Premium Allocation Approach - Complexities of Simplification Under IFRS 17

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As a key tenet of IFRS 17, the insurance industry’s new accounting standard, the Premium Allocation Approach (PAA) is designed to simplify the accounting process for certain types of contract. But what complexities must you consider when adopting the PAA?

The building block approach – how does the PAA fit in?

IFRS 17 breaks down insurance contracts into four "building blocks": future cash flow, time value of money, a risk adjustment measure of non-financial risk, and a contractual service margin that represents any profit expected from fulfilling the contract. Essentially, IFRS 17’s General Measurement Model (GMM) requires you to account for these building blocks by calculating each item separately and releasing it at the appropriate, possibly different, rate over time.

The PAA allows you to simplify the GMM by releasing all elements at a single, assumed rate. Critically, however, you can only apply the PAA to liabilities for remaining coverage – and not liabilities for incurred claims.

Which types of contract accommodate the PAA?

The PAA was primarily conceived for short-term contracts of one year or less, over which time a single rate of release would make no significant impact on the balance sheet. Now, the PAA’s potential use has been extended to any group of contracts for which a GMM or PAA calculation would yield a similar result. This in turn depends on the respective release rates of the building blocks and the significance of the non-cashflow components.

While results are unlikely to be similar when there is significant variability in fulfillment cash flows, a consensus is yet to emerge on how significant the variability could be to still allow the PAA. At this time, there is also no consensus among companies and advisers on the extended use of PAA.

What is clear is that the PAA can be applied to direct written and ceded reinsurance – and, even more importantly, both life and non-life contracts. Although non-life business more often covers shorter terms, life insurers also offer group protection and multi-year contracts for a year or less at a time on a renewable term basis.

So, subject to proof of eligibility, you could also apply the PAA to single premium contracts that last longer than a year, or multi-year regular premium contracts. And there would appear to be good reason to do so, with some insurers believing that the sheer simplicity of the PAA will reduce the calculations needed as well as the governance, data management and process requirements.

This belief, however, is wishful thinking. When a contract is onerous, you will always need to make an appropriate GMM calculation, while governance, data management and process requirements remain the same for both the GMM and PAA. And where your business also includes contracts not subject to the PAA, the additional burden of maintaining, and explaining, two calculation methods may outweigh the advantages achieved.

PAA isn’t just UPR

Calculating the liability for remaining coverage under PAA may seem similar to making traditional Unearned Premium Reserve (UPR) calculations. But the essence of the PAA calculation is actually very different.

UPR calculations often take the premium receivable and assess the unearned proportion prospectively. By contrast, the PAA takes a transactional, effectively retrospective approach – premium received less insurance revenue for the period to date (based on expected premium receipts and the assumed pattern of exposure emergence, passage of time or other measure). Here, there are also data management challenges to consider, as balances are carried forward between reporting periods to facilitate subsequent measurements.

While the UPR approach is commonly used in non-life business already, it may be a new concept for life insurers looking to adopt the PAA. So, the latter may need to make additional adaptations to their systems to manage the PAA.

It’s also worth noting the difference between "premium receivable" in UPR calculations, and "premium received" under IFRS 17 and the PAA. Using these terms interchangeably could cause challenges for some policy and financing systems. Additionally, robust transactional-based calculations, and hence stronger systems, may be needed to support PAA calculations as opposed to UPR calculations.
What if significant financing is involved?

When insurance contracts in the group have a significant financing component, the PAA requires you to adjust the liability for remaining coverage according to the time value of money. That means using the standard IFRS 17 discount rates you determined on initial recognition, which therefore won’t change over the term of the contract. Any adjustments in this case will take the form of the accretion and addition of interest to the liability over time – effectively the unwinding of a discount rate.

Significant financing components may correspond to whether discounting has been applied in the premium rating basis or not. But when future investment income is assumed, in part, to meet future liability cashflows, there is more likely to be a significant financing component.

The IFRS 17 assessment of significant financing, however, could lead to a mismatch between accounting and premium rating bases.

Unit of measurement grouping

Under IFRS 17, there is a specific grouping of contract rules for separately managed portfolios, onerous or not, and underwriting cohorts. Once allocated, an individual contract must remain in the same group throughout its exposure and settlement term.

This stipulation can increase the data provision and management burden, by requiring you to allocate and store IFRS 17 group mappings by individual contracts and allocate individual cashflow items to the same group. As a result, you will need a robust, granular and persistent data store that will potentially stretch and challenge existing capabilities.

