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Project **Insurance contracts**

Topic **Premium allocation approach – a simplification of the building block approach**

1. This paper:

   (a) proposes one way of simplifying the modified approach (referred to in this paper as the premium allocation approach) to address respondent concerns that the approach proposed in the exposure draft was too complicated;

   (b) identifies eligibility criteria that would ensure that, even with these simplifications, the premium allocation approach remains a reasonable proxy for the building block approach (or, in other words, that the insurance contracts standard remains a 'one model' standard); and

   (c) provides a basis for making the premium allocation approach optional rather than mandatory for contracts that meet the eligibility criteria.

Summary of staff recommendations

2. This paper sets out the recommendations of the staff who have developed the premium allocation approach as a *simplification* of the building block approach, ie within the framework of a 'one model' standard. The recommendations of the staff who have developed a premium allocation approach as an *alternative* to the building block approach (ie within the framework of a 'two model' standard) are set out in paper 8C/71C.

3. The staff recommend that, within the framework of a 'one model' standard, an insurer applying the premium allocation approach would:

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(a) measure the liability for remaining coverage (referred to as the 'pre-claims liability' in the exposure draft) by allocating premiums over the coverage period of the contract, either based on the passage of time or on the basis of expected timing of incurred claims and benefits if that pattern differs significantly from the passage of time (paragraphs 17-18);

(b) not accrete interest on the liability for remaining coverage, or discount future premiums receivable for the time value of money. (This assumes that either (a) the period between receipt of the premium and provision of coverage is one year or less, or (b) the effect would be immaterial) (paragraphs 20-21);

(c) recognise incremental acquisition costs as an asset, and amortise them over the coverage period, or, if the coverage period is one year or less, recognise all acquisition costs in the income statement when incurred. The incremental costs of obtaining a contract are the costs that the entity would not have incurred if the contract had not been obtained (paragraphs 22-24);

(d) perform an onerous contract test if and when the facts and circumstances indicate that contracts have become onerous during the coverage period (paragraphs 26-32); and

(e) measure onerous contract liabilities without the inclusion of a risk adjustment (paragraphs 26-32).

4. Regarding the eligibility criteria, the staff recommend that within the framework of a 'one model' standard:

(a) contracts should be eligible for the premium allocation approach described in paragraph 3 if that approach would produce measurements that are a reasonable approximation of those that would be produced by the building block approach.

(b) A contract should be deemed to meet the condition in (a) without further investigation if both of the following conditions apply:

(i) the coverage period is approximately one year or less; and

(ii) the contract does not contain embedded options or other derivatives that significantly affect the variability of cash flows, after unbundling any embedded derivatives.

(c) the boards should add guidance to avoid overly-restrictive interpretations of 'approximately one year'. This guidance could clarify that contracts could meet this definition even if they are several months longer than one year and even if there are a few longer-duration contracts within a portfolio of predominantly one-year contracts.

5. The staff recommend that within the framework of a 'one model' standard, an insurer should be permitted, but not required, to apply the premium allocation approach to eligible contracts.

Overview of paper

6. The paper covers:

Section	Paragraph numbers
Advantages of a 'one model' standard	8-10
Summary of respondents' views	11-13
Similarities between the 'Unearned Premium Reserve' approach used in practice and the requirements of the forthcoming revenue recognition standards	14-15~~16~~
Implications for measurement of the liability for remaining coverage	17-25
Measurement of onerous contracts	26-32
Eligibility criteria	33-42
Whether the premium allocation approach should be permitted or required for contracts that meet the eligibility criteria	43-45
Measurement of the liability for incurred claims	46-49

7. This paper does not discuss presentation requirements for contracts measured using the premium allocation approach, or the unit of account for the onerous contract test. These matters will be covered at future meetings as part of more general discussions of presentation and unit of account issues. For the purposes of this paper we have assumed that the revenue recognition proposals could be applied to the portfolio of contracts.

