Insurance Contract Boundaries - Proposal to replace the guaranteed insurability criteria

Background

The IASB's Discussion Paper "Preliminary Views on Insurance Contracts" (the Discussion Paper) addressed the issue of whether beneficial policyholder behaviour should be reflected in the measurement of an insurance contract. The IASB's preliminary view was:

"An insurer has an asset relating to its ability to derive net economic benefits from future premiums that the policyholder must pay to retain guaranteed insurability. Guaranteed insurability is a right that permits continued coverage without reconfirmation of the policyholder's risk profile and at a price that is contractually constrained." [para 173(a)]

All expected cash flows arising under an insurance contract should be included when measuring that contract, i.e. they should not be restricted by the guaranteed insurability criteria. However, it is also acknowledged that, to ensure consistency, it is important that a clear distinction is made between existing contracts and new contracts. The purpose of this paper is therefore to set out a principle to determine the boundary of the contract and to illustrate that principle by reference to examples used in previous IASB Board agenda papers and real life product examples.

Proposed principle for contract boundary definition

The objective of the principle is to determine when an existing contract ends and a new contract begins. Once that boundary has been determined the expected value of all the cash flows falling within the existing contract should be included in the measurement of the liability. These cash flow estimates should be based on the best expectation in respect of both amount and timing. The contract boundary should be determined using the following criteria:

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.

Basis for Conclusions

Measuring the whole of the contract

The objective of the standard is to measure the insurance contract. That contract is not capable of separation into component parts – the insurer must either settle or transfer the contract in its entirety. Once the insurance contract has met the recognition criteria, all the cash flows attaching to that contract are relevant to its measurement and no further consideration is required as to whether the separate rights and obligations created by that contract meet the recognition criteria established in the IFRS framework. The measurement should reflect the economic substance of the contract.

On this basis once the boundary of the contract has been established the expected value of all cash flows will be included in the measurement of the liability, including reference to the amount and timing of the cash flows and appropriate assumptions as to policyholder behaviour (e.g. lapse expectations).

Stand ready obligation

In determining the contract boundary, it is important to understand the obligation of the insurer. We consider that the insurer has a stand ready obligation to accept premiums under a contract unless it has the ability to freely re-price those premiums taking into account the current risk profile of the individual policyholder or the contract has formally expired (i.e. there is no remaining contractual obligation by either party). Put a different way, unless the insurer can freely re-price the contract the entity is obliged to accept a premium at a rate which contractually has the potential to differ from that at which it would price a new contract. Such premiums should be considered part of the existing contract.

Contract life

In determining the contract life an insurer should consider the terms and conditions of the contract. In most circumstance the contract life is expected to equate to the stated coverage period of the contract but in some limited cases there may be an option in the contract to extend this period which in substance is no different from writing the same contract but for a longer term. For example a five year term life policy with an option to extend for five years at a price which is contractually constrained is no different to a 10 year policy with the same constraint over price.

On the other hand if a policy includes an option to take-up a contract which has substantially different terms and conditions (e.g. in respect of risks, benefits or pricing structures), this second policy is a new contract. For the avoidance of doubt the cost of this option should be included within the measurement of the liability of the existing contract. For example an accumulation contract with a guaranteed annuity option should include the cost of the option but not bring forward the cashflows from the new annuity contract.

Freely re-price

In determining whether an individual contract can be freely re-priced, an insurer should consider whether it is able to re-price the contract taking into consideration both the current market premium and any changes in the individual policyholder's circumstances that may be relevant to the policy. There is considered to be a stand ready obligation unless the insurer is able to freely re-price the contract using the same principles it would use to price a contract for a new policyholder. The ability to re-price a contract based on general market experience without a reassessment of the individual policyholder's risk profile would not meet the freely re-price criteria. As an example if an insurer is able to reassess the premium for a term assurance policy and base that on say the current market rate for a 35 year old male, unless the insurer can also assess the current health of the policyholder it cannot freely re-price the contract.

Group Contracts

For the avoidance of doubt when applying the principle to Group contracts (being those contracts that are underwritten and priced on a Group basis), the individual policyholder in this instance is the individual scheme. In this case freely re-price would apply only if you could reassess the risk profile of the individual scheme and re-price accordingly. It would not be met if there was a change in the premiums payable by all schemes as a result of general market experience (e.g. to reflect general mortality deterioration).