Calculating insurance revenue

Under IFRS 17 and the PAA, insurance revenue equates to the premium receipts expected for the period, typically evenly spread over time. If, however, the release of risk during the coverage period follows a different pattern, you should use the expected timing of incurred insurance service expenses as the basis.

Expected premium receipts may be more variable for some contracts, such as when adjustment or audit premiums are payable following expiry of cover, to reflect actual exposure levels. Another example would be contracts with multiple premiums payable, which can lapse and therefore make the total premium level uncertain at the outset.

In all cases, financial and actuarial systems will need to be in place to correctly assess expected premium receipts and the effects of finance components and revenue amortization.

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What happens with onerous contracts?

IFRS 17 defines a contract as onerous when the PAA liability for remaining coverage is not sufficient to meet the expected fulfillment cashflows – and must therefore be increased to the higher amount.

Guidelines only recommend checking for onerous contracts when facts and circumstances indicate there is a problem, but it remains to be seen how insurers interpret this suggestion in practice. Making checks every period might be safer and potentially wouldn’t require additional system development.

For multi-line insurers, a single platform would allow you to share the measurement models for long-term contracts across all insurance business. Why reinvent the wheel when one general model calculation could work for most contracts, with PAA applied when justified?

So, even where PAA is applied, a process and system may still be needed to calculate the GMM approach alongside it.

The impact on incurred claims

Although the PAA only applies to liabilities for remaining coverage, it can help simplify the treatment of liabilities for incurred claims. Specifically, if you use the PAA and all the claims are “expected to be paid within one year” of their incurrence, they need not be discounted under the GMM.

But what does “expected to be paid” mean? And what precise proportion of claims are we talking about here – strictly all of them, the vast majority, or at least 50 percent? Or will a weighted average payment term of a year or less be sufficient?

But how will you calculate the risk adjustment for incurred claims under the GMM approach? Will you use shock-based projected cash flows – or a cost of capital approach? And if so, can your actuarial systems do this already?

In any case, liabilities for incurred claims still have all the implied locked-in discount rates, financing effects, disclosure requirements, detailed journal entries and so on. Consequently, there may still be a step change in the volume of information that is passed to finance for short-term business, regardless of whether the calculations appear largely the same.
Recognizing acquisition costs

Under the PAA, you can choose to recognize any insurance acquisition cash flows as expenses. However, that’s only possible if the coverage period of each contract in the group is a year or less at initial recognition. The alternative is to amortize the expenditure – but only by passage of time.

Changes to disclosures

The intent of disclosures remains the same under IFRS 17, namely to help assess how a contract will affect the entity’s financial position, financial performance and cash flows. Applying the PAA to remaining coverage, though, makes certain disclosures unnecessary, mainly those relating to the building block split components that no longer need to be calculated.

But disclosures are still required – and simplified disclosures for PAA only apply to remaining coverage and not incurred claims. For both, calculating end-of-period amounts is only part of the answer; you must also report sufficiently on transactions over the period and component splits.

Governance, data and process challenges

Regardless of whether you’re using the GMM or the PAA, you still need to establish appropriate levels of governance, including strict controls, auditability and evidence, and robust, efficient systems and processes. You will also need suitable data management capability for allocating individual policies to a specific group of contracts for the entirety of their term, both for remaining coverage and incurred claims.

Additionally, you’ll need room – and the automated ability – to store data on actual transactions and opening balances by the same grouping of contracts, while making sure that actuarial and finance systems are connected.

In short, adopting the PAA in no way reduces the need for improved governance and data management processes under IFRS 17.

Get business value from IFRS 17

Overall, it’s critical that insurance companies look at IFRS 17 from an enterprise-wide perspective and build a solution that works for all their business segments – life, non-life and health. In practice, however, we’re still seeing business lines and functions operate in silos, resulting in duplicated effort and inefficiencies.

The more positive news is that many leading insurers are waking up to the fact that they can gain considerable business value from achieving more than minimum compliance. With modernized systems and strong, efficient and well-governed processes, these firms are better equipped to meet the modern requirements of today and tomorrow, while improved automation reduces costs and operational risks.

Above all, insurers are finding that a single, end-to-end platform for financial reporting will make it easier to manage the balance sheet under IFRS 17. And that puts them in a stronger position to both exploit the simplicity of the PAA – and handle its distinct complexities.

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