Advantages of a 'one model' standard

8. The IASB developed the premium allocation approach as a means of simplifying the building block approach for short duration contracts. As paragraph BC146 of the exposure draft stated:

> The Board believes that when the pre-claims period is approximately one year or less and provided that the contract contains no significant embedded derivatives, the unearned premium is a reasonable approximation of the present value of the fulfilment cash flows and the residual margin (and achieves a similar result at a lower cost). This is because if significant changes in estimates are made during the coverage period of a short-term duration contract, those changes are more likely to be unfavourable (leading to losses) than favourable (leading to gains). The insurer would recognise these losses because of the requirement to recognise an additional liability when the contract becomes onerous. Thus, requiring an insurer to apply the full measurement model for these contracts would not generate sufficient benefits to justify the costs of adopting the new approach.

9. The premium allocation approach can thus be viewed as a simplified version of the building block approach, rather than as a separate model. The advantages of such a 'one model' standard are that:

   (a) conceptually, the building block approach is as suitable for short-duration contracts as for longer-duration contracts. The measurement of any type of liability needs to take into account the same economic factors: expectations about future cash flows, the time value of money and risk. Different measurement approaches are employed for different liabilities because of different practical considerations (such as whether the time value of money is likely to be significant), not for conceptual reasons.

   (b) Financial statements will be broadly comparable, whichever of the two approaches an insurer applies, because the premium allocation approach would be applied only when that approach produces measurements that are a reasonable approximation of the measurements produced by the building block approach. As a result:

      (i) there would be less scope for arbitrage between the model for short-duration insurance contracts and the full building block approach.

      (ii) the boards could permit the premium allocation approach as an option (rather than making it mandatory) without impairing comparability. By permitting, but not requiring, the premium

allocation approach for short-duration contracts, the boards would address the concerns of insurers that issue both life and non-life contracts (composite insurers) and who wish to apply the full building block approach to all of their contracts. (This matter is discussed further in paragraphs 43-45.)

10. Most respondents to the exposure draft supported the proposal that the premium allocation approach should be developed as a simplification of the building block approach within the framework of a 'one model' standard. Support was noted from all types of respondents, including users; preparers; accountants; actuaries; industry groups and national standard-setters. A limited number of respondents, primarily in the US, thought that different models were required for life and non-life contracts.

Summary of respondents' views

11. The vast majority of respondents supported a proposal to include a premium allocation approach for short-duration contracts, from a cost-benefit and simplicity perspective. The most significant simplification introduced by the premium allocation approach is the absence of a routine requirement to forecast or risk-adjust the expected future claims. Only in the (relatively rare) circumstances in which a portfolio of short-duration contracts is identified as being potentially onerous would it be necessary to perform projected cash-flows calculations.

12. However, as discussed in agenda paper 8A/71A *Premium allocation approach: Overview* many respondents raised concerns that the premium allocation approach proposed in the exposure draft was over-engineered in some respects and tried to stay too close to the building block approach.

13. Many respondents suggested that the premium allocation approach for the liability for remaining coverage should be more like the 'Unearned Premium Reserve' (UPR) approach, which is used widely in practice at present. The UPR is a premium allocation approach that apportions the total premiums received between the earned and unearned components. The effect of the time value of money is generally not considered. When applying the UPR approach, insurers present acquisition costs as an asset and perform an explicit onerous contract test only if there are indications that a portfolio has become onerous. They typically measure onerous contract liabilities without including a risk adjustment.

Similarities between the UPR approach and the revenue recognition standard

14. The UPR approach used by insurers at present is similar to the approach underlying the requirements of the forthcoming standard on revenue recognition. Consequently, a premium allocation approach that aligns the requirements for measuring liabilities for future coverage with the requirements of the forthcoming revenue recognition standard would secure most of the simplifications requested in the comment letters. Such an approach would also:
    (a) retain the ‘one model’ approach, if the eligibility criteria are defined appropriately; and
    (b) help to streamline IFRSs and US GAAP, minimising differences between various accounting models for contracts with customers. Minimising these differences would take pressure off the scope of the insurance contracts standards: contracts with significant service elements would be accounted for in a similar way whether they were included within the scope of the insurance contracts standards or the revenue recognition standards.
15. Accordingly, the staff propose that the simplifications to the building block approach for measuring the liability for remaining coverage be aligned to the approach used in the revenue recognition project.
16. We note that within the framework of a ‘one-model’ standard, the extent of the simplifications affects the number and type of contracts qualifying for the premium allocation approach, because these two factors (criteria for eligibility and extent of simplifications) interact with each other. More simplifications would result in fewer contracts becoming eligible and vice versa. For instance, retaining the proposed requirement for discounting the liability for future coverage would allow straightforward contracts with longer durations to be eligible, but would increase the complexity for the shorter duration contracts. The objective is to find the right balance.