Comparison with the guaranteed insurability criteria

The principle set out in this paper determines the contract boundary and then proposes that the cash in-flows arising within that contract boundary are included on an expected value basis. The contract boundary is determined by the contractual term or the point at which the premiums can be freely re-priced. This differs from the guaranteed insurability criteria as it does not attempt to define explicit premiums that give rise to insurance coverage.

Instead this principle seeks to identify the period for which the insurer has a stand ready obligation to the policyholder to accept premiums under a contract, the terms of which are contractually constrained. The existence of the obligation is the key criterion that determines the contract boundary and hence the period for which it is appropriate to include related future cash in-flows.

This is particularly relevant in a universal life context where there is usually some contractual constraint over the ability to freely re-price the contract as there is no reassessment of an individual's health after the initial contract is signed. This means that the contract boundary is likely to be the contract term and hence the liability valuation will include the expected cash inflows falling within this term.

Under the guaranteed insurability criteria there is an implied requirement to estimate the minimum premiums that must be paid to maintain life cover.

This difference also addresses the issues that have been identified with contracts which have the potential for premium holidays, i.e. no formal premium is received but life cover continues through an allocation of charges to the savings component. In the same manner as universal life contracts, there is no requirement to identify premiums that are needed to maintain life cover. Instead the expected value of the cash flows that the insurer would be obliged to accept on contractually constrained terms are included.

Termination of the contract by the policy holder

The fact that the policyholder can terminate the contract at any time by non-payment of the premium does not negate the fact that at inception of the contract the insurer has a stand ready obligation if the contract limits the insurer's ability to freely re-price/ re-underwrite at the level of the individual policyholder. The fact that some policyholders may chose to terminate is taken into account in the lapse and persistency assumptions in the measurement of the underlying assets and liabilities arising from the contract.

Appendix A: Application of the principles to 12 insurance example insurance contracts set out in the December 2005 IASB agenda paper

The following table sets out the 12 example insurance contracts set out in the December 2005 IASB agenda paper on cancellation and renewal options in insurance contracts and applies the proposed principle to those contracts. A 13th example has been added following discussions with Peter Clark. The table considers which premiums should be included within the boundary of the contract. Once premiums have been determined it should be noted that the claims and costs associated with those premiums should be recognised on an expected value basis with regards to amount and timing.

Contract	Application of the principle	Comment
1) The contract is for a fixed term and the pricing formula is at least partly fixed throughout the term. There are no options to extend the policy term in the contract. Neither the insurer nor the policyholder can cancel the policy during the term. The policyholder can compel the insurer to continue accepting premiums and pay valid claims, and the insurer can compel the policyholder to continue paying premiums.	Include the expected value of the premiums expected to be received during the fixed term	The term of the policy is specified and the insurer cannot both re-price and underwrite during that term. [*Note: It is assumed that even though the price is only partly fixed throughout the contract, there is no underwriting during the contract as both parties can compel the other to continue the contract (if the insurer could completely re-underwrite and re-price, they could price the contract at a level acceptable to them and there would be no compulsion).*]
2) The contract is for a fixed term and the pricing formula is at least partly fixed throughout the term. There are no options to extend the policy term contained in the contract. The insurer cannot cancel the policy during its term. The policyholder can compel the insurer to continue accepting premiums and pay valid claims. The policyholder can cease paying premiums, in which case the policy lapses. The insurer cannot, in practice, compel the policyholder to continue paying premiums.	Include the expected value of the premiums expected to be received during the fixed term	The term of the policy is specified and the insurer cannot both re-price and underwrite during that term. [*Note: It is assumed that even though the price is only partly fixed throughout the contract, there is no underwriting during the contract as both parties can compel the other to continue the contract (if the insurer could completely re-underwrite and re-price, they could price the contract at a level acceptable to them and there would be no compulsion).*]
3) The contract is for a fixed term and there are no options to extend. The insurer cannot cancel the policy during its term. The premiums for each year are based on current market premiums, but the premiums are capped. This cap will be valuable for impaired lives. The policyholder can compel the insurer to continue to accept premiums and pay valid claims. The policyholder can cease paying premiums, in which case the policy lapses. The insurer cannot, in practice, compel the policyholder to continue paying premiums. Policyholders have an economic incentive to continue paying premiums because this keeps alive their option to renew if the cap is likely to come into the money.	Include the expected value of the premiums expected to be received during the fixed term	The insurer cannot freely re-price the contract by reference to the individual policyholder's current risk profile – if there is a deterioration in health then the cap will become effective. Hence the fixed term of the contract is relevant for considering the boundary of the contract.

