

# STAFF PAPER

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## Insurance working group

Project	Insurance contracts		
Paper topic	Reporting back on the premium-allocation approach decisions		
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## Introduction

1. This paper provides:
  - (a) A feedback statement on the IASB's tentative decisions on the premium-allocation approach to date, including an outline of significant matters raised with us and how we responded.
  - (b) A working draft of how we propose to implement the boards' tentative decisions on the premium-allocation approach. This draft has been prepared by IASB staff and has not been reviewed by the IASB. Official pronouncements of the IASB are published only after it has completed its full due process, including appropriate public consultation and formal voting procedures.

## Next steps

2. This paper does not include a review of the line items that would be presented when an insurer applies the premium-allocation approach. The IASB plans to consider this in a future meeting.

### Question for working group members

Do you have any comments on the IASB's tentative decisions or the proposed drafting?

## Introduction

The IASB's exposure draft *Insurance Contracts* (the ED) proposed a modified measurement approach (namely a premium-allocation approach) for some short-duration insurance contracts.

The IASB noted that, in some circumstances, such an approach provides a reasonable approximation of the present value of the fulfilment cash flows plus the residual margin, and achieves a similar result at a lower cost.

The vast majority of respondents supported the proposal to specify a premium-allocation approach that could be applied to short-duration contracts. The premium-allocation approach can be simpler to apply than the building block approach because it requires insurers to forecast or risk-adjust the expected future claims only if they identify contracts as being potentially onerous. As a result, the premium-allocation approach could reduce the implementation costs of the Standard, while maintaining consistency with the general approach required for other insurance contracts. It would be similar to the 'unearned premium reserve' widely used in current accounting for non-life contracts.

However, many respondents expressed concerns that the proposals for the premium-allocation approach in the ED were over-engineered in some respects. They believed that those requirements that they perceived as unnecessary complications—for example, requirements for discounting, interest accretion and onerous contract tests—would defeat the objective of permitting a simplified way of achieving a similar outcome.

In this paper we:

- describe the premium-allocation approach and provide a simple example of how it would work;
- consider the contracts that should be eligible for the premium-allocation approach;
- consider the mechanics of the premium-allocation approach specified by the boards;
- compare the IASB's tentative decisions to the FASB's tentative decisions; and
- provide a working draft that would show how the IASB would implement its tentative decisions.

## What is the premium-allocation approach?

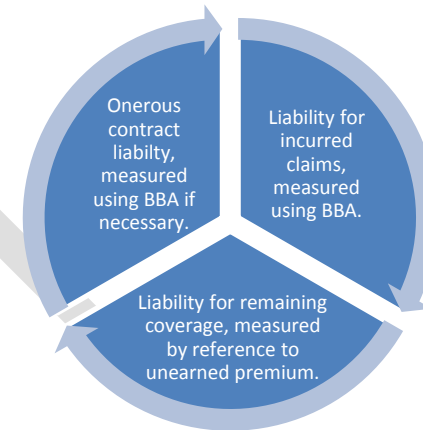
The premium-allocation approach provides a simplified way of measuring the insurer's obligation to pay for future insured events covered by existing contracts (the liability for remaining coverage or 'pre-claims liability'). When applying that approach, an insurer would:

- on initial recognition, measure the liability for remaining coverage at the present value of the premiums received and receivable under the contract, less acquisition costs;
- reduce the measurement of the liability for remaining coverage 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
- recognise an additional liability if a contract is onerous. That liability would be measured at the excess of the present value of the fulfilment cash flows relating to future claims over the carrying amount of the liability for remaining coverage.

The insurer's obligation to pay claims for insured events that have already occurred (the liability for incurred claims, 'unearned premium' or 'claims liability') is measured using the standard measurement requirements (ie the building block approach).

In contrast, when the insurer measures the insurance contract liability directly at the present value of the fulfilment cash flows plus the residual margin (ie when the insurer applies the building block approach), all of the insurer's obligations arising from the contract are measured in the same way. This is illustrated on the right.