Implications for measurement of the liability for remaining coverage

17. The exposure draft proposed that an insurer applying the premium allocation approach for short-duration contracts would:

(a) initially measure the liability for remaining coverage at the present value of the premiums receivable less incremental acquisition costs;

(b) allocate premiums over the coverage period on the basis of the passage of time, or in a systematic way that reflects the exposure from providing insurance coverage if significantly different from the passage of time; and

(c) accrete interest on the carrying amount of the liability for remaining coverage.

18. At their meeting on 27 April, the board tentatively decided that the insurer should amend the proposal described in paragraph 17(b) above so that premiums would be allocated over the coverage period on the basis of time, but on the basis of the expected timing of incurred claims and benefits if that pattern differs significantly from the passage of time.

19. Simplifying these requirements in a way that aligns them with the requirements proposed in the forthcoming standard on revenue recognition would involve:

(a) omitting the requirements for discounting and interest accretion (see paragraphs 20-21); and

(b) changing the requirements for measuring acquisition costs (see paragraphs 22-24).

Omitting requirements for discounting and interest accretion

20. One of the reasons why the boards originally proposed to require discounting and the accretion of interest for the liability for remaining coverage was to ensure consistency with the proposals in the revenue recognition project. At exposure draft stage, the revenue recognition project did not include the practical expedient of a one-year de minimis for discounting and interest accretion.

21. However, after considering comments on the revenue recognition exposure draft, the boards decided not to require an entity to apply discounting and interest accretion if the period between payment by the customer and the provision of services is one year or less. In such circumstances, the effect of the time value of money would not be significant. Introducing a similar practical expedient for insurance contracts ensures that the proposals remain consistent.

Acquisition costs

22. The boards have tentatively decided that the forthcoming standards on revenue recognition should include the following requirements with respect to the costs of acquiring contracts:

    (a) an entity should recognise as an asset the incremental costs of obtaining a contract with a customer if the entity expects to recover those costs;

    (b) the entity would then amortise the costs on a systematic basis consistent with the pattern of transfer of the goods or services to which the asset relates; and

    (c) as a practical expedient, an entity would be permitted to recognise the incremental costs of obtaining a contract as an expense when incurred, if the amortisation period of the asset that the entity would otherwise have recognised is one year or less.

23. Applying those requirements to insurance contracts would result in the following differences compared to the building block approach:

    (a) more costs would be recognised immediately as an expense applying the revenue recognition requirements because:

        (i) only costs that are incremental at individual contract level would be capitalised applying the revenue recognition requirements whereas other direct acquisition costs at the portfolio level[1] would be included in the measurement of the liability applying the building block approach.

        (ii) an insurer would be permitted to recognise all costs of acquiring insurance contracts with a duration of one year or less as an expense when incurred.

    (b) the presentation of insurers' financial position would be different. Applying the requirements of the forthcoming revenue standard, an entity would present capitalised acquisition costs as an asset, whereas applying the building block approach, it would deduct acquisition costs in measuring the liability for remaining coverage.

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[1] The FASB has tentatively decided to limit the costs allocated to contracts to the costs of successful effort only. The IASB has tentatively decided to include the costs of both successful and unsuccessful efforts.

24. The requirements of the forthcoming revenue recognition standards would be simpler to apply than the requirements of the building block approach. For example, there would be no need to identify and allocate non-incremental direct costs, such as the costs of time spent by employees on underwriting activities. Furthermore, it can be argued that the differences would not result in material measurement differences *for short-duration contracts*. All acquisition costs capitalised on initial recognition of insurance contracts with a coverage period of 12 months or less would be recognised as expenses within one year. Differences would become more significant for longer-duration contracts because differences in the amounts capitalised would reverse over a longer period. Consequently, provided that the premium allocation approach is applied only to contracts of reasonably short duration, this approach could apply the requirements of the revenue recognition standards for recognising and measuring acquisition costs and remain a reasonable approximation of the building block approach.

