Combination and Separation of Contracts

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0.1	17 July 2018	Initial Version
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This IFRS17 Discussion Paper aims to facilitate discussion among actuaries and other stakeholders to capture the range of opinions on the application of IFRS17 in the Singapore context and is not meant to serve as standards of actuarial practice or guidance notes.

Any interpretation of IFRS17 set out in this Paper represents a plausible treatment given the text of IFRS17. However, it shall neither be construed as the only possible treatment nor the agreed interpretation for Singapore insurers. Users of this Discussion Paper shall be mindful that differences in the exact fact pattern and operating context facing each insurer may drive different interpretations. Users shall also be mindful that for the same fact pattern and operating context, there is scope for the substance of same transaction to be articulated differently depending on how the transaction is analysed. (For example, in substance, cash flows from a call option with strike price $X on an asset is equivalent to the combined cash flow from the underlying asset and a put option with strike price $X on the asset, less cash of $X.) Differences in articulation can give rise to a range of plausible treatments. An insurer remains responsible for justifying its choice of treatment after discussion with its auditor. Opinions expressed in the discussion papers are not representative of that of the Singapore Actuarial Society.

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1. IFRS17 Standards

The key passages in the IFRS17 standards that relate to contract combination and separation are outlined below:

Paragraph 9
A set or series of insurance contracts with the same or a related counterparty may achieve, or be designed to achieve, an overall commercial effect. In order to report the substance of such contracts, it may be necessary to treat the set or series of contracts as a whole. For example, if the rights or obligations in one contract do nothing other than entirely negate the rights or obligations in another contract entered into at the same time with the same counterparty, the combined effect is that no rights or obligations exist.

Feb 18 TRG Staff Paper
https://www.ifrs.org/-/media/feature/meetings/2018/february/trg-for-ic/ap1-separation-of-insurance-components.pdf

May 18 TRG Staff Paper
https://www.ifrs.org/-/media/feature/meetings/2018/may/trg-for-ifrs-17/ap01-combination-of-insurance-contracts.pdf

2. Interpretation of Standards

The lowest unit of account that is used in IFRS 17 is the contract that includes all insurance components. There is no further guidance from the standards on this.

The Feb 2018 TRG and May 2018 TRG separately discussed the separation of insurance components from the single contract and the combination of insurance contracts. Both may apply to this topic depending on how we interpret the “single legal contract” definition.

In Singapore, most of the riders will share the same signed contract form with the policyholder and the Feb 2018 TRG may be more relevant. Some company may provide separate forms of legal provision for rider. If a company decides to use this as indicator for different legal contract between base plan and rider, it may discuss with its auditor separately.

Based on the Feb 2018 TRG discussion, separating insurance components may happen when “*the legal form of a single contract would not reflect the substance of its contractual rights and obligations*”. Considerations would include the following:

a) Interdependency between the different risks covered;
b) Whether components lapse together;
c) Whether components can be priced and sold separately;
d) Whether insurance cover is included in one legal contract solely for the administrative convenience of the policyholder and the price is simply the aggregate of the standalone prices for the different insurance covers provided

The May 2018 TRG summary is also included below for reference. Based on the May 2018 TRG discussion, the following indicators may be used as guidance, although there is no single determining factor for combination or separation:

e) Whether the series of contracts with the same counterparty are entered into at the same time.
f) The rights and obligations are different when looked at together compared to when looked at individually.

g) Interdependency between the different risks covered in each contract.
h) Lapse or maturity of one contract causes the lapse or maturity of another contract.
i) The existence of discount on a second contract or rider.

3. How it applies to Singapore

For most of the common riders sold in Singapore, the rider will be sold under the same contract as the basic and the lapse of the basic component will trigger the lapse of the rider component. Based on this argument, a potential interpretation of the IFRS17 standards is that the basic and rider components for these common riders should be combined. However, it may be overridden if it can be proved that the existence of a single contract is solely for administrative convenience.

<u>Common riders in Singapore</u>

Critical illness, accident, disability, medical, term, waiver of premium, payor benefit, “multiplier” riders, Shield riders For CI and accident riders, these are also often sold as accelerated benefits as well. These riders can be Par / Non-Par, and can also be attached to Par / Non-Par basic plans too.

Shield riders
There is clear interdependency of risks between basic and rider plans as the rider covers for the deductible and co-insurance. As such, basic and rider components of Shield should be viewed and measured as a single contract.

Accelerated benefit riders
As the rider accelerates the benefit payments, there is a commercial effect, and such riders should be combined with the base plan.

“Multiplier” riders
These riders provide a multiple of the base sum assured as a benefit, and hence cannot be valued separately.

