IASB
Insurance Contracts Project

Field Testing Questionnaire: Policyholder behaviour
Date of issue : November 2009
Name of participant :

Field Testing – Round 1

In Round 1 of the targeted field test we ask you to submit information on specific topics prior to the publication of an exposure draft (ED) in 2010. The questions we would like you to answer are detailed below. Please ensure that you provide the name of your organisation in the box above.

This questionnaire has been made available on the IASB's public website. We shall treat any information that you provide to us in the strictest confidence.

The questionnaire is supported by background information, including the most recent decisions made by the IASB and FASB boards.

Policyholder behaviour

Return date: 15 December

This questionnaire is about policyholder behaviour, which addresses:

- whether the measurement of an insurance contract liability should include recurring premiums (i.e. those premiums that will occur as long as the policyholder does not cancel the existing contract) and other cash flows flowing from those premiums eg benefits and claims; and
- if so, how to distinguish between (1) recurring premium payments related to **existing** contracts and (2) premium payments related to future **new** insurance contracts.

This questionnaire does not cover policyholder participation (policyholder dividends).

Questions for Participants

Background information on the approach in the Insurance Discussion paper *Preliminary Views on Insurance Contracts* is included in the section on Background Information.

The Boundary Issue

All expected cash flows arising under an insurance contract should be included when measuring that contract. However, to ensure consistency, it is important that a clear distinction is made between existing contracts and future new contracts. It is therefore necessary to define the boundary where the existing contract ends and a new or replacement contract begins. A way of distinguishing between existing and new contracts is to consider whether there are constraints in

effect (if so the contract is considered to be the existing and not a replacement or new contract). Once that boundary has been determined the expected present value of all cash flows falling within the existing contract should be included in the measurement of the liability.

Question 1
We have identified 2 alternative sets of constraints that may suggest cash flows result from an **existing** contract:

- the guaranteed insurability test (DP)
- constraints on re-pricing and re-underwriting (which, in our view, probably coincides with the cash flows that would be considered for an onerous contract test).

Can you think of any others?

Guaranteed Insurability

One way to define the cash flows that are part of the contract is to apply a test based on guaranteed insurability. The IASB defined guaranteed insurability in the DP as a right that permits continued coverage without reconfirmation of the policyholder's risk and at a price that is contractually constrained.

All cash flows that pass the guaranteed insurability test are included in the measurement of the contractual liability.

Constraints to re-underwriting and re-pricing

Another way to define cash flows that are part of the contract is to apply a test based on the insurer's unrestricted ability to re-underwrite and re-price an insurance contract. Such a test has been put forward as being an appropriate way of identifying the boundary of the contract ie when the existing contract terminates and a new (replacement) contract begins.

The IASB decided tentatively that the boundary for distinguishing existing contracts from new contracts should be developed based on the insurer's ability to cancel the contract or change the pricing or other terms (rather than looking at a guaranteed insurability test).

The FASB has yet to discuss the contract boundary issue. The staff will send field test participants an update, and any necessary follow-up requests, when the FASB concludes tentatively on this issue.

The main practical effect of the difference between the two tests is:

- the guaranteed insurability test does not capture cash flows resulting from a policyholder option whose value derives from a financial risk (such as interest rates) rather than from an insurance risk (such as mortality).

- the test based on re-pricing constraints would capture those cash flows, unless those cash flows arise in a component that needs to be unbundled (we will consider unbundling separately).

Question 2

In your view, does a test based on the insurer's unrestricted ability to re-underwrite and re-price (or change other terms and conditions of) an individual insurance contract provide a useful principle for defining which cash flows should be included in the measurement of the contractual liability? Please state why/ why not.

Did you identify any issues associated with this principle? Please specify.

Defining the principle for the boundary of a contract

The International Association of Insurance Supervisors (IAIS) has proposed a principle (an alternative to the concept of guaranteed insurability) to define the contract boundary and thereby determine which cash flows should be taken into account when measuring an insurance contract (see extract below). The IAIS proposal is attached as Appendix A.

The relevant cash flows are bounded by the earlier of the following, if they exist:[1]

- *the contractual termination date as extended by any unilateral option available to the policyholder, or*
- *the insurer having a unilateral right to cancel or* ***freely re-underwrite*** *the policy, or*
- *both the insurer and policyholder being jointly involved in making a bilateral decision regarding continuation of the policy.*

Industry groups provided the following principle to determine when an existing contract ends and a new contract begins. The full proposal is attached as Appendix B.

The boundary of a given contract is defined by the cash in-flows that are expected to fall within the contract's term. For these purposes the term of a contract is the shorter of the contract's life and the point, if any, at which the policy can be ***freely re-priced*** *by the insurer at the individual policyholder level, (i.e. up until the point at which the insurer has the ability both to reassess the risk profile of the individual policyholder and change the price for an individual without contractual constraint.)*

Once the contract boundary has been established then the measurement of the insurance liability should take into account the expected value of the cash in-flows to be received within the contract's term. The claims and costs associated with the contract as defined should also be reflected in the liability valuation on an expected value basis.

