TREATMENT OF MEDEX RENEWAL PREMIUMS UNDER IAS.

Introduction

This note has been prepared by the Health and Care Committee of the Society of Actuaries in Ireland. It concerns the treatment of renewal premiums for medical expenses insurance ("Medex") under Phase II of the Insurance Project of the IASB. Our concern is that under some circumstances, such business might be regarded as requiring all future renewals to be taken into account. We believe that this could give rise to misleading results.

We set out the issues and proposed treatment by the IAS and suggest a revision, which we think, would resolve the issue without undermining the intention of the IASB.

This note has been issued with the approval of the Council of the Society of Actuaries in Ireland.

Definition.

We are concerned with the treatment of medical expenses insurance ("Medex"). That is insurance which reimburses the insured for medical expenses paid in respect of treatment received (or pays the medical cost directly to providers, or arranges for the treatment at the expense of the insurer). It is most notably different from Critical Illness insurance or Hospital Cash products, which have fixed lump sums payable on certain medical events, in that the benefit it provides is indemnity of loss.

The form this business takes varies significantly by country of cover as it interacts (inter alia) with the national public health care systems.

It is usual however (and certainly the case in the UK and Ireland) for the accounting to be the same as non-life insurance i.e. each year's premium is treated separately and a unearned premium reserve set up.

Proposals for Accounting Treatment.

The IAS treatment of future premiums under any given insurance policy will depend not on the classification of the type of insurance (e.g. between life and non-life) but on the nature of the risk and the relationship between insurer and insured.

The DSOP stated the following as Principle 4.2

> *"4.50 …cash flows …should include cash flows from future renewals to the extent and only to the extent, that:*
>
> *(a) their inclusion would increase the measurement of the insurer's liability or*
>
> *(b) policyholders hold uncancellable options that are potentially valuable to them*
>
> *4.51 A renewal option is potentially valuable if and only if there is a reasonable possibility that it will significantly constrain the insurer's ability to reprice the contract at rates that would apply for new policyholders who have similar characteristics to the holder of the option"*

The Basis for Conclusions in ED5 (BC6 (d))contains the following

> *"….should include future premiums….if, and only if:*
> *(i) policyholders hold uncancelleable continuation or renewal rights that significantly constrain the insurer's ability to reprice the contract to rates that would apply for new policyholders whose characteristics are similar to those of the existing policyholder; and*
> *(ii) these rights will lapse if the policyholders stop paying premiums"*

<u>Ability to reprice</u>
There are several different reasons why an insurer would wish to charge an existing policyholder more if he/she were a new policyholder than the current renewal premium:

(a) Charges under a policy may be explicit (in an unbundled contract) and may be higher at the start of a contract
(b) The insured risk may have experienced deterioration of individual risk characteristics (notably, for life insurance, deterioration of health), yet under the existing policy no allowance could be made for this
(c) As (c) above, but the group/class characteristics may have changed.
(d) There may be select period effects, whereby due to risk selection by insurers (underwriting), the new entrant risk may have better characteristics than the existing insured.
(e) Risk rates may be age-at-entry based.

Examples
Term insurance would exhibit features b,c,d and e.
Motor insurance would normally exhibit none of these (leaving the "no claims discount" aside)

<u>Applicability to Medex</u>
In Ireland Medex is, at present, characterised by community rating. This "general good" requirement imposed by statute is that a Medex company may not differentiate its price for Medex by age or sex. Entry is open save only for waiting periods and selection on grounds of pre-existing conditions.

It would appear that the only potential option value that applies is (b). The only circumstances in which the insurance company could offer different terms to an existing policyholder if he/she were a new entrant is where the policyholder has developed medical conditions that he/she did not have when the cover was effected. This may indeed be important: if somebody is seriously ill, then renewal on normal terms is extremely valuable. Please note that although premiums may be revised for everybody in a benefit class, individual existing policyholders may not be charged more for the same benefit.

However this is complicated by the right to transfer to another company, another general good provision. So this valuable option applies to the policyholders in poor health against the industry as a whole, though in practice sick people rarely switch insurer.

It should perhaps be mentioned that open entry is restricted to a maximum age, so older people also hold a valuable option, paying premiums much less than the actuarially correct premium.

In the UK, where community rating is not usual, the individual option is definitely against a specific company.

A further complication may arise if entry age pricing is introduced, as is the intention of the Irish authorities. This would mean that the policyholder would be charged a premium based on the age that they first started paying premiums to any company. This would not involve actuarial funding being built up from early premiums but relates more to the concept of social justice in premium payment.

It seems fairly clear that our examples of term insurance and motor insurance fall clearly into defined positions. Medex however has some option value but only a contingent one and applying to individuals not to classes. Furthermore, the pricing of premiums can allow specifically for these unfortunates in poor health (provided they are existing policyholders) by spreading their extra claims across the healthier lives.

Consequences of including Renewal Premiums.

The implications of including renewal premiums would be to severely distort the true earnings experienced in the measurement period. The premiums are not fixed in advance and may, subject to community rating, be increased freely. To project in future renewals would increase subjectivity on a substantial scale.

It should also be borne in mind that Medex inflation can be severe, possibly higher than a normal discount rate. This means that assumptions about future premiums and claims will far outweigh current year experience.

Proposal

We believe that it is not the IASB's intention to bring future premiums into account for Medex. We would ask that this be made specific. This could be done by mentioning this particular case in the Implementation guidance.

Alternatively the wording could be amended to deal specifically with the case where option values are

(a) only present at the individual level
(b) contingent, and
(c) reclaimed from future premiums of others in the same class

In such a case we believe a more appropriate treatment is to leave future premiums out of account.

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