IASB Meeting -week beginning 19 April 2010	IASB agenda reference	**11A**
FASB Meeting TBC	FASB memo reference	**44A**

Contact(s)	**Jane Jordan**	jjordan@iasb.org	+44 (0)20 7246 6423
	Hans van der Veen	hvanderveen@iasb.org	+44 (0)20 7246 6464
	Mark Trench	metrench@fasb.org	+1 (0) 203 956 3455
	Jeffrey Cropsey	jdcropsey@fasb.org	+1 (0) 203 956 5305

Project **Insurance contracts**

Topic **Contract boundaries**

Purpose of this paper

1. This paper asks the boards to decide where the boundary of an existing insurance contract is. The contract boundary determines which future cash flows are included in the measurement of the insurance contract.

2. The paper does not address:

   (a) policyholder options and other options, forwards and guarantees that are unrelated to the existing insurance contract coverage – the boards tentatively decided in January 2010 to exclude such features from the measurement of the contract.

   (b) when an insurer should first recognise an insurance contract. Agenda paper 11B (FASB Memorandum 44B) discusses this question.

   (c) derecognition of an insurance contract- the boards discussed this issue at a previous meeting.

This paper has been prepared by the technical staff of the FASB and the IASCF 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. The staff recommends that:

   (a) the contract boundary is defined as including all cash flows arising under the contract as a result of events occurring during the period ending on the earlier of:

      (i) the contract coverage period (as extended by any renewal options available to the policyholder) and

      (ii) the point at which the insurer has an unrestricted ability to cancel or re-underwrite and re-price coverage of the individual contract. For this purpose, restrictions would be ignored if they have no commercial substance (ie no discernible effect on the economics of the contract).

Structure of the paper

4. This paper is divided into the following sections:

   (a) Background (paragraphs 5 – 8)

   (b) Proposal based on re-underwriting and re-pricing constraints (paragraphs 9 – 17)

   (c) Staff analysis and recommendation (paragraphs 18 – 33)

Background

The Boundary issue

5. When measuring a contract liability using the model proposed in this project, the insurer includes the expected (ie unbiased, probability-weighted average) present value of all future cash flows expected to arise as the insurer fulfils the obligation, including:

   (a) premiums

   (b) benefit and claim payments

(c) the effect of contract options and guarantees on the cash flows in (a) and (b)

(d) policyholder dividends (not addressed in this paper).

6. The contract boundary distinguishes between those premiums (and resulting benefits and claims) that arise from:

(a) existing contracts (included in the measurement of an insurance contract) and

(b) future contracts (not included in the measurement).

Previous Board discussions

7. The boards decided tentatively in January 2010 that policyholder options (such as renewal options), as well as other options, forwards, and guarantees related to existing coverage, should be included in the measurement of the insurance contract on a 'look through' basis using the expected value of future cash flows (to the extent that those options are within the boundary of the existing contract).

8. In May 2009 the IASB tentatively determined the boundary between existing and new contracts as the point at which the insurer can cancel the contract or change the pricing or other terms. The rest of this paper develops that tentative conclusion further. The FASB has not yet discussed the contract boundary in detail.

Proposal based on re-underwriting and re-pricing constraints

9. As mentioned above, in May 2009 the IASB tentatively defined the contract boundary as the point at which the insurer can cancel the contract or change the pricing or other terms. In developing that conclusion further, the staff:

(a) considered more specific proposals received from two external organisations.

(b) sought feedback on those proposals as part of our targeted field testing.

Proposals received from external bodies

10. We received proposals on the contract boundary from two external organisations:

    (a) the International Association of Insurance Supervisors (IAIS) and

    (b) industry groups representing the insurance sector in some countries.

11. Both proposals are based on the premise that the insurer has a stand ready obligation to accept premiums from a policyholder (and pay valid claims) under a contract unless:

    (a) the contract has expired or

    (b) the insurer has the ability to cancel or freely re-underwrite (IAIS) or re-price those premiums taking into account the current risk profile of the individual policyholder (industry groups).

