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Guaranteed insurability: where is its “boundary”?

Francesco Nagari, Deloitte Global IFRS Insurance Leader | April 2023

Presenters



Francesco Nagari

Deloitte Global IFRS Insurance
Leader

frnagari@deloitte.com.hk



Liza Gonzalo

IFRS 17 Director

ligonzalo@deloitte.com.hk

Agenda

- Overview
- Illustrative example
- Practical considerations

Guaranteed insurability: where is its “boundary”?

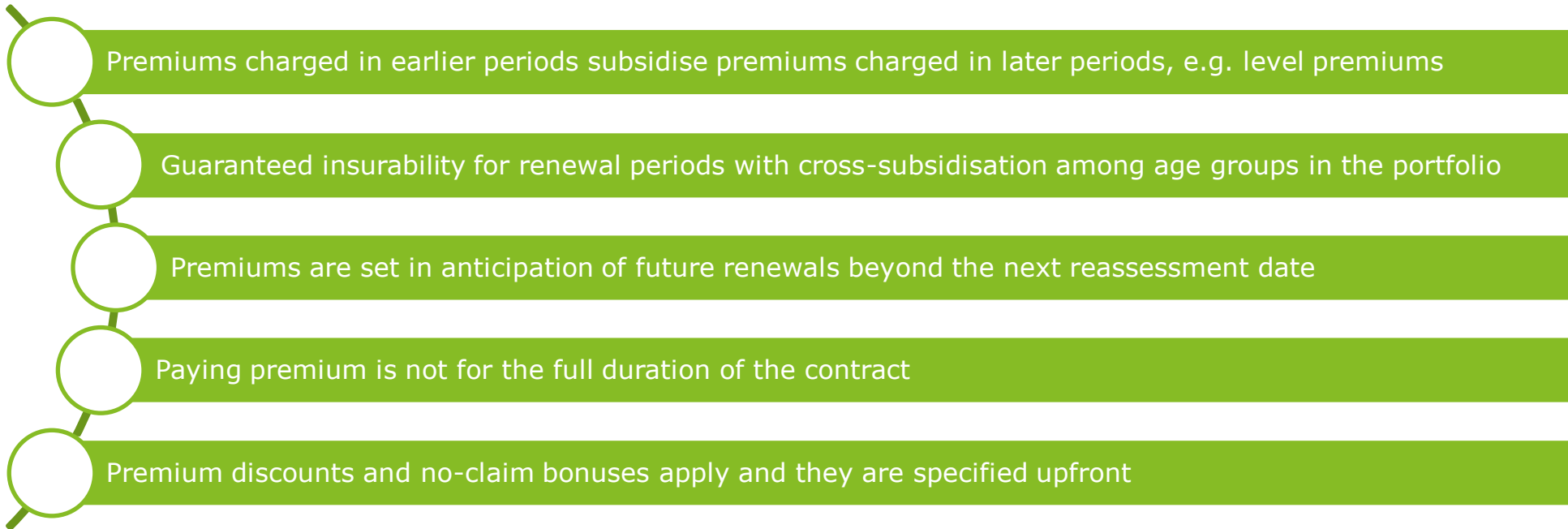
Overview

- The contract boundary is a key parameter in the measurement of a group of insurance contracts. It must be analyzed at individual contract level. IFRS 17 has principles around the contract boundary conclusion that sometimes call for critical judgments to be made.
- Complex situations exist when there is an interplay of substantive rights and obligations in a contract. In this webcast we cover when the determination of the contract boundary is not straight-forward.
- We will cover the topic of determining at what point in time an entity would set the contract boundary under the requirements of IFRS 17:34(b) and its two criteria.
- The typical scenario is where insurers offer guaranteed insurability to their policyholders on a recurring basis but reserve the right to reprice the risk of the entire portfolio in which those policyholders have been placed when they purchased their first insurance contract with the entity.
- Both of the IFRS 17:34(b) criteria should be met for the contract to be bounded at the next reassessment date.
 - Criterion 1 – the insurer has the ability to fully reprice at the portfolio level; and
 - Criterion 2 – the pricing of the contract does not take into account risks that relate to the periods after the reassessment date.

