STAFF PAPER

Insurance working group

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Insurance contracts	**Possible changes to premium allocation approach**		
CONTACT	Leslie Vermaak	lvermaak@ifrs.org	+44 (0)20 7246 6912
	Joan Brown	jbrown@ifrs.org	+44 (0) 20 7246 6410

Purpose of paper

1 This paper asks for your views on possible changes to the premium allocation approach proposed for short-duration contracts.

2 This paper does not discuss eligibility criteria for the premium allocation approach. The staff intend to discuss eligibility criteria with the IASB and FASB in their meeting in the week beginning 17 October and we will report the outcome of that discussion to the working group. We think that many of the changes identified in this paper would be appropriate for, or could be adapted to suit, different eligibility criteria and so it is worthwhile seeking your preliminary views on the changes now.

Exposure draft proposals

3 The IASB exposure draft proposed a modified measurement approach for some short-duration insurance contracts. Contracts eligible for this approach would be those that:

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

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

4 The modified approach is a premium allocation approach. It would require the insurer to measure its liability for remaining coverage ('pre-claims liability') separately from its liability for incurred claims ('claims liability'). The insurer would apply the standard measurement requirements (ie building block approach) for measuring the liability for *incurred claims*. But it would apply a simpler premium allocation approach for measuring the liability for *remaining coverage*. The rationale given in the basis for conclusions accompanying the exposure draft was 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).

5 The proposed premium allocation approach for measuring the liability for remaining coverage would involve:

(a) initially measuring the obligation for remaining coverage at the present value of the premiums received and receivable under the contract, less acquisition costs;

(b) recognising a liability for the amount of the obligation less the present value of future premiums;

(c) accreting interest on the liability;

(d) reducing the obligation over the coverage period on the basis of the passage of time (or on the basis of the expected timing of incurred claims and benefits if that pattern differs significantly from the passage of time); and

(e) recognising an additional liability if contracts are onerous, ie if the present value of the fulfilment cash flows relating to future claims (measured applying the building block approach and including a risk adjustment) exceeds the carrying amount of the obligation for remaining coverage. An additional liability would be recognised for the excess.

6 The premium allocation approach can be simpler to apply than the building block approach because it does not routinely require insurers to forecast or risk-adjust the expected future claims. Insurers need to perform these calculations only if they identify contracts as being potentially onerous, either at initial recognition or later.

Feedback received

7 The vast majority of respondents supported the proposal to include in the standard a premium allocation approach for short-duration contracts. However, many respondents expressed concerns that the specific approach proposed in the exposure draft was over-engineered in some respects and tried to stay too close to the building block approach. Unnecessary complications—for example, requirements for discounting, interest accretion and onerous contract tests—would defeat the objective of the approach.

8 Many respondents also thought that the premium allocation approach should be optional rather than mandatory. They noted that, although mandatory application of the premium allocation approach for eligible contracts might improve comparability between insurers, it would require composite insurers (ie insurers with both short-duration and other contracts) to apply two different approaches. They argued that 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.

9 Some respondents suggested that the premium allocation approach applied in the standard should be more like the ‘Unearned Premium Reserve’ (UPR) approach applied by some insurers at present. Applying the UPR approach, insurers generally ignore the effects of the time value of money, 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.

Possible changes to the measurement of the liability for remaining coverage

10 In response to this feedback, the staff have considered a range of possible changes to the premium allocation approach proposed in the exposure draft. These possible changes would simplify the measurement of the liability for remaining coverage.

11 The changes we have considered would all align the premium allocation approach in the insurance contracts standard more closely with the forthcoming re-exposure draft of the proposed standard *Revenue from Contracts with Customers* (‘the revenue standard’). Aligning the requirements in this way would have advantages:

(a) it would help to streamline IFRSs and US GAAP, minimising differences between the accounting models for different types of contracts with customers (ie insurance and other). Minimising these differences would take pressure off the scope of the insurance contracts standard—contracts with significant service elements would be accounted for in a similar way whether they were within the scope of the insurance contracts standard or the revenue standard.

(b) the overall approach proposed for the revenue standard is similar to the UPR approach applied by some insurers at present. Consequently, aligning the premium allocation approach in the insurance contracts standard with the requirements of the revenue standard would incorporate most of the changes requested in the comment letters.

12 The various changes considered by the staff are listed below. The boards have not yet discussed these possible changes in detail. We would like to hear your views on them.

Changes relating to discounting and interest accretion

	Possible change	Arguments for	Arguments against
A	**Require discounting and interest accretion in the measurement of the liability for remaining coverage *only* for contracts that have a significant financing component.** As a practical expedient, identify types of contracts that would not be regarded as having a significant financing component. The details of the practical expedient would depend on the eligibility criteria for applying the premium allocation approach: • if contracts are eligible for the premium allocation approach *only* if they have a coverage period of approximately one year or less (as was proposed in the exposure draft), the standard could specify that insurers need not consider discounting or interest accretion when applying the premium allocation approach to *any* eligible contract. • if longer-duration contracts are eligible for the premium allocation approach, the standard could state that discounting and interest accretion need not be considered if the period between premiums being due and the provision of coverage is one year or less.	Consistent with proposals for revenue standard. Simplifies approach for the majority of short-duration contracts without significantly changing measurements.	Differs from proposals for building block approach. Could impair comparability, weakening the case for making the premium allocation approach optional rather than mandatory.