IAIS proposal

12. The IAIS suggested the following principle to determine which cash flows should be taken into account when measuring an insurance contract:

> The relevant cash flows are bounded by the **earlier** of the following, if they exist:
>
> - 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

13. The insurance industry groups suggested the following principle:

> 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, (ie 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).

Targeted field test findings

14. We sent out a questionnaire on this topic which included the principles put forward by the IAIS and industry groups. We had a relatively low response rate for this questionnaire, 37% of participants responded, which may be a result of its timing (this questionnaire was the last to be sent out).

Constraints based on re-underwriting and re-pricing

15. Most participants thought that a test based on the insurer's unrestricted ability to re-underwrite and re-price an individual contract provides a useful principle for defining which cash flows should be included. They generally thought that the proposals were well tested and would be workable.

16. Participants did not identify additional factors that should be taken into consideration. Neither did they think that the two sources (IAIS and industry group) would lead to different outcomes in practice and many recommended that the principle in a future standard refer to both 're-underwrite' and 're-price'.

Practice issues

17. For some insurance products, determination of the contract boundary raises specific issues in practice. We asked participants questions relating to the following areas:

    (a) **Group contracts** – does the insurer have a single contract with the employer or separate contracts with each employee? Most thought that

there was a **single** contract between the insurer and the employer. We address the unit of account issue in paragraphs 30 - 32 below.

(b) **Health insurance** - how the boundary would apply? Many thought that such contracts would be treated in a similar way to other protection products. However, some concerns were raised by US health insurers, specifically in relation to the identification of future cash flows and the 'grossing-up' of the balance sheet for one-years worth of premiums (generally premiums for these types of insurance contracts are priced on an annual basis but accounted for on a monthly basis and an unearned premium liability is not recognised for the remaining months of the annual period). Staff will follow up on these concerns in drafting the ED and report back to the boards if necessary.

(c) **Universal Life** – are additional voluntary premiums part of the contract? Most thought that additional voluntary premiums are **part of the contract** (such premiums are anticipated when pricing the contract – they cannot be refused by the insurer nor are they subject to additional underwriting) and should be included in the measurement of the contract.

(d) **Motor insurance** – are lower premiums (where the policyholder has not had any accidents) inducements to renew with the same insurer or a means of providing a more accurate risk classification? This is viewed by most participants as an opportunity to re-assess the policyholder risk profile and re-price the contract (future premiums are not included in the measurement of the liability). This is consistent with the conclusion in example 12 of appendix A.

Staff analysis and recommendation

Staff Analysis

18. We based the staff proposal (in paragraph 3) on the principles suggested by the IAIS and industry groups. In this section we analyse why and ask the boards whether they agree with the staff recommendation.

Unrestricted ability to re-underwrite and re-price

19. If the insurer has an unrestricted ability to change price, coverage and other terms (as a result of the re-underwriting process) after a particular date, then any coverage provided after that point would be regarded as resulting from a new contract, not from the existing contract.

20. In re-pricing an individual contract, the insurer considers:

    (a) any changes in the individual policyholder's circumstances and

    (b) the current premium it would charge for policyholders with the same characteristics.

21. For example, assume that a contract is, or will soon become, onerous due to the policyholder's health. The insurer (if it is not fully restricted) may obtain new information about the policyholder's current state of health from the re-underwriting process (which is the process by which an insurer re-assesses the risk profile of the particular policyholder). This may result in the insurer:

    (a) increasing the policyholder's premium

    (b) reducing the policyholder's benefits, or

    (c) cancelling the contract.

22. In the above example the insurer's unrestricted ability to both re-underwrite and re-price the contract results in:

    (a) a significantly different contract (**new**) or

    (b) **no** contract (ie the insurer discontinues coverage).

