Premium Allocation Approach Working Paper

Version	Date	Comments
0.1	04 Jun 2019	Initial Version
0.2	18 Jul 2019	Second draft version
0.3	28 Aug 2019	Third draft version
1.0	24 Oct 2019	Formatting Changes First circulation

This IFRS17 Working Paper aims to facilitate discussion among actuaries and other stakeholders to capture the range of opinions on the application of IFRS17 in the Singapore context and are not meant to serve as mandatory practice notes.

Any interpretation of IFRS17 set out in this Paper represents a plausible treatment given the text of IFRS17. However, it shall neither be construed as the only possible treatment nor the agreed interpretation for Singapore insurers. Users of this Working Paper shall be mindful that differences in the exact fact pattern and operating context facing each insurer may drive different interpretations. Users shall also be mindful that for the same fact pattern and operating context, there is scope for the substance of same transaction to be articulated differently depending on how the transaction is analysed. (For example, in substance, cash flows from a call option with strike price $X on an asset is equivalent to the combined cash flow from the underlying asset and a put option with strike price $X on the asset, less cash of $X.) Differences in articulation can give rise to a range of plausible treatments. An insurer remains responsible for justifying its choice of treatment after discussion with its auditor. Opinions expressed in the working papers are not representative of that of the Singapore Actuarial Society.

Table of Contents

1. IFRS17 Standards

The IFRS17 Premium Allocation Approach ("PAA") for insurance contracts is described in paragraph 53 to paragraph 59 of the Standard. This paper intends to discuss interpretation of the Standard and its application to the most common insurance contracts in the Singapore market.

Paragraph 53 describes that the PAA is a simplified approach to measure the liability for remaining coverage. It can be adopted if the following conditions are met:

a) the entity reasonably expects that such simplification would produce a measurement of the liability for remaining coverage for the group that would not differ materially from …; or
b) the coverage period of each contract in the group … is one year or less.

Paragraph 55 spells out the component of liability for remaining coverage at initial recognition and subsequent measurement.

a) on initial recognition, the carrying amount of the liability is:
   (i) the premiums, if any, received at initial recognition; ….

Paragraph 57 & 58 specify that if at any time during the coverage period, facts and circumstances indicate that a group of insurance contracts is onerous, an entity shall immediately recognize a loss by increasing the liability for remaining coverage which is equal to the difference between:

a) the carrying amount of the liability for remaining coverage determined applying paragraph 55; and
b) the fulfilment cash flows that relate to remaining coverage of the group, …

If the PAA is adopted, insurance revenue for the period is equal to the amount of expected premium receipts allocated to the period. **Paragraph B126** stipulates the approach of premium allocation to each period of coverage:

a) on the basis of the passage of time; but
b) if the expected pattern of release of risk during the coverage period differs significantly from the passage of time, then on the basis of the expected timing of incurred insurance service expenses.

The following paragraphs are not covered in this paper, as they are straightforward and have limited room for interpretation, or are less relevant in the context of Singapore's insurance business environment:

- Paragraph 54 stipulates that the criterion in paragraph 53(a) is not met if at the inception of the group an entity expects significant variability in the fulfilment cash flows, for example due to the presence of embedded derivatives or length of the coverage. Generally, given the short-term nature of the contracts, it is very unlikely to have significant variability in the fulfilment cash flows. Short-term contracts are also very unlikely to be priced with embedded derivatives.
- Paragraph 56 talks about the need to adjust the carrying amount of the liability for remaining coverage to reflect the time value of money and the effect of financial risk if significant financing component is present. In general, short-term contracts are not expected to have significant financing component. Likewise, the pricing of short-term contracts is unlikely to consider the time value of money in liability due to its immaterial impact.
- Paragraph 59 describes the choice to recognize any insurance acquisition cash flows as expenses when it incurs if the coverage period is no more than one year, as well as the use of the General Measurement Model ("GMM") for the liability for incurred claims.

In addition, paragraph 69 and 70 specify that an entity may use the PAA approach to simplify the measurement of a group of reinsurance contracts held, subject to the similar criteria as discussed above. For example, coverage period is one year or less, PAA is a reasonable approximation to the GMM, etc. Please refer to SAS paper "Reinsurance Contracts" for more details.

2. Interpretation of Standards

Paragraph 53(a)

The PAA can be adopted automatically for contracts with a coverage period of one year or less. The use of PAA is optional. This criterion is clear and straightforward in the Standard.

