STAFF PAPER

Insurance working group

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Insurance contracts	Consequences of contract boundary decision		
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Purpose of paper

1 This paper asks for your views on whether a change in the definition of ‘contract boundary’ could have unintended consequences for life insurance contracts.

Background

2 The exposure draft proposed that, in measuring an insurance contract liability, an insurer should include:

(a) the premiums that are within the ‘boundary’ of the contract; and

(b) other cash flows (eg claims and expenses) resulting from those premiums.

3 The exposure draft proposed to define the boundary of an insurance contract as the point at which the 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.

The Insurance working group is a working group of the IASB, the independent standard-setting body of the IFRS Foundation.
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4 Respondents to the exposure draft generally agreed with the proposal that the contract boundary should be the point at which the insurer can either end coverage or re-price contracts to reflect changes in risk.

5 However, some respondents disagreed with the proposal that the insurer must be able to re-price *individual* contracts to reflect changes in the risk of a particular policyholder. They noted that such a requirement would force a change of practice on health insurers.

6 In many countries, health insurers are required by law to guarantee renewability without reassessing the risks of an individual policyholder. This approach pools risk—policyholders can have confidence that their policies will not be cancelled when they need them most and that their premiums will not increase because they have had a major illness. These insurers can re-price renewals, but only at a portfolio level, ie to reflect changes in the risk of the portfolio as a whole.

7 At present, health insurers account only for the cash flows associated with current (usually annual) coverage periods. The exposure draft's proposed definition of the contract boundary would force them to also include the expected cash flows from expected future renewals. As a result, the contracts would no longer be viewed as short-duration and so would not be eligible for the premium allocation approach of accounting (applying the eligibility criteria proposed in the exposure draft).

8 Respondents opposing this change argued that:

(a) accounting for health insurance contracts as annual contracts most faithfully represents their economics, and the risks the insurers face. Insurers price and manage health insurance contracts as annual contracts. At a portfolio level, the insurers are not exposed to changes in risk beyond the existing annual contracts. The contracts are not long-term in substance: policyholders are free to—and often do—change health insurance providers on an annual basis, often being entitled to do so without penalty.

(b) if expected future renewals were within the boundary of the contract, the new standard would introduce a level of complexity in reporting processes that would be costly for insurers, without commensurate benefits for users of their financial statements. Insurers would need to forecast cash flows relating not only to current periods but also to expected future renewals. Estimating those cash flows would be particularly difficult for health insurance contracts, given the degree of uncertainty about future health care costs. Moreover, the benefits to users would be limited if the insurers have the right or practical ability to adjust premiums to recover unexpected changes in health care costs.

(c) the proposed boundary is different from that proposed being adopted for the European Solvency II Directive. The difference would increase compliance costs.

9 To address these concerns, the IASB and FASB tentatively decided at their March 2011 meeting to change the definition of the contract boundary.

Proposed change in definition

10 The boards tentatively decided to redefine the contract boundary as the point at which the contract no longer confers substantive rights on the policyholder. The boards tentatively decided that, for contracts for which the pricing of the premiums does not include risks relating to future periods, this point could be reached when the insurer has the right or the practical ability to reassess the risk of the portfolio to which the contract belongs and, as a result, can set a price that fully reflects the risk of that portfolio.

11 The staff suggest that the boards could put this change into effect with the following drafting amendments:

27 The boundary of an insurance contract distinguishes the future cash flows that relate to the existing insurance contract from those that relate to future insurance contracts. The boundary of an insurance contract is the point at which ~~an insurer~~ the contract no longer confers substantive rights on the policyholder. This occurs when ~~either:~~

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

~~(b)~~ 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. ~~In assessing whether it can set a price that fully reflects the risk, an insurer shall ignore restrictions that have no commercial substance (ie no discernible effect on the economics of the contract).~~; or

(b) both of the following criteria are satisfied:

(i) the insurer has the right or the practical ability to reassess the risk of the portfolio that contains the contract and, as a result, can set a price that fully reflects that risk of that portfolio; and

(ii) the pricing of the premiums for coverage up to that date does not take into account risks relating to future periods.

27A An insurer shall determine the contract boundary considering all substantive rights held by the policyholder, whether arising from a contract, from law or from regulation. However, an insurer shall ignore restrictions that have no commercial substance (ie no discernible effect on the economics of the contract).

Potential consequences of the change

12 A consequence of the change in wording is that the contract boundary for many health insurance contracts does not extend beyond the current coverage period.

13 When the boards tentatively decided to make this change, they emphasised that any change in the definition should solve the problem for health insurance contracts without inappropriately narrowing the boundary for life insurance contracts.

14 However, some insurers have since suggested to us that the change could also narrow the boundary for some life insurance contracts, because these contracts may also contain clauses that allow insurers to re-price portfolios of contracts after inception to reflect changes in the risks of those portfolios.

15 We have been told that such clauses in life insurance contracts are rarely put into effect, but we do not know why:

(a) perhaps there are restrictions, such that the clauses apply only in extreme circumstances? In which case, do the clauses confer substantive rights on the policyholder?

(b) perhaps there are limits on any premium increases? In which case, do the clauses enable the insurer to set a price that always *fully* reflects the re-assessed risk?

(c) perhaps insurers are constrained by competitive pressures?

Input requested from working group

16 We would appreciate further information and views from you to help us identify and understand the full consequences of the boards' tentative decisions regarding the definition of contract boundary.

Questions for working group members
1 Do you agree that contract boundaries should be narrowed for the health insurance contracts described in this paper, ie those in which the insurer has the ability to re-price renewals at a portfolio level?
2 Are you aware of any contracts for which you think the revised definition (drafted in paragraph 11) would *inappropriately* narrow the contract boundary?
3 If so, what are the features of such contracts that distinguish them from the health insurance contracts for which the boards are seeking a narrower boundary?
4 Do you have any other comments on the boards' tentative decision or the drafting proposed to put it into effect?