23. The proposed test does not depend on whether the insurer actually intends to exercise a contractual right to re-underwrite. For example, suppose an insurer issues a whole life insurance contract with premium reviews after 10 years, at which point it has the ability to re-underwrite and re-price the contract. Even if the insurer does not intend to carry out an individual risk assessment and alter the premium at the guaranteed cover date, the measurement of the liability at inception will only include the first 10 years' of premiums and resulting claims and benefits ie those that occur up to the point when the insurer has the ability to re-underwrite and re-price the individual contract.

24. If the ability of the insurer to change the terms and conditions of the contract is less than unrestricted, there is uncertainty as to which amendments (or the ability of the insurer to make such amendments) to the contract would result in the existing contract being replaced by a new one. We therefore recommend that the boundary principle refers to the insurer's **unrestricted** ability to both re-underwrite and re-price the contract.

25. Staff does not believe however that **any** restriction, however trivial or unlikely, should be permitted to be used to include cash flows within the boundary of the existing contract. For this reason, staff recommend ignoring restrictions that are not expected to have commercial substance (ie have no discernible effect on the economics of the transaction)[1]. For example, suppose an insurance contract states that the insurer cannot increase the price to more than a million times the current premium. Such a restriction should not result in cash flows being included in the measurement of the liability beyond the point when the restriction applies.

26. The examples in appendix A illustrate how the contract boundary principle recommended by staff would apply across a broad range of insurance product types.

---

[1] The notion of commercial substance is already used in IFRS 4 *Insurance Contracts* in the context of significant insurance risk (paragraph B23).

Why both re-underwrite and re-price?

27. 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 unrestricted ability to re-price criteria. This is because the insurance contract has provided the policyholder with something of value (ie continuing insurance coverage without the need to undergo re-underwriting) and so the resulting cash flows should be regarded as arising from the existing contract.

28. For example, an insurer is able to reassess the premium for a term assurance contract based on the current market rate for a 40 year old female. However, unless the insurer can also assess (through the underwriting process) the current health of the policyholder, it does not have an unrestricted ability to re-price at the individual contract level.

29. We have incorporated both 're-underwrite' and 're-price' in the principle in paragraph 3 to distinguish between changes that may come about as a result of:

    (a) a re-assessment of the risk profile of the individual policyholder and

    (b) general changes (eg mortality experience) that would apply to all policies.

Unit of account

30. The contract boundary principle recommended by staff applies to an **individual** insurance contract for the following reasons:

    (a) the project is dealing with rights and obligations that arise at the individual contract level (they do not change when assembled into portfolios) and

    (b) re-underwriting and re-pricing (key components of the principle) occur at an individual contract level.

31. For some contracts the insurer assesses the risk profile and prices the contract on a group basis, for example with some group health insurance plans where the health insurer may have a single contract with an employer for the provision of coverage to its employees. In determining the contract boundary the specific

contractual terms and conditions need to be taken into account to establish whether the unit of account is:

(a) an individual contract with a single policyholder or

(b) a group plan (as described above) where the contract may be with an employer who administers the plan on behalf of its employees.

Staff recommendation and question for the boards

32. Staff recommend that the ED includes the contract boundary principle below.

Question for the boards
Do you agree with the contract boundary principle below? The contract boundary is defined as including all cash flows arising under the contract as a result of events occurring during the period ending on the earlier of: - the contract coverage period (as extended by any renewal options available to the policyholder) and -the point at which the insurer has an unrestricted ability to cancel or re-underwrite and re-price coverage of the individual contract. For this purpose, restrictions would be ignored if they have no commercial substance (ie no discernible effect on the economics of the contract).

33. The proposed principle differs from the approach suggested in the DP *Preliminary Views on Insurance Contracts*, which relied on a concept of guaranteed insurability. We include some background information in appendix B, but do not provide a detailed analysis of that approach because the staff now believe it has no merit, for reasons explained in agenda paper 16B for the May 2009 meeting (FASB memo 20).

