Premium Allocation Approach (PAA)

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Background

1997: International Accounting Standards Board started with the project on reporting for insurance contracts.

2007: Discussion paper with preliminary views on insurance contracts was issued.

2010: Exposure drafts

2017: IFRS 17 released

Insurance Contract

IFRS17 applies to insurance contracts. An insurance contract is defined as follows:

A contract under which one party (the issuer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder.

Insurance risk is defined as risk, other than financial risk, transferred from the policyholder to the issuer of the contract.

An insurer must separate features that are not considered insurance for example,

- Derivatives which are embedded
- Investment components
- Goods or non-insurance services

Objectives

- **Consistent Practices**: Establishes uniform accounting standards globally.
- **Comparability:** Enables comparison of financials across entities and regions.
- **Enhanced Disclosures:** Provides detailed insights into insurance contract profitability.
- **Revenue Alignment:** Aligns revenue with the provision of services, similar to other industries.

Level of Aggregation

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The starting point of aggregating contracts is to identify portfolios of insurance contracts. A portfolio comprises of contracts that are subject to similar risks and are managed together.

IFRS17 then requires an entity to divide the contracts in each portfolio on initial recognition into the following groups:

- Contracts that are onerous at initial recognition
- Contracts that have no significant possibility of becoming onerous subsequently
- Remaining contracts (if any)

Level of Aggregation

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100 'identical' contracts are written with a probability that 5 of the policyholders will claim.

100 contracts are a group. The company does not treat the 5 contracts as a separate group.

A company issues 500 contracts; there is information that 200 identical' contracts are onerous (loss making), but the company expects that the 300 profitable identical' contracts will cover losses on the 200 onerous contracts.

Losses on the 200 onerous contracts are recognized immediately.

Group A

Profits on 300 contracts recognized over the coverage period.

Group B

Measurement Models

The three methodologies under IFRS17 are the General measurement model, the premium allocation approach and the variable fee approach

GMM

- Default model for all insurance contracts
- Mandatory

PAA

- To simplify for short term contracts with little variability
- Optional

Measurement Models

The premium allocation approach (PAA) can be used in the following two cases:

- Coverage period at initial recognition is one year or less.
- It would be a reasonable approximation to GMM when coverage period at initial recognition is more than one year.

Otherwise, the General Measurement Model (GMM) needs to be used.

Insurance Service Revenue

Insurance revenue for the PAA is the amount of expected premium receipts allocated to the period based on the pattern of expected timing of incurred insurance service expenses.

For health insurance products, revenue must be earned allowing for the same seasonality pattern as claims.

The $1/365^{th}$ method of premium earning can be used as an approximation to calculate earned premium (EP) and unearned premium reserve (UPR).

Insurance Service Revenue

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Income Statement	Amount
Gross Written Premium	4,800
UPR – Beginning of the year	2,300
UPR – End of the year	(2,700)
Insurance Service Revenue	**4,400**

Insurance Service Expenses

The insurance service expenses include:

- Gross paid claims
- Adjustments to liability for incurred claims (LIC): It relates to Fulfillment Cash Flows (FCFs) for claims and expenses that are incurred and not yet paid including Risk Adjustment (RA) margins.
- Acquisition and Attributable expenses
- Losses and reversal of losses (onerous contracts)

Future Cash Flows (FCFs)

This is the present value of expected cash flows which includes claims and expenses adjusting for the time value of these cash flows. These need to be presented on a best estimate basis and a risk adjustment needs to be shown separately.

Estimates of cash flows should be:

- current and consistent
- explicit
- reflective of all reasonable and supportable information available without undue cost or effort;

Discounting Adjustment

These requirements reflect the desired characteristics of the discount rates:

- Reflect the time value of money;
- Reflect the characteristics of the cash flows and the liquidity characteristics of the insurance contracts;
- Exclude factors that do not reflect on the characteristics of cash flows, such as credit risk;
- Be consistent with current market rates;

Risk Adjustment (RA)

- This reflects the compensation required by the entity for assuming the uncertainty with respect to the amount and timing of the cash flows
- It is an explicit component of the fulfilment cash flows and disclosed as a separate liability on the balance sheet.
- The scope of the risk adjustment only includes non-financial risks. The RA would exclude financial risks, such as investment returns.
- The risk types that could be included in the RA for Health Insurance are:
  - Lapse/Withdrawal (including due to death)
  - Morbidity/Claims
  - Expenses (Only directly attributable expenses)

Non-Acquisition expenses

- Expenses are considered 'directly attributable' if they can be attributed to a portfolio, even though they may not be directly attributable to individual or groups of insurance contracts. For example, insurance contract maintenance costs, claims settlement costs, etc.