25. Finally, although acquisition costs would be presented differently—ie as an asset rather than as a deduction in measuring the liability for remaining coverage—it could be argued that the presentation differences would not materially detract from the 'one model' principle. They would affect relatively small amounts of costs, and, whether presented as an asset or as a deduction from a liability, the amounts would be disclosed.

Measurement of onerous contracts

26. A premium allocation approach needs to be accompanied by an onerous contract test to avoid possible understatement of liabilities. The exposure draft proposed that if a cohort of contracts within a portfolio becomes onerous, 'the insurer shall recognise an additional liability and a corresponding expense, measured as the difference between the carrying amount of the pre-claims obligation and the present value of the fulfilment cash flows'. The 'present value of the fulfilment cash flows' is the amount at which the insurer would measure the liability by applying the building block approach. In other words, it would take into account the fulfilment cash flows, the time value of money and, in the IASB standard, a risk adjustment.

27. At their meeting in April 2011, the boards tentatively decided that an insurer needs to perform an onerous contract test only if the facts and circumstances indicate that

contracts have become onerous during the coverage period. This decision addressed the concern in the comment letters that the onerous contract test proposed in the exposure draft would over-complicate the premium allocation approach by requiring the insurer to apply the full building block approach routinely to determine whether a contract was onerous.

28. The main difference between the onerous contract test proposed for short-duration insurance contracts under the exposure draft and the onerous contract test proposed for the forthcoming standards on revenue recognition is the risk adjustment—the IASB test proposed for short-duration insurance contracts would require a risk adjustment, whereas the revenue recognition standards would not. Omitting the risk adjustment from the onerous contract test in the insurance contracts standard would broadly align the onerous contract tests in the two standards.

29. In favour of omitting the risk adjustment from the measurement of onerous contracts, it could be argued that:

    (a) contracts would be identified as onerous less frequently. The onerous contract test would become an exception rather than a rule, consistently with the aims of the premium allocation approach.

    (b) the onerous contract test, when required, would be simpler to perform, consistently with the aims of the premium allocation approach.

    (c) although the liability would be different from the liability as measured by applying the full building block approach, the differences are unlikely to be substantial. The reason is that the onerous contract test is used to assess the adequacy of the liability for unexpired coverage. For short-duration contracts, the period of unexpired coverage is short, and the liability for unexpired coverage is very quickly replaced with a liability for incurred claims. As discussed further in paragraphs 46-49, the liability for incurred claims will be measured by applying the full building block approach (which would, in the IASB standard, include a risk adjustment).

30. An alternative solution would be to omit the risk adjustment when identifying onerous contracts (for the sake of introducing the desired simplifications), but once contracts have been recognised as onerous, to measure them including a risk adjustment. In favour of this solution, it could be argued that:

(a) it would reduce the frequency of onerous contract tests without introducing measurement differences for insurance contracts that are identified as onerous; and

(b) it would be consistent with later measurement of incurred claims that ultimately result from contracts that have become onerous.

31. However, it could be argued that excluding a risk adjustment in determining whether a contract is onerous, but including it in the measurement of an onerous contract lacks a conceptual rationale and complicates the requirements of the standard. For this reason, and for the reasons given in paragraph 29, the staff recommend that an insurer applying a premium allocation approach should identify and measure onerous contract liabilities without including a risk adjustment.

32. We will discuss the unit of account for the onerous contract test in a future meeting.

Eligibility criteria

Exposure draft proposals

33. The exposure draft proposed that the premium allocation approach should be applied to contracts that:

(a) have a coverage period of approximately one year or less; and

(b) after unbundling, do not contain embedded options or other derivatives that significantly affect the variability of cash flows.

34. The basis for conclusions explained that:

> The Board believes that when the pre-claims period is approximately one year or less and provided that the contract contains no significant embedded derivatives, the unearned premium is a reasonable approximation of the present value of the fulfilment cash flows and the residual margin (and achieves a similar result at a lower cost).

35. We describe the comments received on the proposed eligibility criteria in agenda paper 8A/71A *Premium allocation approach: Overview*.

