

# Contract Boundary

Version	Date	Comments
0.1	28/06/2018	Initial Version
0.2	27 August 2018	Updated version for Shield considerations
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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 IFRS 17 standard requires measurement of insurance contracts includes only cash flows within the boundary of each contract. The exact requirement and definition of contract boundary in the standard are outlined below:

### Paragraph 33

An entity shall include in the measurement of a group of insurance contracts all the future cash flows within the boundary of each contract in the group (see paragraph 34).

### Paragraph 34

Cash flows are within the boundary of an insurance contract if they arise from substantive rights and obligations that exist during the reporting period in which the entity can compel the policyholder to pay the premiums or in which the entity has a substantive obligation to provide the policyholder with services (see paragraphs B61–B71) A substantive obligation to provide services ends when:

- a) the entity has the practical ability to reassess the risks of the particular policyholder and, as a result, can set a price or level of benefits that fully reflects those risks; or
- b) both of the following criteria are satisfied:
  - (i) the entity has the practical ability to reassess the risks of the portfolio of insurance contracts that contains the contract and, as a result, can set a price or level of benefits that fully reflects the risk of that portfolio; and
  - (ii) the pricing of the premiums for coverage up to the date when the risks are reassessed does not take into account the risks that relate to periods after the reassessment date.

Other related key parts of the standard:

- IFRS17 Appendix B “Application Guidance” B61-66
- IFRS17 Basis for Conclusions BC159-164

This paper attempts to discuss interpretation of the standard and its application to the most common insurance contracts in the Singapore market.

Contract boundary for reinsurance contracts held is not discussed in this paper.

## 2. Interpretation of Standards

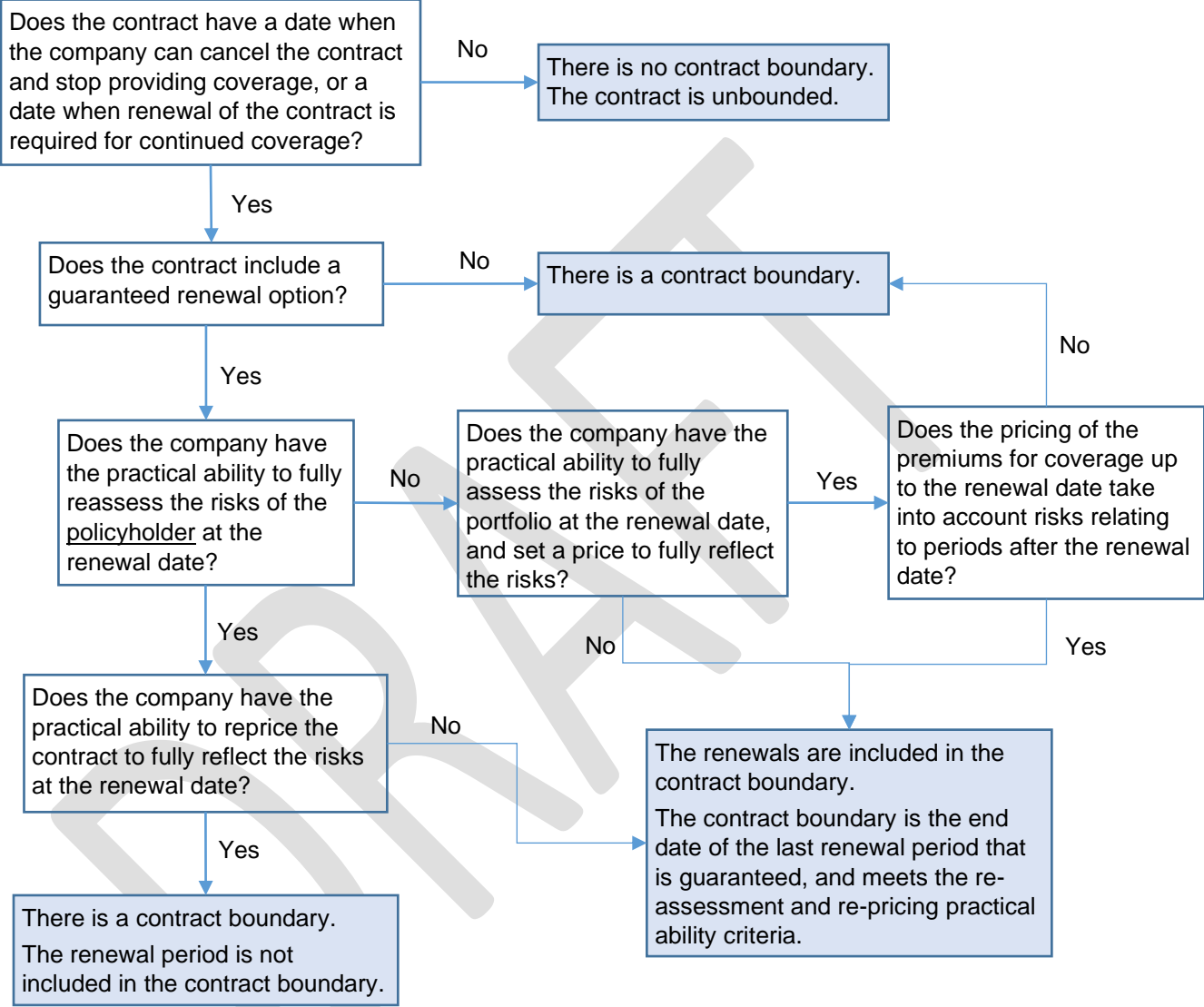
The table below provides an interpretation for the key aspects of the definition for contract boundary.