Guaranteed insurability: where is its “boundary”?

The second criterion of IFRS 17:34(b) – judging an insurer’s pricing practice

- It is universally accepted that the first criterion in IFRS 17:34(b) requires much less judgment than the second one.
- Concluding whether or not the insurer’s pricing takes into account risks beyond the next reassessment date is not straightforward. Below are a few examples when IFRS 17:34(b)(ii) may not be met and the boundary of the contract goes beyond the repricing date



Illustrative example

Simplified fact pattern

Entity A sells yearly renewable health insurance contracts with the following terms:

- offered to policyholders between the age of 20 to 30 years;
- guaranteed cover for another year when the policyholder pays the annual premium, i.e. no new medical underwriting is required for the existing policyholder after purchasing the first insurance contract in this line of business;
- cannot be renewed once the policyholder reaches the age of 31.

Entity A has an unconstrained practical ability to reprice the risks at the portfolio level.

When they purchase the first insurance contract, the policyholders in the portfolio are classified and grouped together based on different health factors (e.g. separating smokers and non-smokers) and each group within the portfolio has its own premium rate. These factors cannot be reassessed at any subsequent renewal date.

The policyholder has the right to renew the contract at the new price quoted annually or to reject the renewal option and lose its guaranteed insurability. The policyholder can also lapse the contract at any time during the annual cover period.

Illustrative example

Simplified fact pattern

Entity A issues two types of contracts:

Contract Type 1: flat portfolio premium rate – a single premium amount is charged yearly to **all age groups**

Contract Type 2: stepped portfolio premium rate – premium rates applied for **each age group** are different across the age groups in the portfolio and they increase as the age of the group increases (i.e. younger policyholders pay less than older policyholders, all other things being the same)



Accounting issue:

Is the next reassessment date the contract boundary?

IFRS 17:34(b) criteria

practical ability to fully reprice risks at portfolio level



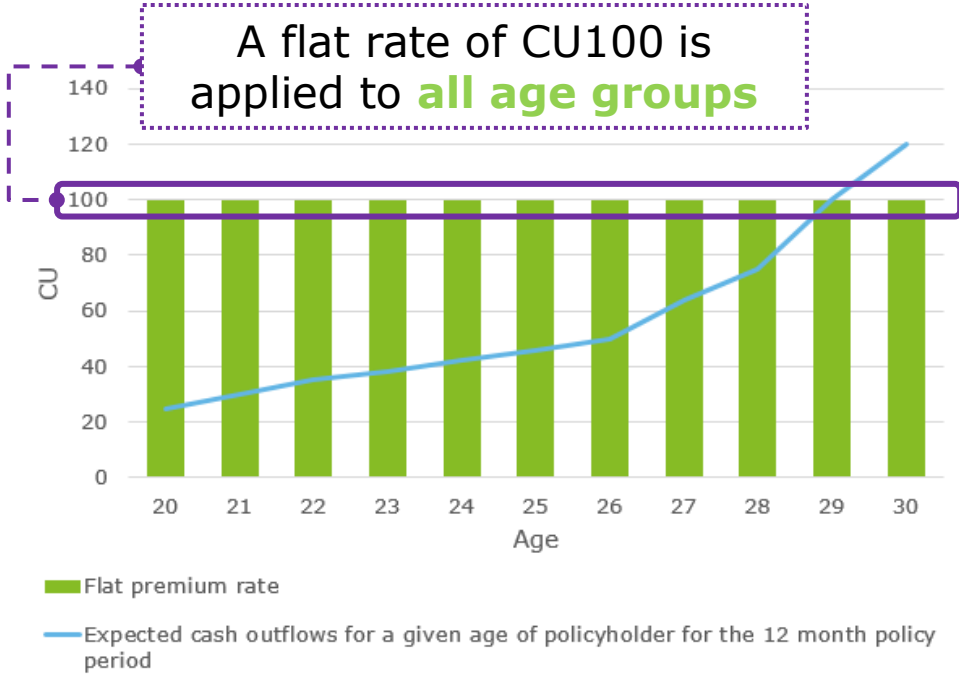
the pricing of the premiums up to the date of reassessment does not take into account the risks that relate to periods after the reassessment date