Staff analysis

36. In this paper, the staff have developed a premium allocation approach within the framework of a 'one model' standard, ie with the objective that the approach should provide a reasonable approximation of the building block approach. Within this

framework, the principle that should underpin the eligibility criteria is clear: a contract should be eligible for the premium allocation approach if the terms of the contract are such that the premium allocation approach produces measurements that are a reasonable approximation of those that would be produced by the building block approach. Stating the eligibility criteria in these principled terms would address concerns that the criteria proposed in the exposure draft were arbitrary.

37. However, stating the eligibility criteria purely in principled terms would raise practical difficulties—insurers might need to calculate their liabilities using the building block approach to prove that the amounts so calculated would not be materially different from the amounts they have recognised by applying a premium allocation approach. They would thus not benefit from the simplifications that the premium allocation approach is designed to achieve.

38. The boards could avoid these practical difficulties by identifying specific features of contracts for which the two approaches are likely to result in similar outcomes, and deeming these contracts to be eligible for the premium allocation approach.

39. The main differences between the premium allocation approach developed in this paper and the building block approach are:

    (a) *in the measurement of the liability for remaining coverage:* future cash flows would not be discounted for the time value of money; only incremental acquisition costs could be deducted in measuring the liability, no interest would be accreted on this liability, and this liability would not routinely be updated to reflect changes in estimates of future claims or risk; and

    (b) *in the identification and measurement of onerous contracts*: onerous contracts would be identified and measured without including a risk adjustment.

40. As a consequence of these differences, the premium allocation approach is likely to provide a reasonable approximation of the building block approach only if the contracts are short in duration. Only then is it likely that the time value of money (and hence the effects of discounting and interest accretion) will be immaterial. Contracts with short coverage periods are also less vulnerable than contracts with longer coverage periods to significant changes in expectations about claims arising in the remaining coverage period. Consequently, the absence of a routine requirement to update estimates, and the differences in the requirements for measuring onerous contracts, are unlikely to lead to significant differences in the measurement of

liabilities for remaining coverage. Finally, the acquisition costs included in the measurement of short-duration contracts are unlikely to be substantial, because these costs will be amortised to the income statement over a short period. Similarly, the option to recognise acquisition costs as an expense would not have a substantial effect compared to costs amortised to the income statement over a short period. Hence the differences in the measurement requirements for acquisition costs are also unlikely to have a substantial impact on the financial statements.

41. These observations support the exposure draft proposal to limit the premium allocation approach to short-duration contracts. However, they do not imply a restrictive definition of 'short-duration'. As some respondents observed, the premium allocation approach could be a reasonable approximation for the building block approach even if it is applied to:

    (a) contracts that are somewhat longer than one year (possibly up to two years) in duration; and

    (b) portfolios of contracts in which most of the contracts are short-duration, but a few are longer-duration.

Staff recommendations

42. On the basis of the staff analysis in paragraphs 36-41, the staff recommend that, within the framework of a 'one model' standard:

    (a) contracts should be eligible for the premium allocation approach if that approach produces measurements that are a reasonable approximation of those that would be produced by the main approach in the standard.

    (b) contracts should be deemed to meet the eligibility criteria without further investigation if both of the following conditions apply:

        (i) the coverage period of the insurance contract is approximately one year or less; and

        (ii) the contract does not contain embedded options or other derivatives that significantly affect the variability of cash flows, after unbundling any embedded derivatives.

    (c) the boards should add guidance to avoid overly-restrictive interpretations of 'approximately one year'. This guidance should clarify that contracts could

meet this definition even if they are several months longer than one year and even if there are a few longer-duration contracts within a portfolio of predominantly one-year contracts.

Whether the premium allocation approach should be permitted or required for contracts that meet the eligibility criteria

43. The exposure draft proposed that the premium allocation approach should be mandatory (ie required rather than permitted) for all eligible contracts.

44. Some respondents agreed with this proposal, on the grounds that it would enhance comparability. However, most respondents thought that the premium allocation approach should be permitted, but not required, for eligible contracts. This view was expressed at each of the round tables, and particularly in the comment letters from composite insurers. Respondents argued that:

    (a) although mandatory application of the premium allocation approach for eligible contracts might improve comparability between insurers, it would require composite insurers to apply two different approaches. Applying two approaches could be more complicated than applying a single (building block) approach for all contracts, thereby defeating the objective of the premium allocation approach.

