AMERICAN ACADEMY of ACTUARIES

December 21, 2011

Mr. Patrick Finnegan
International Accounting Standards Board
30 Cannon Street
London, EC4M 6XH

Dear Patrick,

The American Academy of Actuaries'[1] International Accounting Standards Task Force is pleased to submit the following comments on the topic of defining the contract boundary for insurance contracts. This letter expresses our recommendations as actuaries in our role as experts that support the preparation, analysis, and auditing of insurer financial statements.

1. Background and Scope

On October 24, 2011, the IASB Insurance working group issued a staff paper titled "Insurance Contracts: Consequences of Contract Boundary Decision." That paper documented the evolution of the definition of the boundary of an insurance contract. The definition as presented in the Insurance Contracts Exposure Draft (ED) was interpreted by writers of health insurance to unnecessarily require future accounting of health insurance to contemplate contractual cash flows beyond the current typically considered horizon of 12 months, thereby causing a level of complexity in the valuation of associated insurance contracts that was deemed unnecessary and unprecedented by many ED commenters. Based on these comments, the IASB put forward a revised definition of the boundary of an insurance contract intending to address the concerns of writers of health insurance.

The current working version of a definition of contract boundaries (as we understand it as of the date of this letter) is provided below:

a) *Contract renewals should be treated as a new contract:*
   i. *when the insurer is no longer required to provide coverage; or*
   ii. *when the existing contract does not confer any substantive rights on the policyholder.*
b) *A contract does not confer on the policyholder any substantive rights when the insurer has the right or the practical ability to reassess the risk of the particular policyholder and, as a result, can set a price that fully reflects that risk.*

[1] The American Academy of Actuaries is a 17,000-member professional association whose mission is to serve the public and the U.S. actuarial profession. The Academy assists public policymakers on all levels by providing leadership, objective expertise, and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice, and professionalism standards for actuaries in the United States.

c) *In addition, for contracts for which the pricing of the premiums does not include risks relating to future periods, a contract does not confer on the policyholder any substantive rights when the insurer has the right or the practical ability to reassess the risk of the portfolio the contract belongs to and, as a result, can set a price that fully reflects the risk of that portfolio.*
d) *All renewal rights should be considered in determining the contract boundary whether arising from a contract, from law or from regulation.*

This letter intends to address 1) the lack of clarity in the link between the terms "contract boundary," "coverage period," and the determination of contract duration; 2) whether the revised definition of contract boundary appropriately addresses concerns raised by writers of health insurance; and 3) whether the revised definition has any unintended consequences on the valuation of other types of insurance contracts.

We have approached these three issues by evaluating the working definition in the context of several products issued in the U.S. insurance market. A product-by-product analysis is attached to this document.

2. Contract Boundary, Coverage Period, and the Determination of Short- versus Long-Duration

The ED defines the term "coverage period" as follows:

> *coverage period The period during which the insurer provides coverage for insured events.*

From the above, coverage period is not explicitly a function of the contract boundary. Paragraph 54 of the ED goes on to define the characteristics of an insurance contract that would cause it to be deemed short duration:

> *54 Paragraphs 55–60 [which summarize a premium allocation approach for short duration contracts] apply to insurance contracts that meet both of the following conditions:*
>
> *(a) The coverage period of the insurance contract is approximately one year or less.*
>
> *(b) The contract does not contain embedded options or other derivatives that significantly affect the variability of cash flows, after unbundling any embedded derivatives in accordance with paragraph 12.*

Based on the above, the determination of long- versus short-duration does not reference contract boundary. Rather, contract boundary affects the methodology for determination of the pre-claim liability for short duration contracts in paragraphs 57-58.[2]

[2] We note that the definition of pre-claims liability in paragraph 56 makes some assumptions that may cause problems for retrospectively rated policies. Retrospectively rated policies allow for premium adjustments (up and/or down) based on the actual loss experience under the contract. Prior to settlement, premium adjustments are currently estimated based on estimates of incurred claims, and then those adjustment estimates are revised over time as the associated incurred claim estimates are revised. As such, some "future premiums"

56 The pre-claims liability is the pre-claims obligation (as described in paragraphs 57 and 58), less the expected present value of future premiums, if any, that are within the boundary of the existing contract.

57 For insurance contracts specified in paragraph 54, an insurer shall measure its pre-claims obligation at initial recognition as

(a) the premium, if any, received at initial recognition, plus the expected present value of future premiums, if any, that are within the boundary of the existing contract; less

(b) the incremental acquisition costs.

