no commercial substance (ie the restriction has no discernible effect on the economics of the transaction). In the Board's view, if a restriction has no commercial substance, it does not bind the insurer.

BC59 The draft IFRS captures the above conclusions by proposing that the contract boundary is the point at which the insurer is no longer required to provide coverage, or has the right or the practical ability to reassess the risk of the particular policyholder and can set a price that fully reflects that risk. The Board expects that these two tests will often give the same result in practice, but the first test is written in a manner that may be more intuitive for single premium contracts and the second test is written in a manner that may be more intuitive for recurring premium contracts.

BC60 The approach to contract boundaries proposed in the discussion paper is substantially the same as the approach proposed in the draft IFRS, except that the draft IFRS proposes a single test for the contract boundary, whereas the discussion paper proposed two tests depending on whether a contract was onerous:

(a) an onerous test for a contract that is, or has become, onerous—under that test, the insurer would include future premiums from those contracts (and other cash flows, such as claims and policyholder benefits, arising from those premiums) that would result in an increase in the liability.

(b) a guaranteed insurability test for a contract that is not onerous—under that test, the insurer would include those premiums from those contracts (and other cash flows relating to those premiums) that permit the policyholder to continue its coverage without reconfirmation of risk and at a price that is contractually constrained.

Appendix B – Health insurers concerns relating to contract boundaries

This extract from the International Federation of Health Plans [iFHP] describes in more detail the concerns of health insurers.

"A boundary defines when a period of risk begins and ends in a contract between a policyholder and an insurer. This affects accounting, valuation, product pricing, data management, and solvency assessment.

Health insurance is unlike other forms of insurance because health insurers tend to offer annual guaranteed renewability and repricing of policies, but do not reprice individual policyholders at the point of renewal. Instead, policies are repriced based on an assessment of the level of risk across a portfolio. In other words, prices for individual policyholders are based on the economic experience of the portfolio.

Health insurers take this approach because health insurance is affected by factors external to the insurer/policyholder contractual relationship. Social developments, political action, new technologies, and macro economic factors like medical inflation can often affect the experience of the whole systemically rather than at the level of the individual policyholder.

In addition, there is an element of social solidarity that goes with the pooling of health insurance risks in this way. It is generally considered unfair and not in society's interest to have a system in which some people might be unable to get health insurance as a consequence of having - or having had - a major disease.

These differences between health insurance and other types of insurance are important to the accounting standards because under paragraph 27 of the Exposure Draft, the standard would require that contracts with guaranteed renewal features, but which do not allow the full re-assessment of the risks of particular policyholder contracts, to treat all future cash flows arising from such a policy, including any arising from a renewal, as being within the contract boundary.

So even though health insurance policies are renewed by the customer either annually or on a shorter payment period basis, the [IASB ED / FASB DP] approach treats health insurance as if it were like a multi-year life insurance business, with contracts running over many years.

iFHP believes that health insurance should not be viewed as part of a life-long contract. Consumers with health insurance are free to change insurers, which facilitates competition in the market. Some countries such as Australia require that customers are able to switch freely between health insurers without penalty. So, a life long perspective is not how health insurers, consumers, regulators or users of financial statements view health insurance.

The potential impact on the health insurance industry

If the IASB proceeds with this approach, the new standard would introduce a level of complexity in reporting and pricing processes that will be costly for health insurers but serve no meaningful purpose.

Health insurers will have to undertake the unnecessary step of developing actuarial estimates of lapse rates, administrative costs, allocated overhead costs, incremental acquisition costs, future premiums, projected claims and claim handling costs and tax rates for many years into the future until the portfolio ultimately expires. Many of these assumptions will be defensible, and they will obscure the reporting of experience in a useful and needed way.

In addition, it could increase the cost of capital because health insurers may need to capitalise themselves under a solvency standard that was designed for the lifelong risks associated with policyholders in poor health rather than the risks associated with a portfolio that is repriced regularly. Health insurers will have to pass these added costs on to consumers, which could result in health insurance becoming too expensive for some people. Rising costs could also decrease competition and drive innovation out of the market, just when new solutions for rising healthcare costs are needed in health systems around the world.

The proposed model is not currently used by any health insurer globally and if introduced it will be an unnecessary and systemic change. The end result may be to reduce transparency and consistency, rather than improve it.

[Staff note: We note that some insurers that offer health insurance, for example in Germany do regard some types of health insurance as a long duration contract. We understand that those insurers are able to conduct a detailed risk assessment at inception to determine an initial premium that reflects the policyholder's health status. They can adjust the premium subsequently to reflect the experience of the group, but not for changes in the health status of the particular policyholder. In addition, the premium charged for those contracts in early years exceeds the amount that might be charged on a stand-alone basis for an annual contract. That excess funds coverage in later years that is expected to be more costly than the premiums charged for those years. Moreover, the policyholder has no right to receive the accumulated funding on lapse. In contrast, in some jurisdictions, health insurers are not permitted to conduct a risk assessment at inception and set premiums in the light of the expected costs on a annual basis .]