Illustrative example

Simplified fact pattern

Contract type 1



Flat premium rate table

Age group	Expected cash outflows for a given age of policyholder for the 12-month policy period	Annual premium for each age group
20	30	100
21	32	100
22	34	100
23	36	100
24	40	100
25	44	100
26	52	100
27	65	100
28	76	100
29	97	100
30	120	100

Illustrative example

Contract boundary assessment – flat premium rate for all age groups

Contract type 1

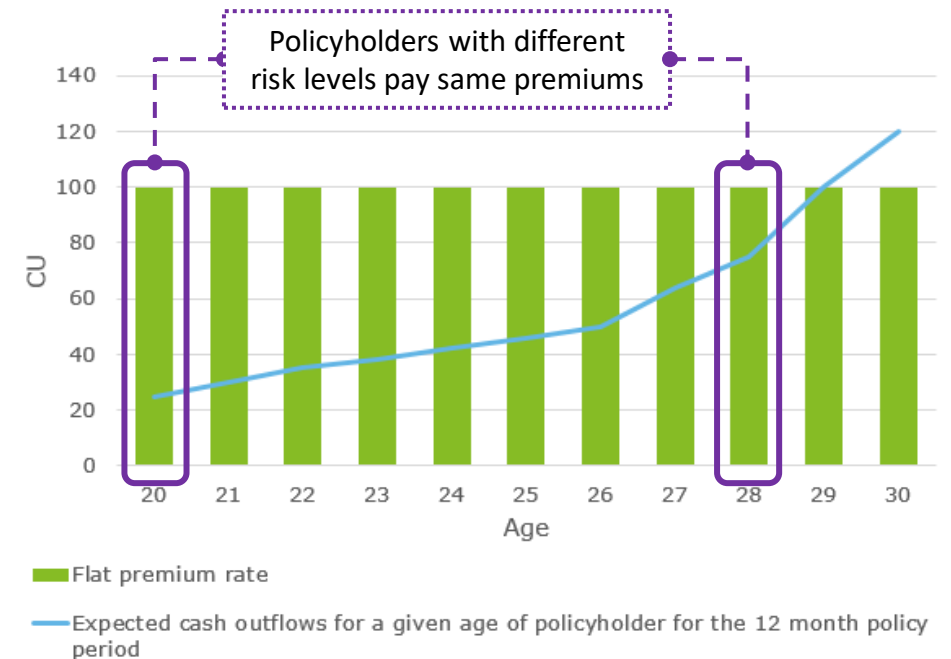
Entity A has the practical ability to **reprice the portfolio freely every twelve months**. However, when pricing the portfolio:



Future morbidity trend beyond 12 months is considered to set the annual premium for each age group



Existing policyholders gain insurability of their morbidity risk at a blended portfolio rate that is independent of their individual health circumstances at renewal date.