Key Aspect	Interpretation
Substantive rights and obligations	When determining the boundary of a contract, an entity shall consider its substantive rights and obligations from the contract as well as law or regulations, and disregard terms that have no commercial substance (i.e. no discernible effect on the economics of the contract). For example, ability for the entity to terminate and the right to refuse renewal do not itself constitute a boundary. They might be deemed to have no commercial substance if it is never exercised and the entity has no intention to exercises such right in the future.
Risks in scope	B64 states when assessing whether the entity has the practical ability to set a price that fully reflects the risks in the contract or portfolio, it shall consider all the risks that it would

Key Aspect	Interpretation
	<p>consider when underwriting equivalent contracts on the renewal date for the remaining coverage.</p> <p>The February 2018 TRG AP02 staff paper (“Boundary of contracts with repricing mechanism”) indicated that the assessment of contract boundaries should consider only policyholder risks which does not include any other risks the entity might be exposed to or considered when pricing the contract.</p> <p>Hence, policyholder risks include risks that policyholder transfer to the entity. The most common ones are longevity, mortality, morbidity and investment risks. Lapse and expense risk should not be considered as policyholder risk.</p>
<p>Practical ability to reassess and fully reprice the risks</p>	<p>B64 suggests that the ability for entity to reprice existing contracts to fully reflect the risks should be deemed to be free from constraints if both renewal and new contract with the same characteristics are charged with the same premium. Such interpretation is supported by the observations made in both the February 2018 TRG AP02 staff paper and the May 2018 TRG AP03 staff paper (“Cash flows within the contract boundary”):</p> <p>The February paper stated in paragraph 23:</p> <p><i>The staff believe that the underlying principle of the determination of the contract boundary is that a contract renewal with the same premium that would be available to a new policyholder should be treated as a new contract because the existing contract does not confer on the existing policyholder any further substantive rights.</i></p> <p>The May paper also had the following observations for the determination of contract boundary:</p> <p><i>(a) a constraint that equally applies to new contracts and existing contracts would not limit an entity’s practical ability to reprice existing contracts to reflect their reassessed risks.</i></p> <p><i>(b) when determining whether it has the practical ability to set a price at a future date that fully reflects the reassessed risks of a contract or portfolio, an entity shall:</i></p> <ul style="list-style-type: none"> <li><i>(i) consider contractual, legal and regulatory restrictions; and</i></li> <li><i>(ii) disregard restrictions that have no commercial substance.</i></li> </ul> <p><i>(c) IFRS17 does not limit pricing constraints to contractual, legal and regulatory constraints. Market competitiveness and commercial considerations are factors that an entity typically considers when pricing new contracts and repricing existing contracts.</i></p> <p><i>(d) a constraint that limits an entity’s practical ability to price or reprice contracts differs from choices that an entity makes (pricing decisions), which may not limit the entity’s practical ability to reprice existing contracts in the way envisaged by paragraph B64 of IFRS17.</i></p> <p>Entity should apply judgement to decide whether commercial considerations are relevant when considering the requirements in paragraph 34 of IFRS17.</p>

### 3. Decision tree for contract boundaries

The key elements of IFRS17 contract boundary requirements can be summarized in the form of a decision tree, which provides a more organized approach for assessing contract boundaries.



## 4. How it applies to Singapore

Here are some of the issues discussed in the IFRS17 workgroup:

1. The definition of IFRS 17 contract boundary could give rise to a different policy term from the existing local statutory valuation. MAS intends to introduce contract boundary definition in RBC2. However, the definition can be different from IFRS17.
2. Riders and basic plan, which form one single legal contract, might need to be measured together under IFRS17. Contract boundaries should be assessed for riders and basic plan combined.
3. Contracts with reviewable premium rates might be contract bound. However, for products with level premium or charges but increasing insurance cost (such as mortality and morbidity) over time, they should not be contract bound. The most common products with such features are critical illnesses cover.
4. Some products might have non-guaranteed renewal clauses in the policy contract. The insurer can terminate the contract upon giving notice to policyholders, e.g. personal accident plans. These contracts could have shortened contract boundary under IFRS17.

Insurers need to assess if their ability to terminate contracts has commercial substance. For example, if the termination options have never been exercised before, and there is no triggering mechanism in place or plans to exercise them, it could be argued that the ability to refuse renewal has no commercial substance.