Changes to the requirements for acquisition costs

13 The exposure draft proposed that the treatment of acquisition costs would be the same whether the entity was applying the building block approach or the premium allocation approach. In their most recent discussions of acquisition costs, the boards tentatively decided that, in applying the building block approach, insurers should deduct all 'direct' acquisition costs from the contract liability. Direct acquisition costs include incremental costs (such as agent commissions) and other direct costs (such as the time spent by employees on underwriting activities).

14 The staff have identified three possible changes to the treatment of acquisition costs for contracts accounted for using the premium allocation approach:

	Possible change	Arguments for	Arguments against
B1	As a practical expedient for contracts with a coverage period of one year or less, **permit insurers to recognise all acquisition costs as an expense when incurred**. (If contracts are eligible for the premium allocation approach *only* if they have a coverage period of approximately one year or less, this practical expedient could apply whenever the insurer applies the premium allocation approach.)	Consistent with proposals for revenue standard. Simplifies the application of the premium approach. Unlikely to cause material measurement differences—even if deferred, the acquisition costs would all be recognised within 12 months of being incurred.	Differs from proposals for building block approach. Could impair comparability between entities applying the building block approach and those applying the premium allocation approach. The possible loss of comparability weakens the case for making the premium allocation approach optional rather than mandatory. Insurers would be permitted but not required to apply this practical expedient. So there could also be a loss of comparability among entities applying the premium allocation approach.

	Possible change	Arguments for	Arguments against
B2	**Specify that only 'incremental' acquisition costs should be deducted from the liability for remaining coverage**. Incremental acquisition costs are those costs that the insurer would not have incurred if it had not obtained the contract**.**	Consistent with proposals for revenue standard. Incremental costs are easier to identify and measure than other direct costs. For most short-duration contracts, the non-incremental direct costs are not material.	Differs from latest proposals for building block approach. Composite insurers would need two different systems for capturing acquisition costs. Could impair comparability, weakening the case for making the premium allocation approach optional rather than mandatory.
B3	**Require insurers to present deferred acquisition costs as an asset** rather than as a deduction from the liability for future coverage.	Consistent with proposals for revenue standard. Consistent with gross presentation of premium revenue and amortisation of acquisition costs in the statement of comprehensive income (as was proposed in the exposure draft).	Initial measure of liability would not represent solely the entity's future obligations, but also the amount that the policyholder implicitly paid to cover acquisition costs. Differs from proposals for building block approach (assuming that the boards decide not to change this aspect of the building block approach). Composite insurers would have to present some acquisition costs as an asset while deducting other acquisition costs from the contract liability. Could impair comparability, weakening the case for making the premium allocation approach optional rather than mandatory.

Changes to the requirements for identifying and measuring onerous contract liabilities

	Possible change	Arguments for	Arguments against
C1	**Clarify that an onerous contract test is needed only when facts and circumstances indicate that contracts have become onerous in the coverage period.**	To address concerns expressed in comment letters that insurers might need to perform onerous contract tests routinely, defeating the objective of the premium allocation approach.	Greater risk that some onerous contract liabilities will be overlooked.
C2	As a practical expedient, **require insurers to perform onerous contract tests *only* for contracts with coverage periods that exceed one year.** (If contracts are eligible for the premium allocation approach *only* if they have a coverage period of approximately one year or less, the premium allocation approach could omit *any* requirement to identify and recognise onerous contract liabilities.)	Consistent with proposals for revenue standard. Simplifies application of premium allocation approach. Might not lead to material differences between the premium allocation approach and the building block approach. Losses would not remain unrecognised for long. (If a contract is of short duration, the liability for remaining coverage quickly turns into a liability for incurred claims. The liability for incurred claims is measured by applying the full building block approach.)	A backward step – IFRS 4 requires insurers to apply a liability adequacy test to *all* contracts at present. Omitting this requirement for some contracts could delay recognition of losses. There are several differences between the onerous contract test proposed for the revenue standard and that proposed for the insurance contracts standard. Eliminating one of these differences (ie adding a one-year threshold) will not fully align the two standards. A further difference between building block approach and premium allocation approach, which could weaken the case for making the premium allocation approach optional rather than mandatory.

	Possible change	Arguments for	Arguments against
C3	If not completely omitting requirement for onerous contract test for contracts of less than one year (see item C2 above), **omit requirement to include a risk adjustment in the measurement of onerous contract liability**. (Relevant for IASB standard only.)	Consistent with proposals for revenue standard. Contracts would be less likely to be measured as onerous if the measurement of the liability excluded a risk adjustment. The onerous contract test would be required less frequently and would be easier to perform, simplifying the application of the premium allocation approach. Might not lead to material differences between the premium allocation approach and the building block approach. The risk adjustment would not remain unrecognised for long. (If a contract is of short duration, the liability for remaining coverage quickly turns into a liability for incurred claims. The liability for incurred claims is measured by applying the full building block approach, including a risk adjustment.)	The measurement of liabilities for remaining coverage would be inconsistent with the measurement of liabilities for incurred claims. Possibly not a simpler approach, given that a risk adjustment must be measured when claims are incurred. A further difference between the building block approach and premium allocation approach, which could weaken the case for making the building block approach optional rather than mandatory.

Question for working group members
What are your views on each of the possible changes to the premium allocation approach listed in the tables above?