    (b) permitting an option to apply the premium allocation approach would be more consistent with the view that the premium allocation approach is a simplification of the building block approach, rather than a different model.

45. In the staff's view, the recommendations in this paper mean that the premium allocation approach can be viewed as a reasonable approximation of the building block approach for eligible contracts. Consequently, concerns about comparability are not justified. Furthermore, given that the premium allocation approach is intended to be a proxy for the building block approach, it would be inappropriate to prevent insurers from applying the building block approach in full. Accordingly, the staff propose that the premium allocation approach developed in this paper (ie within the framework of a 'one model standard') should be permitted but not required.

Measurement of liability for incurred claims

46. The liability for remaining coverage that is recognised when applying a premium allocation approach measures only the liability for expected future claims. Insurers applying this approach also need to recognise a separate liability for 'incurred claims', ie for claims received or likely to be received in relation to insured events that have occurred before or on the reporting date.

47. The exposure draft proposed that an insurer applying a premium allocation approach for short-duration contracts should recognise and measure its liability for *incurred* claims using the full building block approach. This approach would involve estimating the expected future cash flows, discounting them to their present value (if the effect of time value of money is material) and, in the IASB model, adding a risk adjustment (if there is material uncertainty about the future cash flows relating to incurred claims). Almost all respondents did not comment on the proposal.

48. The staff have not identified any compelling reasons for simplifying these requirements:

    (a) simplifications could involve removing the requirements for discounting or risk adjustments. However, even for short-duration contracts (ie with short coverage periods), some types of claim could take substantial time to agree and settle and so the effect of discounting and risk could be material. Ignoring these components could introduce significant differences between the premium allocation approach and the building block approach, thus moving away from a 'one-model' approach and putting more pressure on the eligibility criteria for the premium allocation approach.

    (b) the forthcoming standards on revenue recognition do not contain detailed requirements for recognising and measuring 'incurred-claim'-type liabilities (because the liabilities remaining after goods or services have been delivered to a customer are, for most types of customer contract, not substantial). Hence, there is no existing approach in those standards that could be employed as an alternative to the building block approach. The requirements of other existing standards (such as IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*) would be as complicated to apply as the building block approach (IAS 37 requires discounting using a discount rate that reflects

the risk specific to the liability), while not having the advantage of providing guidance that is specific to insurance contracts.

49. Accordingly we have assumed that an insurer would measure the liability for incurred claims by using the building block approach.

Questions for the boards

Question 1: premium allocation approach
Do the boards agree that, within the framework of a 'one model' standard, an insurer applying the premium allocation approach: (a) should measure the liability for remaining coverage by allocating premiums over the coverage period of the contract, either based on the passage of time or on the basis of expected timing of incurred claims and benefits if that pattern differs significantly from the passage of time? (b) should not accrete interest on the liability for remaining coverage, or discount future premiums receivable for the time value of money. (This assumes that either (a) the period between receipt of the premium and provision of coverage is one year or less, or (b) the effect would be immaterial); (c) should recognise incremental acquisition costs as an asset, and amortise them over the coverage period, or, if the coverage period is one year or less, recognise all acquisition costs in the income statement when incurred? (d) should perform an onerous contract test if and when the facts and circumstances indicate that contracts have become onerous during the coverage period? (e) should identify and measure onerous contract liabilities without the inclusion of a risk adjustment?

Question 2: eligibility
Do the boards agree that, within the framework of a 'one model' standard: (a) contracts should be eligible for the premium allocation approach if that approach produces measurements that are a reasonable approximation of those that would be produced by the building block approach? (b) contracts should be deemed to meet the eligibility criteria without further investigation if both of the following conditions apply: (i) the coverage period of the insurance contract is approximately one year or less; and

(ii) the contract does not contain embedded options or other derivatives that significantly affect the variability of cash flows, after unbundling any embedded derivatives?

(c) the boards should add guidance to avoid overly-restrictive interpretations of ‘approximately one year’. This guidance could clarify that contracts could meet this definition even if they are several months longer than one year and even if there are a few longer-duration contracts within a portfolio of predominantly one-year contracts.

Question 3: permit or require

Do the boards agree that, within the framework of a ‘one model’ standard, the premium allocation approach should be permitted but not required?