5. Some products might have guaranteed renewal clauses in the policy contract. The issuer has the unilateral right to vary premiums and policy benefits after giving notice to policyholders. Premium rates for such contracts are usually revised regularly to reflect the change in risks of the portfolio the contracts belong to. Contract boundary for such contracts (e.g. integrated shield plans) is less clear and its assessment might require significant judgement, in particular, with respect to if entity's ability to amend the premiums or the benefits under the contract is free from any external constraints.
6. Policyholder generally bears the full investment risks for investment-linked policies in Singapore. Charges of insurance coverage are normally not guaranteed. Contract boundary for investment-linked contracts needs to be assessed by considering the detailed product features.

## 5. Integrated Shield Plans contract boundaries

The workgroup has two different views on the determination of the contract boundary for the integrated shield contracts.

**View A: Regulatory constraint restricts insurer's ability to set a price to fully reflect the reassessed risks. Hence, the contract should not be bound.**

MOH approval is required for integrated shield plan premiums and product design, and there have been historical instances where MOH has intervened with Shield product features and premium rates.

- Introduction of Medishield Life in 2015 and a moratorium to freeze IP premiums for a year.
- In March 2018, MOH announced a mandate for insurers to withdraw sales of policies with first dollar cover, with all new rider plans having a mandatory co-payment of 5% from 1 Apr 2019 onwards.

MOH's interventions would be viewed as a constraint on insurers' practical ability to reprice an existing contract such that the price fully reflects the risks of a portfolio, and this restriction is an argument for integrated shield plans and the riders attached to such plans to be considered as an unbounded contract.

Some market practitioners have suggested that the regulatory restriction on repricing Shield might only apply for a limited number of years, i.e. the contract is only bounded by the length of time needed to reprice to fully reflect risks, based on company's business plan or re-pricing policy.

However, it is worth noting that if this view is taken, any projected healthy profit margin for measurement under IFRS17 would be hard to justify given that the entity expects not to be able to revise the premium fully to reflect the underlying claims risk in the long term.

**View B: While there were past government interventions, there is no evidence that government intervention restricts an insurer's ability to set a price to fully reflect the reassessed risk. Moreover, renewal and new contracts are generally offered with the same benefits and premium rates. Existing contract should not confer any further substantive rights to the policyholder. Hence, the contract should be bound.**

Some practitioners have expressed the view that the regulators generally have not intervened in insurers' repricing exercises, and they are unlikely in the future to restrict the insurers from increasing prices to the extent that they fully cover the cost of claims. These two events had very limited short-term effect on premiums rates. They neither restricted insurers ability to reflect the underlying claims risk into the pricing, nor create any expectation that government will have frequent intervention in private health insurance market.

They also argued that, based on Para B64 of standards and the discussion in TRG staff papers, when new Shield contracts and existing contracts have the same premium rates and benefits, for the assessment of contract boundary, entity's ability to reprice the existing contracts should not be considered to be limited by any constraint which are equally applied to both new and existing contracts.

Taking this view, integrated shield contracts and their rider plans should be bounded to the next repricing date when the renewal premium is revised.

It is uncertain if all companies should adopt the same contract boundary under IFRS17, or if each company has the discretion to form their own interpretation of the standards, given that they may have different pricing strategy and claims management practices. Accounting profession might also have their own view, and it is uncertain that if the views will eventually converge.

It is also noted that companies may have a preference to use the same contract boundaries for RBC2 and IFRS17.

## **6. Investment-linked policies contract boundaries**

For investment-linked products, premiums paid by policyholders, after deductions if applicable, are invested in unit funds. Insurance coverages and administration charges are usually charged through regular deductions from the unit account or the premiums paid. The deductions including expense are usually made monthly.

IFRS17 does not require such investment linked contract be unbundled into protection components and investment component. Contract boundary assessment is performed on a whole-contract level.

The February TRG AP02 staff paper discussed the contract boundary for a unit-linked contract combined with unit deducting rider with reviewable charges. Based on the fact pattern presented in the paper, it suggests that such contract should be contract bound to the next repricing date, noting that the unit-linking feature automatically reprices the investment component. However, the TRG notes that the facts and circumstance of each contract should be assessed.

Many ILP policies sold in Singapore have different product features from fact patterns described in the staff paper. When determining the contract boundary, the following common product features should be taken into consideration:

- All COI charges might be levied upfront at contract issuance.
- COI and expense are fixed at inception of contract and cannot be altered, or any revision is subject to limits and caps.
- Presence of any guarantee clauses such as no-lapse guaranteed
- Premium allocation rate rising above 100% in the later policy years
- Loyalty bonuses
- Presence of surrender penalty

## **7. Next steps**

On the topic of Shield, the workgroup will discuss with other related stakeholders (ISCA, SAS General Insurance IFRS17 workgroup) on the approach to adopt for Integrated shield plans.