Appendix A Insurance Product Examples

A1. The examples in this appendix are based on those provided by industry groups. They illustrate what premiums (and resulting claims and costs) would be taken into consideration on an expected value basis when applying the proposed principle for the contract boundary definition. For each fact pattern after the first, **bold** text is used to highlight how the fact pattern differs from the previous fact pattern.

A2. In fact patterns 1 and 2 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 freely re-underwrite and re-price, it could price the contract at a level acceptable to it and there would be no compulsion for the insurer).

#	Insurance contract features	Application of staff's principle	Supporting rationale
1	▪ Fixed term contract. ▪ Pricing formula is partly fixed throughout the term. ▪ No options to extend the contract term. ▪ Neither the insurer nor the policyholder (PH) can cancel the contract during the term. ▪ The PH can compel the insurer to continue accepting premiums and paying valid claims. ▪ The insurer can compel the PH to continue paying premiums.	▪ Include the expected value of the premiums (and resulting cash outflows) to be received during the fixed term.	▪ The term of the contract is specified and the insurer is restricted in its ability to re-underwrite and re-price during that term.
2	▪ Fixed term contract. ▪ Pricing formula is partly fixed throughout the term. ▪ No options to extend the contract term. ▪ Insurer cannot cancel the contract during its term. ▪ The PH can compel the insurer to continue accepting premiums and paying valid claims. ▪ **The PH can cease paying premiums, in which case the contract lapses.** **The insurer cannot, in practice, compel the PH to continue paying premiums.**	▪ Include the expected value of the premiums (and resulting cash outflows) to be received during the fixed term.	▪ The term of the contract is specified and the insurer is restricted in its ability to re-underwrite and re-price during that term.

#	Insurance contract features	Application of staff's principle	Supporting rationale
3	▪ Fixed term **life** insurance contract. ▪ No options to extend the contract term. ▪ Insurer cannot cancel the contract 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 PH can compel the insurer to continue accepting premiums and paying valid claims. ▪ The PH can cease paying premiums, in which case the contract lapses. ▪ The insurer cannot, in practice, compel the PH to continue paying premiums. ▪ **PHs have an economic incentive to continue paying premiums because this keeps alive their option to renew if the cap could come into the money.**	▪ Include the expected value of the premiums (and resulting cash outflows) to be received during the fixed term.	▪ The insurer cannot freely re-price the contract by reference to the individual PH's current risk profile – if there is a deterioration in health then the cap will become effective.
4	▪ Fixed term contract. ▪ No options to extend the contract term. ▪ Insurer cannot cancel the contract 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 PH can compel the insurer to continue accepting premiums and paying valid claims. ▪ The PH can cease paying premiums, in which case the contract lapses. ▪ The insurer cannot, in practice, compel the PH to continue paying premiums. **The contract includes an investment component and a significant penalty for early surrender gives PHs an economic incentive to continue paying premiums.**	▪ Include the expected value of the premiums (and resulting cash outflows) 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, eg whether there has been a decline in health (for life insurance). ▪ The insurer cannot freely re-price the contract to reflect all known factors about the policyholder.

#	Insurance contract features	Application of staff's principle	Supporting rationale
5	▪ Fixed term contract. ▪ No options to extend the contract term. ▪ Insurer cannot cancel the contract 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 PH's risk profile. ▪ The PH can compel the insurer to continue accepting premiums and paying valid claims. ▪ The PH can cease paying premiums, in which case the contract lapses. ▪ The insurer cannot, in practice, compel the PH to continue paying premiums. ▪ **The PH 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 (and resulting cash outflows) 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, eg whether there has been a decline in health (for life insurance). ▪ The insurer cannot freely re-price the contract to reflect all known factors about the policyholder.
6	▪ **Renewable annually.** ▪ **Renewed automatically each year at current premium rates for a further year unless the policyholder or insurer gives 3 months notice of cancellation.**	▪ The annual premium only (and resulting cash outflows) is included.	▪ The insurer can 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 depends on the recognition criteria.