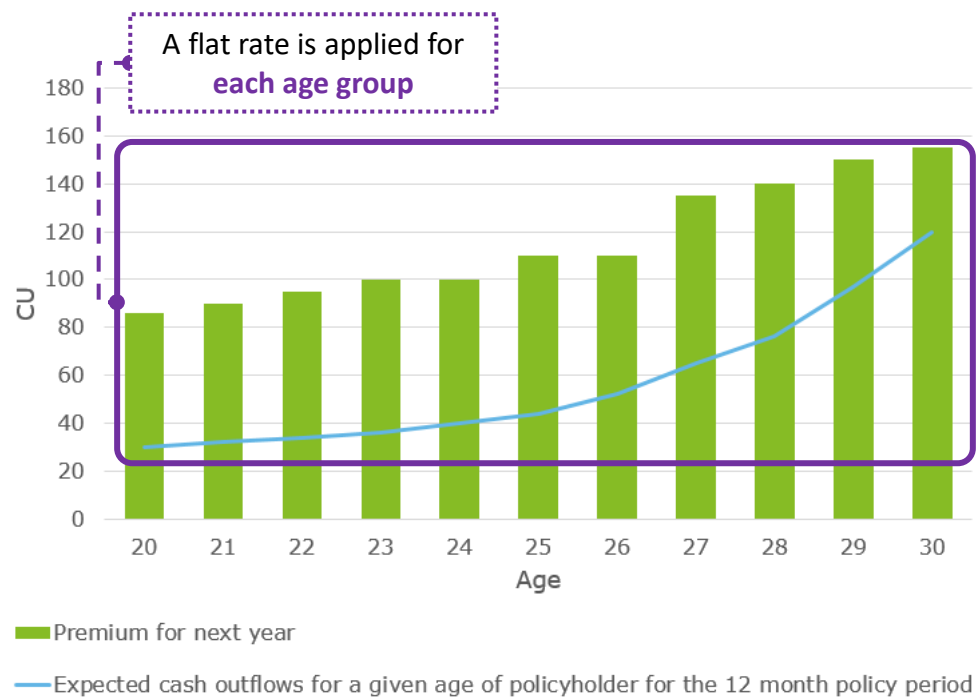
Assessment result:

IFRS 17:34(b)(ii) criterion is not met. The next reassessment date is not the contract boundary

Illustrative example

Fact pattern – step-rated premium

Contract type 2



Premium table

Age group	Expected cash outflows for a given age of policyholder for the 12-month policy period	Annual premium for each age group
20	30	86
21	32	90
22	34	95
23	36	100
24	40	100
25	44	110
26	52	110
27	65	135
28	76	140
29	97	150
30	120	155

Illustrative example

Contract boundary assessment – stepped portfolio rate of premium

Contract type 2

Entity A has the practical ability to **reprice the portfolio freely every twelve months**. However, when pricing the contract:

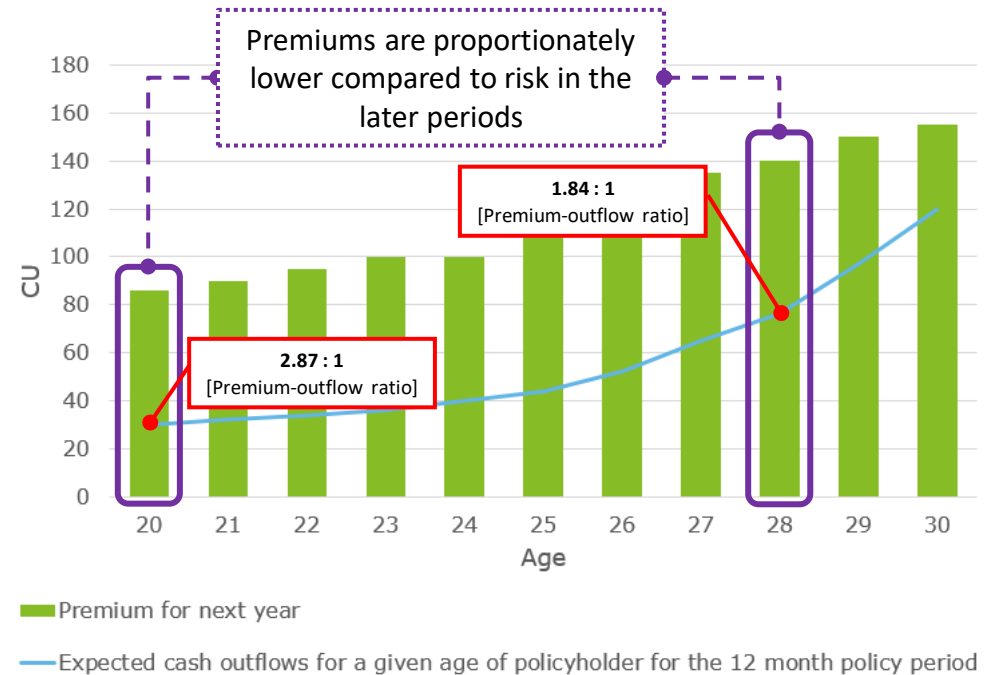


Future morbidity trend beyond 12 months is considered in setting the premium.



