Contract boundaries under IFRS 17

[This article is one in a series of articles (which can be found here and here) published on behalf of the IFRS 17 CSM Working Party. Members are Antoon Pelsser, Asim Ghosh, Clarence Er, James Thorpe, Joanna Stansfield, Kruti Malde, Natalia Mirin (Deputy Chair), Richard Dyble, Rob Walton, Timothy Berry, Weihe Qin and Wijdan Yousuf (Chair).]

1. Introduction

The contract boundary for an insurance contract under IFRS 17 determines which cash flows should be included within the fulfilment cash flows, and hence the value of the CSM.

Many actuaries are familiar with the concept of contract boundaries from Solvency II. As with a number of other overlapping concepts between Solvency II and IFRS 17, there are differences in the details.

This article explores some of these differences, as well as identifying product features which may require judgement to determine the appropriate contract boundary under IFRS 17.

Whilst the article focuses on insurance contracts written, the contract boundary requirements apply equally to reinsurance. Please see an earlier article on reinsurance contract boundaries which considers some of the specific reinsurance points.

2. IFRS 17 v Solvency II

IFRS 17 defines the contract boundary as follows:

"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." (source: IFRS17.34)*

This definition seems to start from the preface that any possible future cash flow is inside the contract boundary, unless you can meet the high bar of the criteria to exclude.

In contrast, under a common interpretation of the Solvency II definition (see appendix for the definition), the burden of proof is on the entity to justify that cash flows are inside the contract boundary, particularly for unit linked business.

As a result of these differences, even though for many products / features the contract boundary will be the same for Solvency II and IFRS 17, there is potential for **longer** contract boundaries under IFRS 17, i.e. some cash flows that are outside the contract boundary for Solvency II, may be inside the contract boundary for IFRS 17.

3. Example: Unit linked regular premium workplace pension

To demonstrate some of the judgements that need to be made, and potential divergences from Solvency II, consider an example looking at a unit linked regular premium workplace pension. It should be noted that the assessment of contract boundaries will depend on the specific details of the products, consequently different conclusions could be drawn from those in this example.

Future regular premiums:

The first key question for contract boundaries for unit linked (UL) regular premium business is whether the future regular premiums are inside the contract boundary. Under Solvency II, future regular premiums are generally outside the contract boundary unless the entity can compel the policyholder to pay the premiums or there is an economically significant guarantee or death benefit. Unlike Solvency II, the IFRS 17 definition of contract boundaries does not differentiate explicitly between cash flows relating to paid and future premiums, we should therefore assess against the standard contract boundary requirements:

- **Substantive rights and obligations**: Whilst an entity doesn't have a substantive right to make policyholders pay future regular premiums, if premiums are paid then the entity likely has a substantive obligation to provide services related to those premiums[1]. Therefore, unless future regular premiums fall in scope of the IFRS 17 criteria for determining when a substantive obligation ends, then we can conclude that these future regular premiums, and the cash flows related to them, should be within the contract boundary.

- **IFRS 17 criteria for determining when a substantive obligation ends:**
    - **Practical ability to reassess risks at policyholder level**: unit linked product pricing tends to be done at fund level and hence limited practical ability to reprice at policyholder level.
    - **Practical ability to reassess risks at portfolio level**: this will depend on specifics of the product terms and conditions (T&Cs) and administrative options and therefore likely to vary by product and entity. This should also take into consideration any contractual charge caps applying.
    - **Risks related to future cash flows not included in pricing of premiums to date:** this could vary by entity and product, but it is common practise to allow for future regular premiums in initial pricing and hence this condition is unlikely to be met.

Conclusion: future regular premiums are likely to be inside the IFRS 17 contract boundary based on information contained in this example.

Increments:

Having concluded that future regular premiums are inside the contract boundary, it now remains to be considered whether future increases/decreases to those regular premiums should be inside the contract boundary, as well as other future premiums (such as single premium increments e.g. transfers in from another pension scheme). The drivers of increments into workplace pension schemes will vary, and could include salary increases, auto enrolment step ups, marketing campaigns to encourage transfers or pension savings. The contract boundary assessment could differ for these but entities will need to keep an eye on the practicability of applying any assessment.

Considering increments against the IFRS 17 contract boundary assessment criteria:

- **Substantive rights and obligations**: as for regular premiums, entities don't have a substantive right to make policyholders pay increments. The question is, therefore, whether the entity has a substantive obligation to accept if a policyholder wishes to increment their existing policy. This will require an assessment of the T&Cs to consider under what circumstances the entity can refuse or stop accepting increments. This may

[1] This is not necessarily the case so should be specifically assessed for specific product under consideration.

vary by product and by entity. Entities should also consider whether the policyholder expectations at sale, that the product will meet their financial needs, could create a substantive obligation (noting the Standard does not say “contractual right or obligation”). Typically for pension accumulation products, it could be argued that the ability to change premiums as policyholder circumstances (e.g. their salary) changes is fundamental to the contract meeting the policyholders’ financial needs and potentially creates a substantive obligation to accept future premium increases, irrespective of the T&Cs.