58 Subsequently, the insurer shall reduce the measurement of the pre-claims obligation over the coverage period in a systematic way that best reflects the exposure from providing insurance coverage, as follows:

(a) on the basis of the passage of time, but

(b) on the basis of the expected timing of incurred claims and benefits, if that pattern differs significantly from the passage of time.

Based on all of the above, the pre-claims liability starts at the premium received at initial recognition less incremental acquisition costs. Subsequently, the amount is reduced by an "amortization" *over the coverage period* of cash flow items *within the contract boundary*. If the two (coverage period and contract boundary) were somehow out of line, there may be unintended accounting results.

For the purposes of presenting product-specific analyses contained in the attachment and referenced throughout this letter, we have made the assumption that the contract boundary defines the end of the coverage period, despite the fact that the two are not directly linked. We recommend that the IASB explicitly state that the two concepts are linked in the final version of the standard.

3. Considerations and Concerns with the Contract Boundary Definition

We generally found the language "*All renewal rights should be considered in determining the contract boundary whether arising from a contract, from law or from regulation"* referenced above to be somewhat ambiguous. We interpret the language to mean that the preparer of the financial statement could not look only at the rights and obligations of only the insurer and the contract holder in making determinations about the contract boundary.

referred to in paragraph 56 may relate to the post-claim portion of the contract, not the pre-claim portion of the contract. This would be a non-issue if future premiums are reported separately from future claim payments (such as under the current non-life reporting approaches used in most countries) but may cause issues under the current proposals if attempts are made to split pre-claims from post-claims liabilities.

Our product-by-product analysis, contained in the attachment, yielded the following additional insights:

- In addition to having rights to re-price insurance contracts on a cohort basis, in some instances insurers also maintain the right to non-renew insurance contracts on a cohort basis despite not being able to non-renew insurance contracts on a specific policyholder basis. We recommend that the definition of contract boundary be revised to contemplate this right of the insurer.

- Language regarding an insurer's ability to "set a price that fully reflects the risk" takes on more nuance in light of a requirement to consider the role of the regulator in the determination of setting pricing:
    - It would seem that an insurer could submit a rate increase request for regulatory approval, have the regulator approve a lesser increase, and still have a "price that fully reflects the risk," but a price that does not achieve target profitability levels.
    - It is difficult to forecast future regulatory environments.

- There are certain reinsurance contracts—typically YRT reinsurance—for which the reinsurer may have the right under some circumstances to reassess premiums for the risk of the contract. However, the right may be limited by contract or by custom and practice. It is also possible that despite the potential right to increase rates, the permitted increases may be inadequate to reflect the true experience on the business. We therefore believe that such products should maintain their current long-duration status.

- It is not uncommon for insurers to manage cohorts of contracts that within them contain both products for which rate guarantees extend beyond 12 months and those that do not, but for all of which there is no pre-funding of future years in the current pricing; or products for which the first contract period is different in length from subsequent contract periods, but for all of which periods there is no pre-funding of future years in the current pricing. Having similar accounting across those cohorts of contracts, in spite of those types of differences in contract features, would be preferable.

- It is unclear as to whether the working definition includes things such as the cost of insurance or other charges of a Universal Life product in the definition of "premiums."

- Certain products (e.g., Universal Life) may entitle the insurer to reassess and change future premiums at the cohort level, but subject to certain limitations made explicit within the contract. It is unclear whether or not these limitations cause the insurer to lose the ability to "set a price that fully reflects the risk of that portfolio."

4. Conclusion

The definition of the boundary of an insurance contract is critical to classifying and valuing liabilities related to insurance contracts. We respectfully request that the IASB consider formally addressing the link between the definitions of contract boundary and coverage period. We also further request that the IASB consider the potentially adverse product-specific situations that arise when attempting to value certain insurance contracts using the working definition of contract boundary. We suggest that the application of a principle-based judgment on a case-by-case basis may be an effective way of dealing with this issue.

We greatly appreciate the opportunity to offer these comments. If you have any questions, please contact Tina Getachew, senior policy analyst, Risk Management and Financial Reporting Council, via email (getachew@actuary.org) or phone (202/223-8196).

Sincerely,

Stephen J. Strommen
Chair, International Accounting Standards Task Force
American Academy of Actuaries

ATTACHMENT

Contract Boundary Definition Considerations on a Product-by-Product Basis

Products Included:

- Individual Major Medical Insurance
- Small Group Major Medical Insurance
- Issue-age Rated Medicare Supplement Insurance
- Yearly Renewable Term Reinsurance
- Group Life or Long Term Disability Insurance (with a multi-year rate guarantee)
- Universal Life Insurance

Approach:

Each product above was considered in light of its current accounting basis for U.S. GAAP. The contract boundary for each product was considered on the basis of the working definition as defined in the comment letter. Considerations in the determination of contract boundary are provided below, including a likely definition of the contract boundary under IFRS. Key and general considerations from this analysis are summarized in the comment letter.