A stepped rate pricing reduces the cross-subsidy compared with contract type 1. A critical judgment is to assess whether or not IFRS 17:34(b)(ii) has been met or not.

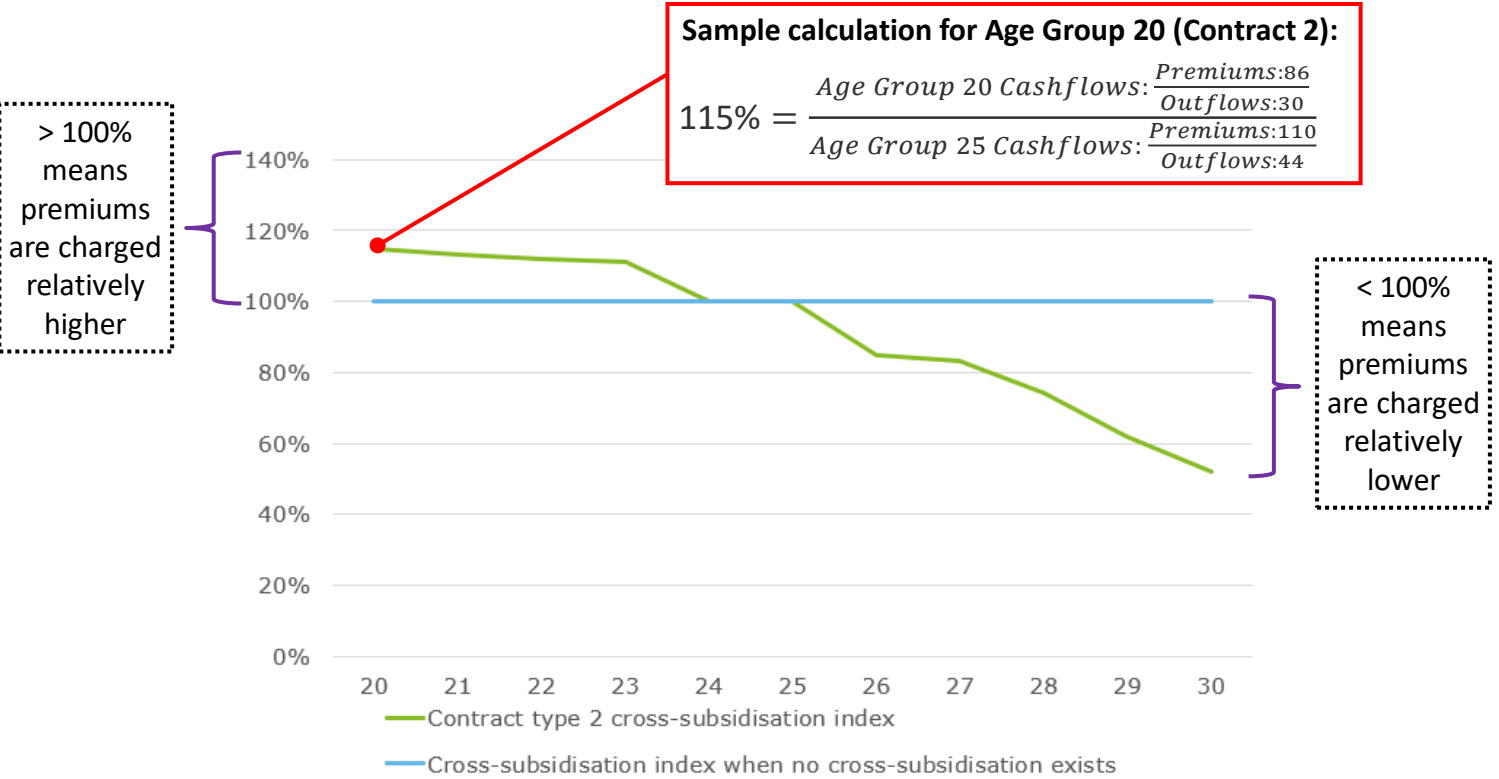
We want to illustrate an example where the conclusion is negative.