Staff intends to use those two proposals as direct input when drafting the principle for the contract boundary. So far, staff has not identified any cases in which those two proposals would result in a different outcome.

Question 3

[1] For certain types of long-duration life policy with an indefinite term, these would be evaluated through the potential life of the policyholder, allowing for lapse or surrender in the probabilities attached to each cash flow.

Have you identified any circumstances under which the two proposals mentioned above (ie the proposals by the IAIS and by industry groups) could give rise to a different outcome? Please specify.

Did you identify any issues in determining the boundary of an existing contract based on those proposals? Please specify.

Do you have any other comments on those proposals?

The two proposals mention 'freely re-underwrite' and 'freely re-price'. That implies that if, or to the extent that, the insurer's ability to re-underwrite and re-price is not constrained, the future premiums would be outside the boundary of the existing contract.

Question 4
In assessing the proposals for the contract boundaries, did you identify any circumstances where the ability of the insurer to re-underwrite and re-price is not fully constrained, but the cash flows in your view should be part of an **existing** contract rather than a future contract? Please describe those circumstances.

Practice issues

For some insurance product lines, determination of the boundary of the contract based on a guaranteed insurability test or a test based on the insurer's unrestricted ability to re-underwrite and re-price individual contracts raises specific issues.

Based on the product-lines you have experience of, please answer the following questions:

Question 5
With regard to Group contracts or Group health plans, does the insurer have a single contract with the employer or separate contracts with each employee?

Please state why/ why not.

Question 6
How would the proposals for defining the boundary of a contract apply to health insurance contracts? Would this result in a change from how you currently account for health insurance contracts?

Question 7
With regard to Universal life contracts, if a contract permits additional voluntary premiums, are they part of that contract or a separate transaction?

Please state why/ why not.

Question 8

Policyholders pay lower premiums if they have had no accidents in prior years. Are the resulting discounts inducements to renew with the same insurer, or a means of providing more accurate risk classification in future periods? Please state why/ why not.

Please submit your results to Jane Jordan (jjordan@iasb.org) by 15 December.

Background Information

Where are the boards?

IASB

The IASB discussed this topic at their April and May meetings. At its May meeting the Board decided tentatively:

- that the measurement should include the expected (ie probability-weighted) cash flows (future premiums and other cash flows resulting from those premiums, eg benefits and claims) resulting from those contracts, including those cash flows whose amount or timing depends on whether policyholders exercise options in the contracts

- to identify the boundary between existing contracts and new contracts, the starting point would be to consider whether the insurer can cancel the contract or change its the pricing or other terms.

FASB

- The FASB has yet to discuss the contract boundary issue. The staff will send field test participants an update, and any necessary follow-up requests, when the FASB concludes tentatively on this issue.

IASB Discussion paper

Chapter 4 of the IASB's Discussion Paper (DP), *Preliminary Views on Insurance Contracts* considered:

- onerous contracts and
- contracts that guarantee insurability

as 2 types of contracts with recurring premiums that should be included in the measurement of the insurance contract liability, along with the expected benefit and claim cash flows that accompany the recurring premiums.

Onerous contracts
Recurring premiums from onerous contracts are paid by policyholders who will, as a group, receive more benefit payments (due perhaps to ill health) as a result of paying their premiums than the amount of those recurring premiums.

Contracts that guarantee insurability
One way to define whether cash flows are part of the contract is to apply a test based on guaranteed insurability. The IASB defined guaranteed insurability in the DP as a right that permits continued coverage without reconfirmation of the policyholder's risk and at a price that is contractually constrained.

The IASB decided that recurring premiums paid by policyholders who renewed their contracts to guarantee their continued insurability and future coverage were not a contractual cash flow (the

policyholder could not be compelled to pay the premiums) but instead result from a customer relationship intangible asset (based on the existing contractual relationship with the policyholder).

The IASB proposed to measure the customer intangible as a part of the insurance liability because of the interrelationship of the recurring premium payments with the benefit and claims cash flows and the resulting inability to separate the measurement of the intangible asset from the liability on a non-arbitrary basis.

Although the DP used the guaranteed insurability test in the context of a boundary for the customer intangible, this test can be applied equally for determining which cash flows are part of the contract. All cash flows that pass the guaranteed insurability test are included in the measurement of the contractual liability.

Other sources of information

Agenda papers

- IASB paper 16B Policyholder behaviour (May 2009 meeting)

Other

- The International Association of Insurance Supervisors (IAIS) proposal on Contract Boundaries (Appendix A).

- A proposal from Industry groups to replace the guaranteed insurability criteria (Appendix B).