Product: Individual Major Medical			
U.S. GAAP Duration Treatment: Various			
Criterion		T / F	Commentary
a) i)	The insurer is no longer required to provide coverage at the end of a 12 month or shorter period.	F	Insurers typically have the right to non-renew the coverage *on a cohort basis*, given that these contracts are typically issued on a Conditionally Renewable basis. The cohort in this basis is typically all policies issued under the same policy form in the same regulatory jurisdiction.
b)	The insurer has the right or the practical ability to reassess the risk of the particular policyholder at the end of a 12 month or shorter period and, as a result, can set a price that fully reflects that risk.	F	
c) part 1	The pricing of the premiums does not include risks relating to future periods.	T or F	Due to the impact of underwriting at policy issuance, claims experience can, but may not always, vary significantly based on the amount of time elapsed since policy issuance. Practice varies among insurers on whether to reflect this phenomenon in pricing. Some insurers charge higher premiums in early policy durations in order to mitigate the level of future rate increases required to reflect durational deterioration in morbidity. Other insurers do not.
c) part 2	The insurer has the right or the practical ability to reassess the risk of the portfolio the contract belongs to at the end of a 12 month or shorter period and, as a result, can set a price that fully reflects the risk of that portfolio.	F	The insurer typically has the right to reassess the risk of the portfolio and submit to its regulator a price that fully reflects the risk of that portfolio. However, the price that is ultimately approved by the regulatory body may be less than what is submitted and/or less than a price that fully reflects the risk of that portfolio. Certain regulatory jurisdictions offer "file and use" regulations, whereby the insurer simply needs to submit the current rates with the regulator and can implement the revised rates at its discretion. In such jurisdictions, the insurer can set a price that fully reflects the risk of that portfolio. However, there exist certain regulatory jurisdictions wherein the regulator has exercised its authority to limit the amount of submitted rate increase; in some cases

			insurers would argue that the allowed rate increase was less than an amount necessary to "fully reflect the risk of that portfolio" of contracts. For example, significant media attention has been devoted to rate increase requests made by health insurers that have in many cases been denied by state insurance regulatory bodies. The following website describes one such example: http://ifawebnews.com/2010/04/23/court-affirms-maines-decision-to-deny-rate-hike-for-anthem/
IFRS Duration Treatment*: Long			

*IFRS duration treatment is short duration if [*a) i)*] OR [*b)*] OR [*c) part 1 AND c) part 2*].

In short, the determination of the boundary of a contract may be different for the same product sold in many different regulatory jurisdictions due to varied ability to achieve targeted rate increases with different regulatory bodies. Further, the wording "fully reflect the risk of that portfolio" is somewhat ambiguous with respect to regulatory oversight of premium increase requests—at what point does the ultimately approved rate increase, if less than requested, fail to "fully reflect the risk of that portfolio"? When the insurer is no longer able to maintain targeted profitability? When the insurer no longer expects to be profitable? In the latter situation, the contract would become onerous. Perhaps there is a mechanism for including consideration of adverse regulatory environment in the onerous contract test as opposed to the definition of the contract boundary.

Despite the commentary in the preceding paragraph, the working definition of contract boundary fails to consider the right the insurer has to non-renew the business on a cohort basis. Incorporation of contemplation of this right alone into the definition would seem sufficient to put such contracts in a short-duration category.

Product: Small Group Major Medical			
U.S. GAAP Duration Treatment: Generally Short			
Criterion		T / F	Commentary
a) i)	The insurer is no longer required to provide coverage at the end of a 12 month or shorter period.	F	These products are often Conditionally Renewable or Guaranteed Renewable, meaning that the insurer cannot non-renew Small Group contracts on a contract-by-contract basis. Where issued as a Guaranteed Renewable contract, the insurer does not retain the right to non-renew even at the cohort of contracts level.
b)	The insurer has the right or the practical ability to reassess the risk of the particular policyholder at the end of a 12 month or shorter period and, as a result, can set a price that fully reflects that risk.	F	There are some regulatory restrictions at the policyholder level on premiums. For example the insurer may be restricted from charging a premium that is more or less than some stated percentage of a base rate for the portfolio of Small Group contracts. However, the pricing is generally sufficient at a portfolio level even if there are some specific policyholders for which the regulatory rate caps prevent the insurer from fully reflecting that policyholder's risk.
c) part 1	The pricing of the premiums does not include risks relating to future periods.	T	
c) part 2	The insurer has the right or the practical ability to reassess the risk of the portfolio the contract belongs to at the end of a 12 month or shorter period and, as a result, can set a price that fully reflects the risk of that portfolio.	F	Restrictions similar to those for Individual Major Medical exist for Small Group Major Medical Insurance.
IFRS Duration Treatment*: Long			