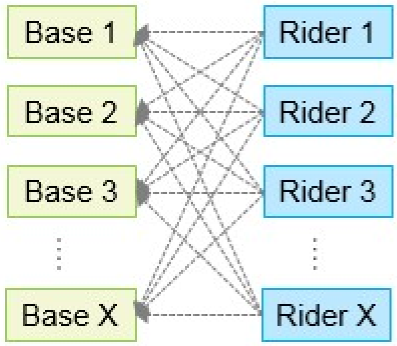
4. Considerations and Challenges in combining all riders with basic plans

- **Operational / modelling complexity**
  Optional riders can be attached to multiple base plans, and a base plan can have multiple riders attached.

  Currently most insurers in Singapore adopt a modelling approach which considers base plans and riders separately, as this ensures better flexibility of model when handling optional riders. It is also a function of the common setup in the policy administration system, where basic and rider plans are classified as separate components.

  Combining all riders with corresponding base plans may involve significant work, which could include:
  - Changing the policy admin system to add identifiers to map riders to base plans
  - Re-designing valuation data extracts to cater and re-coding of multiple products in the model corresponding to various combinations of base plan and rider.
  - Changing data conversion and model codes to cater for the combination

The number of combinations may even grow drastically in the future when more and more different riders are launched, as illustrated below:



Multiple riders that can be attached to several different base plans will lead to a considerable number of possible permutations that need to be modelled.

As the MAS reporting requires separation of Par fund from the other funds, if a company decides to use a consistent model for both reporting, it may also need to design an allocation method for the Par fund portion within the combined modelling.

It can be very complex and involve significant valuation data enhancements to map various riders to various basic plans. The cost of these enhancements may not justify the benefit brought.

- **Impact on choice of measurement model**
  Combining non-par riders with a Par base plan may cause the combined contract to fail the VFA criteria. This could result in adopting different measurement models for the same product, e.g. par policies with riders attached would be measured under the GMM model, whilst base plans with no riders would be measured under the VFA model.

- **Pricing intent / administrative convenience**
  Optional riders that can be attached to several base plans are often priced independently. Such riders are usually included in the same legal contract as the base plan for administrative convenience, and risks are interdependent.

5. Proposed treatment for separation / combination of riders in Singapore

The table below outlines a proposed treatment for the separation or combination of riders in Singapore, based on consideration of the following:

- Whether risks are interdependent
- Whether there is commercial effect

Although all riders would lapse together with the base plan, we do not think this should be a primary consideration, as we are of the view that if the coverage provided by the rider can be provided on a standalone basis, or an equivalent product is available in the market, then the combination of the rider with the base plan during the sales process is generally borne out of administrative convenience.

The following proposed treatment is non-prescriptive.

Rider type	**Combine / separate**	**Rationale**
Compulsory riders	Combine	As the riders are compulsory and the base plan cannot be purchased

		independently, hence the riders and base are likely to be combined.
Shield	Combine	There is clear interdependency of risks between basic and rider plans as the rider covers for the deductible and co-insurance. As such, basic and rider components of Shield are likely to be viewed and measured as a single contract.
Accelerated CI / TPD	Combine	As the rider accelerates the benefit payments, there is a commercial effect, and such riders should be combined with the base plan.
Unit-deducting riders	Combine	As these riders impact the future unit value of the policy, the risks are interdependent, and the riders should be combined.
Multiplier benefit	Combine	A more common multiplier benefit rider is one that is attached to Par base plan and where its benefits depends on the non-guaranteed elements of the base plan. As such, it cannot be valued separately. There could be different variants of multiplier benefit rider in the market in which separation could be considered in a similar way as all other optional riders below.
All other optional riders	Separate	All other optional riders that do not fall in the above categories can be separated for the purposes of valuation, as long as the rider's risks are independent, and there is no commercial effect from combining / separating the rider from the base plan. Examples of such riders include Waiver of Premium, Payor Benefit, Personal Accident Riders, Term riders and etc. (list is not exhaustive)

The table above outlines a proposed approach for valuation of riders, however it does not prescribe how the modelling of these riders should be performed. Each company should have the flexibility to adopt the modelling approach best suited to its products and valuation models.

If a company decides to model components separately, and only combine the results at higher level, the following points below should be considered:

- Consistency of modelling approach between basic and rider, this includes assumptions, stochastic scenarios, any interaction between basic and rider on cash flows, reserve items (i.e. CSM and loss component aggregation), and any other guarantee(s).
- Financial difference between separating and combining modelling should be carefully assessed and maintained as evidence of immateriality on the alternative modelling approach.