Appendix C: Analysis of contract boundary principles to selected product types

This appendix illustrates how the proposed contract boundary principle would apply to selected products.

	Product characteristics	**ED proposals**	**If new contract arises when existing contract does not confer any substantive rights (proposed)**	**If risk assessed at portfolio level**	**If restrictions imposed by regulation or law are disregarded**
1	Annual contract, no obligation to offer renewal.	No renewal rights, therefore **new contract** on renewal.	The insurer would underwrite new contracts on the same basis as existing contracts. No substantive rights conferred. Therefore **new contract** on renewal.	As under ED proposal.	NA

	Product characteristics	ED proposals	If new contract arises when existing contract does not confer any substantive rights (proposed)	If risk assessed at portfolio level	If restrictions imposed by regulation or law are disregarded
2	Annual contract. If eligibility conditions are met, the insurer must renew the contract. Premiums offered are allowed to reflect an aggregate risk assessment of the individuals within the portfolio. However the extent to which the insurer may adjust premiums to reflect a risk assessment for an individual policyholder is limited by regulation.	No right or ability to reprice the risk of the particular policyholder. Renewal is **within contract** boundary.	The insurer assesses new policyholders based on their individual risk and existing policyholders based on aggregate risk in the portfolio. Thus, the existing contract confers substantive rights on the policyholder. Renewal is **within contract** boundary.	Insurer has right to reprice the risk of the portfolio of contracts. Therefore **new contract** on renewal.	Restrictions on pricing that arise only from regulation would be disregarded. Insurer is regarded as having the ability to adjust premiums freely within the bounds of regulation and there is a **new contract** on renewal.

	Product characteristics	ED proposals	If new contract arises when existing contract does not confer any substantive rights (proposed)	If risk assessed at portfolio level	If restrictions imposed by regulation or law are disregarded
3A	Annual contract that renews automatically unless cancelled by policyholder or insurer. The insurer has the right to reprice based on the individual claim record of the particular policyholder. The right to reprice is limited by the regulator, **but this restriction does not affect the insurer's ability to fully reflect the risk in practice.**	No renewal right that has commercial substance therefore **new contract** on renewal	There is no substantive restriction on the price set for either new policyholders or existing policyholders. Therefore the existing contract does not confer any substantive rights and there is a **new contract** on renewal.	As under ED proposal.	As under ED proposal.

	Product characteristics	ED proposals	If new contract arises when existing contract does not confer any substantive rights (proposed)	If risk assessed at portfolio level	If restrictions imposed by regulation or law are disregarded
3B	Annual contract that renews automatically unless cancelled by policyholder or insurer. The insurer has the right to reprice based on the individual claim record of the particular policyholder. The right to reprice is limited by the regulator **and this restriction affects the insurer's ability to fully reflect the risk in practice.**	The insurer's ability to reprice to reflect the risk of the policyholder is limited. Renewal is **within contract** boundary.	The pricing is constrained for existing policyholders. Thus, substantive rights are conferred on the policyholder and renewal is **within contract** boundary.	As under ED proposal.	No renewal right because regulatory restrictions are disregarded therefore **new contract** on renewal.

	Product characteristics	**ED proposals**	**If new contract arises when existing contract does not confer any substantive rights (proposed)**	**If risk assessed at portfolio level**	**If restrictions imposed by regulation or law are disregarded**
4	Renewable annual contract. Policyholder can cancel contract annually. Insurer has no right to cancel. Contract specifies that premium cannot be increased for risks relating to the particular policyholder. However, premiums may be increased collectively for a group to reflect increased costs for medical care or increased life expectancy.	The insurer cannot fully reflect risks of the policyholder in repricing and the renewal term is **within contract** boundary.	The insurer would underwrite new contracts on the basis of risks relating to the particular policyholder. Therefore renewal is **within contract** boundary.	The insurer can fully reflect risks of the portfolio of policyholders in repricing and renewal creates a **new contract**.	As under ED proposal.

	Product characteristics	ED proposals	If new contract arises when existing contract does not confer any substantive rights (proposed)	If risk assessed at portfolio level	If restrictions imposed by regulation or law are disregarded
5	Annual health contracts in jurisdictions in which the law requires: 1. No premium differentiation 2. Acceptance of all prospective policyholders The claims are equalized between insurers for the population of policyholders in total and the premiums are set at a level adequate for the portfolio.	The insurer cannot fully reflect risks of the policyholder in repricing and the renewal term is **within contract** boundary.	The insurer is required to accept all policyholders whether new or existing. There is therefore no distinction between new and existing policyholders and renewal creates a **new contract**.	The insurer can fully reflect risks of the portfolio of policyholders in repricing and renewal creates a **new contract**.	The restrictions on renewal are imposed by law and therefore disregarded. Renewal creates a **new contract**.