*IFRS duration treatment is short duration if [*a) i)*] OR [*b)*] OR [*c) part 1 AND c) part 2*].

Insurers participating in the Small Group Major Medical market are typically required to issue contracts to all takers with limited ability to underwrite. As such, durational rating that may be present in Individual Major Medical insurance is not present in Small Group. Such contracts are therefore priced at a portfolio level in a way that only contemplates the next 12 months of risk. Nonetheless, the working definition of Contract Boundary would seem to push such contracts into a long duration accounting model.

Product: Issue-age Rated Medicare Supplement			
U.S. GAAP Duration Treatment: Varies			
Criterion		T / F	Commentary
a) i)	The insurer is no longer required to provide coverage at the end of a 12 month or shorter period.	F	As long as the policyholder pays the premium, the insurer has to provide coverage
b)	The insurer has the right or the practical ability to reassess the risk of the particular policyholder at the end of a 12 month or shorter period and, as a result, can set a price that fully reflects that risk.	F	
c) part 1	The pricing of the premiums does not include risks relating to future periods.	F	Premiums are set level, so there is a pre-funding of the risk
c) part 2	The insurer has the right or the practical ability to reassess the risk of the portfolio the contract belongs to at the end of a 12 month or shorter period and, as a result, can set a price that fully reflects the risk of that portfolio.	F	The insurer typically has the right to reassess the risk of the portfolio and submit to its regulator a price that fully reflects the risk of that portfolio. However, the price that is ultimately approved by the regulatory body may be less than what is submitted and/or less than a price that fully reflects the risk of that portfolio.
IFRS Duration Treatment*: Long			

*IFRS duration treatment is short duration if [*a) i)*] OR [*b)*] OR [*c) part 1 AND c) part 2*].

Since there is a pre-funding of the risk, the issue-age rated contract is currently a long duration product; taking the present value of future benefits minus the present value of future premiums would generate a reserve. The current IFRS definition keeps this product a long-duration product. However, in situations where the insurer issues both issue-age and attained-age rated contracts the reserving may be handled on a line of business basis so that there is not an active life reserve for the combined block.

Product: Yearly Renewable Term Reinsurance Contract			
U.S. GAAP Duration Treatment: Long			
Criterion		T / F	Commentary
a) i)	The insurer is no longer required to provide coverage at the end of a 12 month or shorter period.	F	Yearly renewable Term reinsurance (YRT) is a contract that commits the reinsurer to provide reinsurance protection for the life of the underlying contract, which for most life insurance contracts is until the policy is terminated by the policyholder or upon the death of the insured.
b)	The insurer has the right or the practical ability to reassess the risk of the particular policyholder at the end of a 12 month or shorter period and, as a result, can set a price that fully reflects that risk.	T	While under some circumstances the reinsurer may be able to reassess the premiums charged, rate increases may be limited by contract or by custom and practice.
c) part 1	The pricing of the premiums does not include risks relating to future periods.	F	As mentioned above, YRT provides protection over a long period of time. If the underlying contract is a product that lasts until the end of the original insured's life, then so too does the reinsurance. Pricing determination of the scale of premiums at contract inception takes into account the expected premiums and claims over the life of the block of underlying contracts. Typically, a scale of premiums is established that varies by duration of the underlying contract, and the durational pattern of the premium scale may differ from the expected shape of the pattern of claims (for a variety of commercial reasons), making pricing assessment of risks over the life of the underlying contracts fundamental.
c) part 2	The insurer has the right or the practical ability to reassess the risk of the portfolio the contract belongs to at the end of a 12 month or shorter period and, as a result, can set a price that fully reflects the risk of that portfolio.	T	It is possible for the experience on the business to be worse than would be covered by the guaranteed maximum premiums. Thus even under circumstances where the reinsurer may be able to reset the price of the coverage, it may not be able to reprice in a way that fully reflects the risk of that portfolio.
IFRS Duration Treatment*: Short			

*IFRS duration treatment is short duration if [*a) i)*] OR [*b)*] OR [*c) part 1 AND c) part 2*].