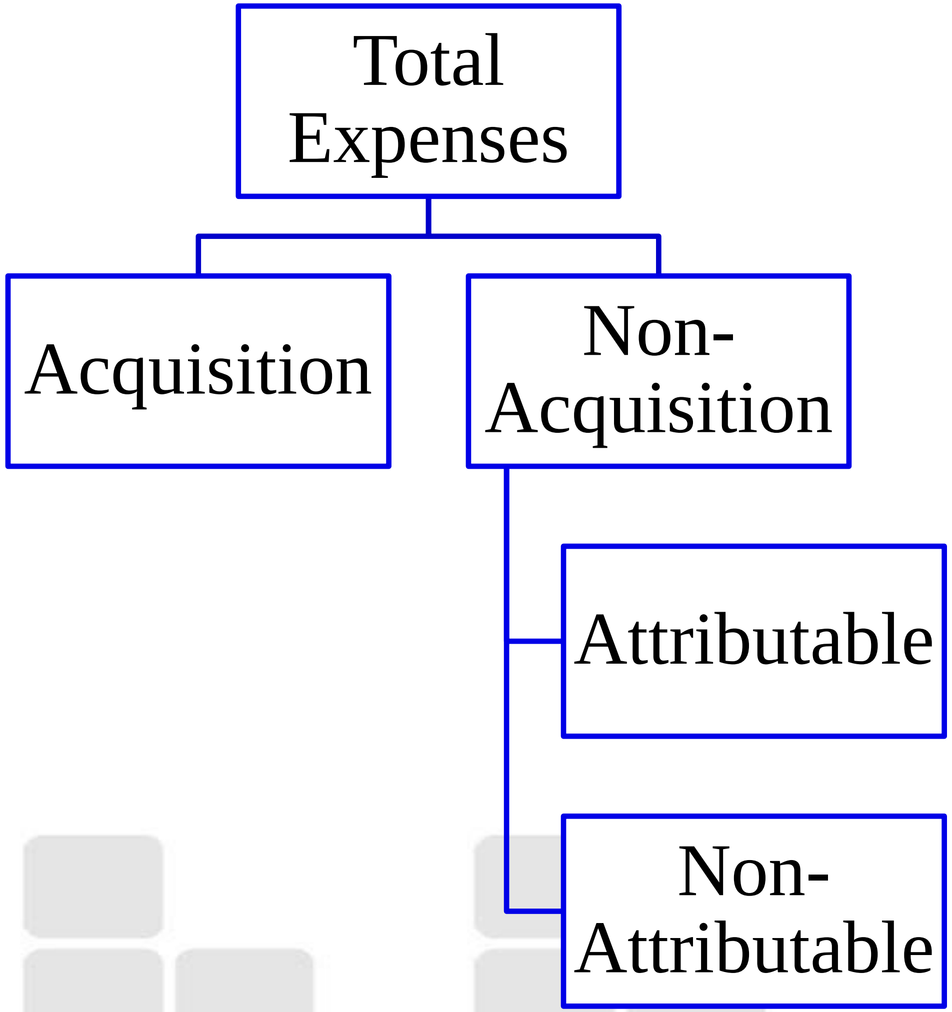
- Expenses are considered 'non-attributable' if they cannot be attributed to a portfolio, For example Salaries of product development Actuaries, Brand marketing which is not product specific, Investment management expenses, etc.

Acquisition expenses

- Acquisition expenses are cash flows arising from the costs of selling, underwriting and starting a group of insurance contracts. Examples include:
  - costs related to pricing activities.
  - costs associated with policy issuance or renewal.
  - costs related to sales and distribution, including salaries, commissions and agency costs.

- Deferred acquisition costs (DAC) are the acquisition expenses that are to be amortized against contracts written in the future.

Expenses


Total Expenses
Acquisition
Non-Acquisition
Attributable
Non-Attributable

Expenses

- Total Expenses
  - Acquisition
  - Non-Acquisition
    - Attributable
    - Non-Attributable

Loss Component

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- The loss component (LC) is the amount recognized when the present value of the expected future cash outflows (claims and expenses) for an insurance contract exceeds the sum of the present value of expected future cash inflows (premiums).
- Calculation:
  - Estimate the expected future payments for claims and expenses related to the insurance policies.
  - Estimate the expected earnings of premiums from policyholders.
  - Adjust for Time Value of Money: Discount these cash flows to their present value using an appropriate discount rate.

Insurance Service Expense

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Income Statement	Amount
Gross Claims Paid	1,800
Change in LIC PVFCF and RA	350
Acquisition and Attributable Cost	950
Loss Component	900
Insurance Service Expense	**4,000**

Insurance Service Result

Income Statement	Amount
Insurance Service Revenue	4,400
Insurance Service Expense	4,000
Insurance Service Result	**400**

- The insurance service result is gross of reinsurance.
- Income or expenses from reinsurance contacts held need to be presented separately from the income and expenses of the insurance contacts held.

Allocation of Reinsurance Premiums

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- As per the current accounting regime, the total reinsurance (RI) premium ceded is accounted for as an expense. Under IFRS17, this is separated into the following components:
  - Non-distinct Investment Component (NDIC): Separates investment components that are not contingent on insured events.
  - Reinsurance Commission: Commissions received from reinsurers.
  - Reinsurance Expensed: Total premium ceded less NDIC and reinsurance commission.

Reinsurance Service Expense

Income Statement	Amount
Reinsurance Premium Expensed	200
RI UPR – Beginning of the year	100
RI UPR – End of the year	(125)
RI Service Revenue	**175**

Reinsurance Recovery

Income Statement	Amount
Claims Recovered	100
Change in AIC PVFCF and RA	40
Loss Recovery Component	30
Recoverable from reinsurers	**170**

AIC = Assets for Incurred Claims

Reinsurance Result

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Income Statement	Amount
Reinsurance Service Expense	175
Reinsurance Recovery	170
Reinsurance Result	**5**

Net Insurance Result

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Income Statement	Amount
Insurance Service Result	400
Reinsurance Result	(5)
Net Insurance Result	**395**
Interest on PVFCF, RA, LC	(10)
Non-Attributable Expenses	(50)
Operating Profit	**335**

Any Questions?

Thank You