4) The contract is for a fixed term and there are no options to extend. The insurer cannot cancel the policy during its term. The premiums for each year are based on current market premiums but there is no reassessment of the individual policyholder's risk profile. The policyholder can compel the insurer to continue accepting premiums and pay valid claims. The policyholder can cease paying premiums, in which case the policy lapses. The insurer cannot, in practice, compel the policyholder to continue paying premiums. The contract includes an investment component and a significant penalty for early surrender gives policyholders an economic incentive to continue paying premiums.	Include the expected value of the premiums expected to be received during the fixed term.	Although the premium is set annually to the market rate, there is no reassessment of the individual itself, e.g. whether there has been a decline in health for life insurance etc. Therefore the insurer cannot freely re-price the contract to reflect all known factors about the policyholder. Even in a case where the contract has an option to extend, if the premium after the extension is based on general market experience without reassessment of the individual policyholder's risk profile, the insurer cannot freely re-price the contract.
5) The contract is for a fixed term and there are no options to extend. The insurer cannot cancel the policy during its term. The premiums for each year are based on current market premiums at the time of renewal but there is no reassessment of the individual policyholder's risk profile. The policyholder can compel the insurer to continue accepting premiums and pay valid claims. The policyholder can cease paying premiums, in which case the policy lapses. The insurer cannot, in practice, compel the policyholder to continue paying premiums. The policyholder has some economic incentive to continue paying premiums because of the guarantee of continued insurability, but the premiums charged will always reflect the current market rates.	Include the expected value of the premiums expected to be received during the fixed term.	Although the premium is set annually to the market rate, there is no reassessment of the individual itself, e.g. whether there has been a decline in health for life insurance etc. Therefore the insurer cannot freely re-price the contract to reflect all known factors about the policyholder.
6) The contract is renewable annually. The policy is renewed automatically each year at current premium rates for a further year unless the policyholder or insurer gives three months notice of cancellation.	The annual premium only is included	The option to cancel, effectively gives the insurer the opportunity to freely re-price the contract for the second year. The second year of the contract is therefore a new contract and premiums should not be recognised as part of the first contract. The point at which the second contract should be recognised is dependent on the criteria underpinning recognition rather than contract definition.

7) The contract is annual. The insurer sends the policyholder a renewal notice annually. In practice, a new contract starts at current premium rates, unless the policyholder informs the insurer that renewal will not take place. The insurer has the right to reassess the individual policyholder's risk profile. Legally, renewal is not automatic, but in practice, the contract is administered in a way that makes renewal virtually automatic.	The annual premium only is included	As current premium rates can be assessed with regards to both market experience and the current risk profile of the individual being insured, then clearly the insurer is freely re-pricing on an annual basis and only these premiums should be included.
8) The contract is annual. The policyholder is required to sign a pre-printed proposal form containing all the relevant contract details, as recorded in the insurer's database, and to confirm any changes in circumstances. If the policyholder does not sign and return the proposal form, no new contract starts.	Only the annual premium is included (assuming prices are set on the basis of the new information).	Clearly the insurer is freely re-pricing the contract based on the current risk profile of the individual policyholder.
9) The contract is annual. The regulator requires the insurer to continue writing certain types of business as a pre-condition for being authorised to write any class of insurance in that jurisdiction.	It depends on the nature of the contract written with the policyholder.	The contract boundary is determined by the terms and conditions of the policy. If the policy enables the insurer to re-price the contract as if the policyholder had taken out a new policy then the contract should be treated as an annual contract. Any cap placed on pricing by the regulator is assumed to apply to all policyholders (new and existing) and hence is not considered relevant to determining the contract boundary.
10) The contract is annual. Because of concerns for its reputation, the insurer feels obliged to continue writing certain classes of business. There is no constraint in the contract on pricing or ability to underwrite.	The annual premium only is included	At the end of the annual period, a policyholder may renew and the insurer feel compelled to accept but the existing contract does not oblige the insurer to issue a policy at a price which is in some way constrained.
11) The contract is annual. There are no legal, commercial or other considerations that compel the insurer to continue writing insurance. However, no other insurers are active in a certain class of business. As a result, policyholders feel compelled to continue renewing policies with the insurer.	The annual premium only is included	At the end of the annual period, a policyholder may feel compelled to renew but the insurer is able to freely re-price the contract and so there is no contractual constraint over the price of the second contract.
12) The contract is annual. There are no legal, commercial or other considerations that compel either the insurer or the policyholder to renew contracts. Past experience shows that the level of renewals is highly predictable.	The annual premium only is included.	At the end of the annual period, a policyholder may renew but the insurer is able to freely re-price the contract based on the current risk profile of the policyholder.