Note that the PAA can only be used to measure the liability for remaining coverage. The liability for incurred claim should still be measured by the GMM. Also, the PAA is similar to the commonly practiced Unearned Premium Reserve ("UPR") methodology, while having a few key differences which will be discussed below.

Paragraph 53(b)

For contracts with a coverage period of more than one year, an entity can apply the PAA only if the liability for remaining coverage produced by the PAA would not differ materially from the one that would be produced by the GMM. In other words, PAA must be a reasonable approximation to the GMM.

Although the Standard does not explicit specify the need for a test to prove that the PAA is a reasonable approximation to the GMM, reasonable validations should be conducted to satisfy the Standard as well as potential audit requirements. The complexity and frequency of validations will depend on company-specific factors and circumstances, and it may necessitate parallel run and sensitivity analysis to justify that the PAA is a reasonable approximation to the GMM, in terms of both liability for remaining coverage and profit patterns. Nonetheless, judgement is still required in setting the materiality threshold and frequency of review.

In the April 2019 Transition Resource Group ("TRG") meeting, Agenda Paper 02 discussed about whether an entity is required or permitted to reassess a contract's eligibility for the PAA and as a result to revoke its election to apply the approach. The Board opined that given the PAA eligibility criteria are assessed at inception, the standard does not require or permit reassessment of the eligibility criteria or the election to apply the approach. This implies that once the PAA eligibility criteria are met and elected for insurance contracts, the insurers are expected to continue applying the PAA approach for these contracts until they run off, given the short-term nature of these contracts.

Paragraph 55

According to paragraph 25, an entity shall recognize a group of insurance contracts it issues from the earliest of the following: (a) the beginning of the coverage period of the group of contracts; (b) the date when the first payment from a policyholder in the group becomes due; and (c) for a group of onerous contracts, when the group becomes onerous.

In the context of Singapore's short-term insurance contracts, the coverage date and first premium due date usually occur on the same day, but actual premium may not be received on time. This means that there could be situations where the coverage of an insurance contract has already commenced, and the insurer is required to measure the liability of the contract while actual premium has been invoiced but not received yet.

This phenomenon is not uncommon currently, due to the insurer's operational efficiency and occasionally business considerations. Typically, if the insurer has reasonable grounds to believe that the actual premiums will be received in due course, the insurer will recognize a premium receivable and use this information to assess the unearned proportion of premium and to set up UPR accordingly.

Under the PAA approach, "premium received" should be used to measure the liability for remaining coverage. In the Exposure Draft - Amendments to IFRS 17 issued in June 2019, it was mentioned in the Basis for Conclusion that some stakeholders suggested that it would be easier to apply those requirements (for PAA calculation) if they referred to premiums receivable instead of premiums received. The Board disagreed with the suggestion to amend the requirements in paragraphs 55(a)(i) and 55(b)(i) of IFRS 17 to refer to premiums receivable because such an amendment would result in the premium allocation approach no longer meeting its objective of approximating the general model. In order words, the PAA takes a transactional and cash approach, instead of an accrual approach widely adopted by the insurance industry in the computation of UPR currently.

Please refer to the example below which shows the accounting treatment when premium is received upfront (i.e. on time) and received after the commencement of coverage period. This example demonstrates that the timing of premium receipts do not directly affect the revenue recognition applying the PAA.

- An entity issues an insurance contract on 1 July 2022
- The coverage period is 1 year (i.e. from 1 July 2022 to 30 June 2023)
- The premium charged is $1,200.

i. Premium received upfront

Reporting Date	1/7/2022	30/9/2022	31/12/2022	30/4/2023	30/6/2023
Opening balance	0	(1,200)	(900)	(600)	(300)
55(a)(i) Premium received on initial recognition	(1,200)				
55(b)(i) Premium received in the period					
55(b)(v) Insurance revenue applying B126		300	300	300	300
Closing balance of insurance contract asset/(liability)	(1,200)	(900)	(600)	(300)	0

ii. Premium received at the end of the coverage period

Reporting Date	1/7/2022	30/9/2022	31/12/2022	30/4/2023	30/6/2023
Opening balance	0	0	300	600	900
55(a)(i) Premium received on initial recognition					(1,200)
55(b)(i) Premium received in the period					
55(b)(v) Insurance revenue applying B126		300	300	300	300
Closing balance of insurance contract asset/(liability)	0	300	600	900	0

** This example was included as an Appendix to Agenda Paper 6 discussed at the 2 May 2018 TRG meeting. It was simplified for illustration purpose in this working paper.*
https://www.ifrs.org/-/media/feature/supporting-implementation/ifrs-17/premium-allocation-approach-example.pdf

Paragraph 57 and 58

In addition, the Standard specifies that if facts and circumstances indicate that a group of insurance contracts measured under the PAA becomes onerous during any coverage period (i.e. the carrying amount of liability under the PAA approach is not sufficient to cover the expected fulfillment cashflows), an additional liability must be set up and a loss is immediately recognized. The additional liability should be calculated as the difference between liabilities calculated by the GMM and the PAA. In other words, the GMM model must be used to measure the liability for remaining coverage if a contract is onerous.