- **IFRS 17 criteria for determining when a substantive obligation ends:**
    - **Practical ability to reassess risks at policyholder level**: as above, there will be generally limited practical ability to reprice at policyholder level.
    - **Practical ability to reassess risks at portfolio level**: as above, this will vary by product and entity.
    - **Risks related to future cash flows not included in pricing of premiums to date:** this could vary by entity and product, but it is not uncommon to allow for future increments in pricing.

Conclusion: this will need careful consideration of the specifics of the product including how it is priced and administered. However, there is a reasonable possibility that some or all future increments to UL contracts will be inside the IFRS 17 contract boundary.

<u>Implications:</u>

Firstly let’s consider the impact on the CSM if the above cash flows are inside or outside the IFRS 17 contract boundary.

- Regular premiums and increments are inside the contract boundary:
    - Initial recognition: the CSM will be based on projected cash inflows and outflows which include best estimate expectations of the size and timings of future regular premiums and increments.
    - Subsequent recognition: as regular premiums and increments are received these will be included in the measurement of the CSM group of the original contract. Experience variances between the received and expected premiums/increments will arise. If these relate to future service then these will adjust the CSM.
- Increments are outside the contract boundary:
    - Initial recognition: the CSM calculation will not include projected cash inflows or outflows resulting from future increments.
    - Subsequent recognition: as increments are received, these should be recognised as new contracts, put into the relevant open cohort group at the time the increment is received and a new CSM recognised.

As a result of the above impacts, there could be a number of operational and commercial implications, e.g.

- SII differences: There is a high likelihood of different contract boundaries between SII and IFRS 17 for UL business.
- Operational:
    - changes to contract boundaries from IFRS 4 / SII will likely require developments to actuarial models.
    - If the conclusion is that some, but not all, types of increments are inside the contract boundary, data will required to enable increments to be allocated between those inside and outside the contract boundary – this data may not exist.
    - If additional cash flows are inside the contract boundary then:
        - New demographic assumptions may be needed, for example paid up rates and/or level of increments. These assumptions are likely to be highly judgemental and potentially material.
        - Additional experience variance analysis of the differences between expected and actual cash flows may be needed to correctly calculate the CSM at subsequent recognition.
    - If certain cash flows are not inside the contract boundary then:

        - Future premiums/increments will need isolating from the original contract for inclusion in the appropriate CSM group, Separating policies in this way could give rise to data and modelling challenges.
- Commercial:
    - If some increments are moved inside the contract boundary then this will change when new business is recognised and hence new business premium KPIs will be impacted. This change will need to be carefully managed internally and externally.
    - The Standard requirements will potentially result in contract boundaries more inline with pricing assumptions. This may reduce the risk of recognising loss making contracts.

4. Conclusion

The IFRS 17 contract boundary requirements differ from the SII requirements and therefore could result in entities having different contract boundaries for some products between the two metrics. Determining the contract boundaries under IFRS 17 will require significant judgement, taking into consideration a number of factors, including:

- Features and terms and conditions of products
- Any implied substantive obligations/rights arising from the features of the product or policyholder needs it is meeting
- Pricing practices
- Administrative practices

Changes to contract boundaries could have far reaching operational and commercial implications which will need careful consideration.

5. Appendix

The key text of the Solvency II contract boundary regulations is given below for reference *(source: Solvency II Delegated Authority, Article 18, paragraphs 2-5):*

"All obligations relating to the contract, including obligations relating to unilateral rights…to renew or extend the scope of the contract and obligations that relate to paid premiums… unless otherwise stated…[in later paragraphs].

Obligations which relate to… cover provided… after any of the following dates do not belong to the contract, unless the undertaking can compel the policyholder to pay the premium for those obligations:

a) the future date where the insurance or reinsurance undertaking has a unilateral right to terminate the contract;
b) the future date where the insurance or reinsurance undertaking has a unilateral right to reject premiums payable under the contract;
c) the future date where the insurance or reinsurance undertaking has a unilateral right to amend the premiums or the benefits payable under the contract in such a way that the premiums fully reflect the risks.

Obligations that do not relate to premiums which have already been paid do not belong to an insurance or reinsurance contract, unless the undertaking can compel the policyholder to pay the future premium, and where all of the following requirements are met:

(a) the contract does not provide compensation for a specified uncertain event that adversely affects the insured person;
(b) *the contract does not include a financial guarantee of benefits." (source: Solvency II Delegated Authority, Article 18, paragraphs 2-5)*

[END]

Disclaimer: The views expressed in this publication are those of invited contributors and not necessarily those of the Institute and Faculty of Actuaries. The Institute and Faculty of Actuaries do not endorse any of the views stated, nor any claims or representations made in this publication and accept no responsibility or liability to any person for loss or damage suffered as a consequence of their placing reliance upon any view, claim or representation made in this publication. The information and expressions of opinion contained in this publication are not intended to be a comprehensive study, nor to provide actuarial advice or advice of any nature and should not be treated as a substitute for specific advice concerning individual situations. On no account may any part of this publication be reproduced without the written permission of the Institute and Faculty of Actuaries.