#	Insurance contract features	Application of staff's principle	Supporting rationale
7	▪ **Annual contract**. ▪ **Insurer sends PH a renewal notice annually.** ▪ **In practice, a new contract starts at then current premium rates, unless the PH informs the insurer that renewal will not take place.** ▪ **Insurer has right to reassess the individual PH's risk profile before renewal.** ▪ **Legally, renewal is not automatic, but in practice, the contract is administered in a way that makes renewal virtually automatic.**	▪ The annual premium only (and resulting cash outflows) is included.	▪ Current premium rates can be assessed with regards to both: o market experience and o the current risk profile of the individual being insured. ▪ Therefore the insurer is freely re-pricing on an annual basis.
8	▪ Annual contract. ▪ **PH 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 PH does not sign and return the proposal form, no new contract starts.**	▪ The annual premium only (and resulting cash outflows) is included.	▪ The insurer can 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 depends on the recognition criteria.
9	▪ Annual contract. ▪ **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 ability to underwrite and price.**	▪ The annual premium only (and resulting cash outflows) is included.	▪ The existing contract does not oblige the insurer to issue a contract at a price which is in some way constrained.
10	▪ Annual contract. ▪ **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, PHs feel compelled to continue renewing contracts with the insurer.**	▪ The annual premium only (and resulting cash outflows) is included.	▪ At the end of the annual period, a PH 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.

#	Insurance contract features	Application of staff's principle	Supporting rationale
11	▪ Annual contract. ▪ No legal, commercial or other considerations that compel the insurer or the PH to renew contracts. ▪ **Past experience shows that the level of renewals is highly predictable.**	▪ The annual premium only (and resulting cash outflows) is included.	▪ At the end of the annual period, a PH may renew but the insurer is able to freely re-price the contract based on the current risk profile of the PH.
12	▪ Annual contract. ▪ No legal, commercial or other considerations that compel the insurer or the PH to renew contracts. ▪ **However, if the PH has not claimed in the past year the insurer will insure the policyholder for a further year inclusive of a 'no-claims' discount (subject to a maximum).**	▪ The annual premium only (and resulting cash outflows) is included.	▪ At the end of the period a PH may wish to renew, but the insurer is able to freely re-price the contract based on the current risk profile of the PH. ▪ The no-claims discount is only applied if there has been no accident – ie the contract is effectively re-priced taking into account the PH's claims history and hence its effect on his/her risk profile.

Appendix B Guaranteed Insurability

IASB Discussion paper

A1. The approach in the DP on Insurance contracts would have included future premiums (and resulting cash inflows and outflows) in the measurement if they met one of the following conditions:

(a) the insurer could compel the policyholder to pay those future premiums

(b) the receipt of those future premiums is unfavourable to the insurer (onerous contracts)[2]

(c) the contract provides the policyholder with guaranteed insurability.

A2. The IASB defined guaranteed insurability in the DP as

> a right that permits continued coverage without reconfirmation of the policyholder's risk profile and at a price that is contractually constrained.

All cash flows that pass the guaranteed insurability test would, under the DP approach, be included in the measurement of the contractual liability.[3]

A3. Respondents to the DP disagreed with the guaranteed insurability approach. They thought it was too narrow (for example, a guarantee of a mortality rate would qualify, a guarantee of an interest rate would not) and difficult to implement. This approach was rejected by the IASB and we do not discuss it further in this paper.

---

[2] Recurring premiums from onerous contracts are paid by policyholders who will, as a group, receive more in benefit payments as a result of paying their premiums than the amount of those recurring premiums.

[3] Although the DP used the guaranteed insurability criterion in the context of identifying a customer relationship intangible asset, the IASB proposed to measure this intangible as 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 from the liability on non-arbitrary basis.