13) The contract is annual. There are no legal, commercial or other considerations that compel either the insurer or the policyholder to renew contracts. However if the policyholder has not claimed in the past year the insurer will insure the policy for a further year inclusive of a “no-claims” discount (subject to a maximum).	The annual premium only is included.	At the end of the annual period a policyholder may renew but the insurer is able to freely re-price the contract based on the current risk profile of the policyholder. The no-claims discount is only applied if there has been no accident – i.e. the policy is effectively re-priced taking into account the policyholder’s claims history and hence its effect on his risk profile.

Appendix B – Application of principles to products issued by member companies

The examples below consider what premiums would be taken into consideration when applying the proposed principle for contract boundary definition.

Product 1: Group Life/Group PHI/ Individual annual motor

Product features

The policyholder expects to pay premiums for one year and for the insurer to pay claims if the insured event occurs during that same year.
The contract is for a period of one year.
There is no restriction on the price or underwriting for any further new one-year contract.
There is no obligation on the part of the policyholder to renew, although in practice a vast proportion may do (and have done). These contracts are annually renewable.

Application of the principle

Only the premiums for the first contract should be taken into account.

Rationale: there is only a restriction on the insurer's ability to freely re-price and/or re-underwrite during the first year. At the end of the first year, i.e. at the end of the contract period, there is no restriction. The insurer can then re-assess the policyholder's (be it an individual or a scheme in a group life context) risk profile.

Product 2: Extension of term (with premiums) at maturity

Product features

The policyholder pays premiums for the full contract term. At the end of the term, the policyholder decides to extend the term of the policy, continuing to pay premiums. The insurer is not required to accept the premium and the policy does not include any clauses which constrain the price and underwriting that can be performed at maturity.

Application of the principle

Only the premiums up until the maturity date should be taken into account. There are no terms and conditions contained in the contract that constrain the price of any extension by the policyholder at maturity.

Product 3: Deferred annuity with guaranteed annuity option

Product features

At the end of a savings/accumulation phase, the maturity benefit may be paid out as a lump sum or as an annuity, for which a guaranteed annuity rate is provided. This guaranteed rate effectively provides an investment and mortality guarantee (combined).

Premiums may be single or variable during the accumulation phase. These products are offered in the USA.

Application of the principle

Only the premiums up until the maturity date of the deferred annuity contract itself should be taken into account. The cash flows of the second contract (the annuity contract) should not be taken into account. The fact that the cash flows under the second contract are not included does not prevent the need to value the cost of issuing a guarantee or option with the first contract (i.e. there would be a need to value the GAO as it is an inherent part of the first contract).

If a contract provides for an accumulation phase which is followed by an annuity phase and in substance the terms of the contract are such that this represents a single contract, which has both accumulation and annuity phases, then all cash flows for the whole contract life should be included.

Rationale: The second annuity contract is considered a different contract from the first as it has different terms and risks and so is not in substance part of the first contract. The policyholder has an option to take up a second different contract, which he may or may not decide to take out based on circumstances arising at maturity of the first contract. This option should be valued as part of the liability measurement of the first contract but the cashflows of the annuity contract should not be brought forward into the accumulation contract.

Product 4: Voluntary automatic premium increases

Product features

Certain recurring premium contracts have a facility in the application form and the policy contract that premiums will increase automatically on an annual basis at a fixed rate or at the rate of inflation. If the policyholder takes no further action, then the premiums will increase (and the insurer will increase debit orders etc annually so as to receive the increased premiums). The policyholder has the option at any stage of intervening to prevent future increases from being deducted.

Application of the principle

These premium increases are paid during the term of the contract. No further underwriting or re-pricing is done before these premiums are accepted. Hence the premium increases should be allowed for. As these premiums will be included on an expected value basis there will be suitable allowance for policyholder behaviour.

Product 5: Universal Life type products

Product features

There are many variants around the world for these products. They work on the principle that every month, the recurring premium can be divided into a savings component and a life cover component. The life cover component is calculated as the rate for the insured's age for that month multiplied by the sum insured. The sum insured may have a pre-defined pattern or is fixed in some other way (e.g. there is a fixed death benefit, including the savings component, until breakout point; life cover is thus the balancing figure).