Illustrative example

Analysis of presence of cross-subsidisation as a test on the insurer pricing practice

The graph below shows the analysis of the cross-subsidisation for contract type 2, taking the 25-year-old age group as the modal group to construct a simple cross-subsidisation index to help the analysis



Assessment result:

The contract boundary is **beyond the next reassessment date** because:

- the pricing approach **considers the risks beyond the next reassessment date**; and
- that is proven by **material cross-subsidisation**.

Age group	Contract type 2 index	Index when no cross-subsidisation exists
20	115%	100%
21	113%	100%
22	112%	100%
23	111%	100%
24	100%	100%
25	100%	100%
26	85%	100%
27	83%	100%
28	74%	100%
29	62%	100%
30	52%	100%

Practical considerations

Some practical considerations when implementing the requirements of IFRS 17 relating to this topic:

- The assessment of the contract boundary depends on individual facts and circumstances of each contract. All substantive rights and substantive obligations in a contract must be taken into account when performing the assessment.
- The presence of an annual renewal pricing mechanism at portfolio level (criterion IFRS 17:34(b)(i)) does not result in a contract boundary at the next renewal date. Judgment is required when determining whether or not the pricing does not take into account risks relating to periods beyond the next renewal date (criterion IFRS 17:34(b)(ii)).
- Insurers may need to analyse their past, present and future pricing philosophy to judge whether or not pricing is conducive to meet or fail criterion IFRS 17:34(b)(ii). Insurers should gather and regularly maintain documentary evidence such as the pricing policy that guides the pricing team's consideration of what future risk is and how it is reflected in the pricing and repricing.

Practical considerations (cont.)

Some practical considerations when implementing the requirements of IFRS 17 relating to this topic:

- IFRS 17:B64 requires to reassess the contract boundary at each reporting date. Hypothetically, a material change in pricing philosophy could trigger a different outcome on meeting (or not) criterion IFRS 17:34(b)(ii). This could have material implications on the financial statements of an insurer.
- Financial reporting governance should include discussion with pricing executives to ensure any changes in the pricing philosophy are implemented appropriately in the IFRS financial statements. Documentation may need upgrade to make it easier to validate IFRS 17 requirements (e.g. through the regular calculation of a cross-subsidisation index by portfolio)
- Deloitte noted that several risk-based capital regulations around the world have borrowed the contract boundary concept from IFRS 17 to introduce or change the valuation of insurance liabilities for insurance solvency capital purposes. Insurers need to consider all similarities and differences between IFRS 17 and other regulations that may borrow the contract boundary concept to ensure internal consistency and to capture material operational efficiencies in the calculations of the fulfilment cash flows



Contact details

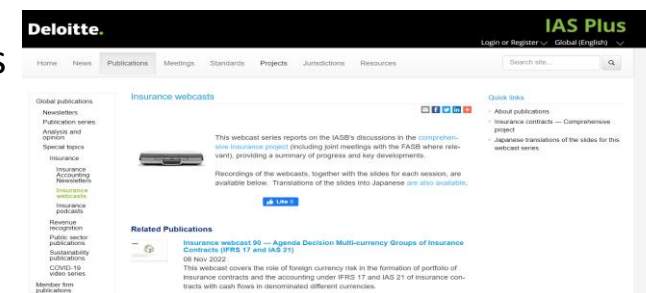
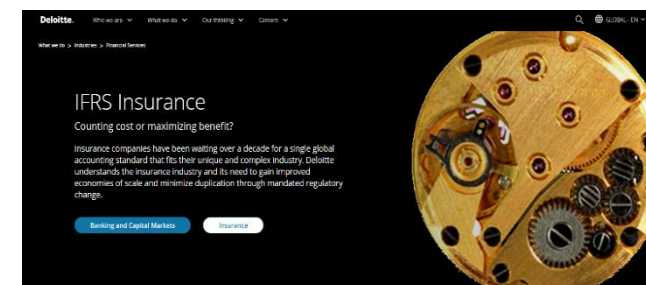
Francesco Nagari

Deloitte Global IFRS Insurance Leader

+852 2852 1977 or frnagari@deloitte.com.hk

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