Again, significant judgement would be exercised in determining what constitutes "facts and circumstances indicate that a group of contracts is onerous". In order to assess this objectively, it is advised to develop a methodology to regularly monitor the experience and expected profitability of each group of insurance contracts. One possible approach is to leverage on the current monitoring of unexpired risk reserve ("URR"), as Singapore regulations require premium liabilities to be equal to the maximum of URR and UPR.

Also, it should be noted that the GMM is still the default model and the use of the PAA is optional. Therefore, if there are some contracts within a portfolio which are not eligible for the PAA, it would create operational challenges where the PAA is used for part of the portfolio and the GMM is used for the rest. Thorough considerations should be given to this and whether it would be more tenable to just adopt the GMM for all contracts within the portfolio.

Paragraph B126

Lastly, the premium allocation to each period is based on the passage of time. This is similar to the UPR methodology. Nonetheless, if the pattern of the release of risk is materially different from the passage of time, premium allocation to each period should instead be based on the timing of incurred insurance services expenses (i.e. claims). An entity shall change the basis of allocation as necessary if facts and circumstances change.

Also, in the September 2018 TRG meeting, Agenda Paper 04 covered how differences between expected premiums and actual premiums (i.e. premium experience adjustments) which relate to current or past service should be accounted for. TRG members discussed and observed that the requirements in paragraph B126 apply to expected premium receipts, including premium experience adjustments.

Based on the discussion, it is not necessary to differentiate premium experience adjustments relate to past/current or future service for the PAA approach. The requirement only applies to the GMM where adjustments would be made to CSM if they relate to future service.

Operationally, premium experience adjustments for the PAA should be reflected in 55(b)(i), which would increase/decrease the carrying amount of liability for remaining coverage and subsequently result in higher/lower premium allocation and thus insurance revenue for the remaining period of coverage.

3. How it applies to Singapore

The assessment below is based on the common features of short-term products sold in Singapore which are more likely to meet the eligibility criteria of the PAA. There could be other products which have other features that could change the assessment results. There could also be other contract-specific circumstances for which the assessment below may not apply.

General and Group Insurance	53(a)	Most of the insurance contracts have a coverage period of one year or less, which automatically qualify under the PAA.
	53(b)	Some general insurance contracts might have a coverage period of more than one year, for example maid insurance typically last for two years. Test on whether the PAA is expected to produce a reasonable approximation to the GMM is required, especially if the proportion of these group of contracts is significant.
	55	Generally, it is common for Group Insurance contracts to have actual premium received after premium due date, even though coverage has already started. Under the PAA, premium received (cash basis) should be used to measure the liability for remaining coverage. Please refer to the example above-mentioned on the accounting treatment when premium is received after the commencement of coverage period.
	57	Regular experience studies and sensitivity analysis shall provide adequate insights into the expected profitability of each group of contracts, as well as the likelihood of them turning onerous.
	B126	Generally, the uniformity of claim distribution over a short coverage period would make passage of time a suitable approach for premium allocation.
Yearly-renewable Accident and Health (A&H) products	53(a)	Depends on the assessment of contract boundary on whether the coverage period is one year or less.
	53(b)	If the contract boundary is assessed to be long-term, the coverage period would generally be much greater than one year which makes it less likely to fulfill the PAA's criteria.
	55	Similar to the considerations under General/Group Insurance, but actual premium is more likely to be received on time for individual business.
	57	Similar to the considerations under General/Group Insurance.
	B126	Similar to the considerations under General/Group Insurance.

On an overall assessment based on the above:

- General/Group Insurance contracts are expected to meet the PAA eligibility criteria. Nonetheless, an assessment on the contracts with a coverage period of more than one year will be necessary, especially if the proportion of these contracts is significant.
- For yearly-renewable A&H products, it would generally depend on the contract boundary chosen.
- For short-term contracts that fulfill the requirements of the PAA, “premium received” on cash basis should be used to calculate the liability for remaining coverage. Passage of time is usually a suitable approach for premium allocation to insurance revenue.