From the policyholder's perspective, there is flexibility in terms of premium payment. If policyholders fail to pay premiums, cover may still continue to be provided by deducting the cost of the life cover from the savings account each month.

At least some versions do not guarantee mortality rates. In other words, the insurer may increase the cost of the life cover purchased during the term if mortality experience is worse than expected. The policyholder could elect to either pay a higher premium or to leave the premium unchanged in which case less of the premium would be available for savings resulting in a reduction in life cover.

Application of the principle

There is generally a term associated with universal life contracts (some are for whole of life). After inception, no further underwriting of the individual is done before the premiums are accepted. Hence the premiums expected to be received during the term should be allowed for.

At least some universal life contracts are structured so that the insurer can change the risk charges during the term of the contract depending on mortality experience – these changes would be done at a portfolio level and not at an individual policyholder level, i.e. an individual policyholder's risk profile is not reassessed. Again, this leads to the inclusion of premiums expected to be received during the term.

Product 6: Term assurance with premium reviews

Product features

Term assurance or whole life contracts are issued where premiums are guaranteed for a certain number of years. In terms of the policy contract, at this guaranteed cover date, the life office has the opportunity to review the premium rate for the balance of the term if experience is significantly different to that expected. The policyholder can reject the premium change – in which case the contract would cease. Importantly, review means increases and decreases to rates, depending how experience unfolds.

Application of the principle

There is a term associated with these term assurance contracts (some are for whole of life), even though there may be a guaranteed cover date after which charges for risk cover can be reviewed, depending on mortality experience. After inception, however, no further underwriting of the individual is done before the premiums are accepted. Any premium reviews would be done at a portfolio level and not at an individual policyholder level, i.e. an individual policyholder's risk profile would not be reassessed. Hence the premiums expected to be received during the full term of the contract should be allowed for.

Product 7: 5 year motor policy

Product features

The policyholder and insurer enter into a policy that runs for 5 years. The policy generally cannot be cancelled by the insurer without the occurrence of an accident or without cause, but may be cancelled by the policyholder in the event of premium increase.
The policyholder pays one year of premium (full or instalments can be possible), and expects the insurer to pay claims originating during the policy period.
At the end of each year, the insurer can re-rate the contract, i.e. adjust for experience during the policy period, as well as make general rate increases.
In practice, few policyholders cancel at the end of a policy year, although liberalization of the market has increased the trend.
The insurer pays the agent 5 years of commission upfront, but commissions are generally recoverable on a pro rata scale should the policyholder cancel.

Application of the principle

Only the cash flows for the first year of the contract should be taken into account.

Rationale: there is only a restriction on the insurer's ability to freely re-price during the first year. At the end of the first year, i.e. at the end of the contract period, there is little/no restriction.
If the insurer chose to terminate the contract during the first year, there would need to be a refund of premiums for the balance of the year.

Product 8: Post-level term products

Product features

A term policy with scheduled rate increases. Policyholder may be given a choice at inception as to how long the policy runs before a rate increase (e.g. 10, 20 or even 30 years), but the policy will cover not only that period but the additional period thereafter. The rate increase will not reflect a re-underwriting of the individual policy at that time, but will in fact be an adjustment for general market experience which would apply to all policies at that point if they reach the point of the “step-up” in the premium. We would be obliged to accept the premium if the policyholder continues to pay the new premium.

Application of the principle

The principle would look at the cash flows of the entire contract, including the period included after the step-up. There is no ability to reassess the individual’s risk profile at the point of step-up and hence the contract is not re-priced as if it is a new contract.

Product 9: Whole-Life Insurance with Term Life Rider

Product features

Premiums for the whole-life insurance contract are fixed and guaranteed at the issue of the contract. The term life rider has a certain period of coverage (typically 10 years), and premiums for the term are fixed and guaranteed at the issue or renewal of the rider. Neither the whole-life insurance contract nor the term life rider can be cancelled by the insurer after the issue. The policyholder has an option to renew the term life rider. The policyholder can renew the term life rider without reassessment of the risk profile of the policyholder, and the insurer cannot reject the renewal. Re-pricing of premiums for the renewed term life rider is based on current market premiums without reassessment of the individual policyholder's risk profile.

Application of the principle

The term life rider is able to be renewed up to a certain period/age. The premiums up until the maturity date of the lastly-renewable term life rider should be taken into account.

Rationale: Re-pricing of premiums for the renewed term life rider is based on general market experience without reassessment of the individual policyholder's risk profile. Hence, the renewal of the term life rider cannot be freely re-priced by the insurer.