The name of the product is a misnomer in that the contracts are typically neither yearly nor renewable. In fact, the typical YRT agreement is meant to be a long-term relationship between the ceding company and the reinsurer. The main reason for the name is that the premium rates typically increase annually by age and duration from issue.

Product: Group Life or Long Term Disability (with a multi-year rate guarantee)			
U.S. GAAP Duration Treatment: Generally Short			
Criterion		T / F	Commentary
a) i)	The insurer is no longer required to provide coverage at the end of a 12 month or shorter period.	F	Although the insurer can terminate the coverage after expiry of the rate guarantee period, the rate guarantee period typically extends beyond the 12-month window.
b)	The insurer has the right or the practical ability to reassess the risk of the particular policyholder at the end of a 12 month or shorter period and, as a result, can set a price that fully reflects that risk.	F	Although the insurer can reprice the coverage after expiry of the rate guarantee period, the rate guarantee period typically extends beyond the 12-month window.
c) part 1	The pricing of the premiums does not include risks relating to future periods.	T	
c) part 2	The insurer has the right or the practical ability to reassess the risk of the portfolio the contract belongs to at the end of a 12 month or shorter period and, as a result, can set a price that fully reflects the risk of that portfolio.	N/A	
IFRS Duration Treatment*: Long			

*IFRS duration treatment is short duration if [*a) i)*] OR [*b)*] OR [*c) part 1 AND c) part 2*].

Most Group Life or LTD contracts carrying multi-year rate guarantees typically have no pre-funding aspect to them. The risk is generally thought to remain level over the rate guarantee period. Benefit reserves are not typically held on such contracts. Unearned premium reserves are often negligible on such contracts as well, as premium is often collected on a monthly or more frequent basis. If the 12-month limitation defining long versus short duration contracts were lifted, such contracts would seem to be determined to be short duration contracts under the IASB definition by virtue of the insurer no longer being required to provide coverage at the end of the contract period. This would allow such contracts to be accounted for similarly to Group Life or LTD products issued that don't carry rate guarantees, consistent with current practice.

In addition to causing different durational accounting for similar contracts within a portfolio, the current definition as worded could also cause different durational accounting for different renewals of the same contract. Many Group Life or LTD contracts may not be pro-actively renewed by the insurer when the multi-year rate guarantee expires, meaning the insurer allows the current rate inforce to be renewed annually when the case is running profitably. So, if an insurer had a contract with an initial 3-year rate guarantee and treats it as long duration, does that insurer switch to short duration accounting when it is within one year of the end of the guarantee? Would the insurer switch to short duration accounting if it does not set a renewal rate and has the monthly right to change rates?

Product: Universal Life Insurance			
U.S. GAAP Duration Treatment: N/A (Accounting Dictated by SFAS 97)			
Criterion		T / F	Commentary
a) i)	The insurer is no longer required to provide coverage at the end of a 12 month or shorter period.	F	So long as the policyholder account can fund the required Cost of Insurance (COI) and other charges, the policy remains in force and coverage is provided.
b)	The insurer has the right or the practical ability to reassess the risk of the particular policyholder at the end of a 12 month or shorter period and, as a result, can set a price that fully reflects that risk.	F	Not possible.
c) part 1	The pricing of the premiums does not include risks relating to future periods.	?	Depends on your definition of premium. Since premiums are flexible, the product pricing is mostly independent of the premium payment pattern; instead it is based on the charges made to the policyholder account. Those charges may follow the actual risk of the policy or may include some advance funding. For instance, while most policies have Cost of Insurance (COI) charges that increase with age, some have charges that are flat, thereby incorporating some advance funding. Still others will have increasing COI charges that do not follow precisely the pattern of mortality increases, thereby incorporating a lesser degree of advance funding than a flat pattern.
c) part 2	The insurer has the right or the practical ability to reassess the risk of the portfolio the contract belongs to at the end of a 12 month or shorter period and, as a result, can set a price that fully reflects the risk of that portfolio.	F	Insurers change interest rates regularly to reflect changes in the financial market. Those changes are at the portfolio level. Furthermore, the insurer can change COI and other charges to the policyholder account so long as they don't exceed any maximum charge under the policy. Because of these maximums, it's conceivable that the full risk cannot be reflected in those changes.
IFRS Duration Treatment*: Long			

*IFRS duration treatment is short duration if [*a) i)*] OR [*b)*] OR [*c) part 1 AND c) part 2*].