Premium-allocation approach



Building block approach



### ***A simple example illustrating the premium-allocation approach***

<b>Assume</b>	
Premium received at inception	1200
Coverage period	12 months
Expected future claims (68 per month)	816
Risk premium (20 per month)	240
Acquisition costs	24
Claims expected evenly over coverage period	
Risk expected to expire evenly over coverage period	
For simplicity, discount of future cash flows and accretion of interest on the liability are ignored	
<b>After 1 month:</b>	
Actual claims	60
Risk adjustment on incurred claims	10
No change in expected claims or the risk assumptions	

**Statement of financial position at start of contract:**

	Liability measured, applying:			
	Building block approach	Premium-allocation approach		
		Remaining coverage	Inurred claims	Total liability
Future cash outflows	816			
Risk premium	240			
Residual margin (1200 - 816 - 240 - 24)	120			
Unearned premium (1200 - 24)		1176		
Carrying amount	<u>1176</u>	<u>1176</u>	<u>0</u>	<u>1176</u>

**Statement of financial position after 1 month:**

	Liability measured, applying:			
	Building block approach	Premium-allocation approach		
		Remaining coverage	Inurred claims	Total liability
Future cash outflows (816 -(68-60))	808		60	
Risk premium (240 - 20 +10)	230		10	
Residual margin (120*11/12)	110			
Unearned premium (1176*11/12)		1078		
Carrying amount	<u>1148</u>	<u>1078</u>	<u>70</u>	<u>1148</u>

**Profit or loss for month 1**

	Building block approach
Premiums earned (1200/12)	
Claims incurred (60 + 10)	
Amortisation of acquisition costs (24/12)	
Change in risk adjustment	10
Release of residual margin (120/12)	10
Changes in estimate (68-60)	8
Profit or loss	<u>28</u>

**Premium-allocation approach**

	100
	(70)
	(2)
	<u>28</u>

## Eligibility criteria

### *Proposal in the ED*

The ED proposed that the premium-allocation approach would be required for contracts 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.

### *Respondents' comments*

Some respondents to the ED were concerned that the proposals in the ED:

- would result in different accounting for similar products for different durations because there would be a 'bright line'; and
- should be amended to reflect what respondents perceived to be differences in the economics of a contract or the business model of the insurer. We discuss this concern and our response in more detail on the following page.

A small number of respondents (including many users) thought mandating (rather than merely permitting) the premium-allocation approach for eligible contracts would improve comparability. However, many respondents thought that the premium-allocation approach should be optional, particularly because of operational concerns for composite insurers that issue both short-duration and other contracts.

### *Our response*

We clarified the principle that the premium-allocation approach should be permitted, but not required, when it provides a reasonable approximation to the building block approach. That principle would apply to the measurement of both insurance contract liabilities and reinsurance assets.

We provided application guidance that this principle would be met if:

- the coverage period is 1 year or less; or
- both of the following apply:
  - significant changes in estimates are not likely to occur before the claims occur; and
  - significant judgement is not needed to allocate the premium.

The IASB and the FASB reached different decisions about the eligibility criteria for the premium-allocation approach. We compare these decisions on pages 9 and 10.

## Business models for insurance contracts

*The premium-allocation approach is similar to the unearned premium approaches that have historically been used for non-life insurance contracts. Many users and preparers of financial statements believe that unearned premium approaches adequately account for some contracts.*

### Respondents concerns

Some regard insurers as having one business model for traditional non-life insurance contracts and a different business model for traditional life insurance contracts. They believe that insurers should continue using the premium-allocation approach for all non-life contracts, even if the resulting measurement differs from that produced by the building block approach.

Those who hold this view believe that a separate accounting model is justified for non-life contracts because they believe that such contracts:

- Provide cover for different risks, ie for both the timing and amount of insured losses, rather than only the timing of the insured event.
- Primarily provide risk protection rather than investment return.
- Focus on underwriting, rather than investment management and asset-liability matching strategies.
- Are typically re-underwritten and re-priced annually and managed through fixed, single premiums rather than discretionary, recurring premiums.

### Our response

In the past, different accounting models have evolved to address the specific features of different types of contract. However, while some insurance contracts focus predominantly on one type of activity, most blend different activities in different proportions. Sometimes the importance of those activities varies over the life of a contract. For example:

- some property-casualty contracts may result in the payment of annuity payments, rather than a single lump sum. Such contracts combine underwriting risk (ie whether the insured event will occur) and investment risk (after the insured event occurs).
- an account-driven contract may include a guaranteed minimum death benefit. In the early stages of the contract, the risk undertaken in providing the death benefit is most significant. However, as the account balance builds up, the death benefit becomes less significant and the investment return and asset spreads become more relevant.

Applying different accounting models for different types of contracts creates problems when contracts blend activities because it is not clear which model should be applied to the contract as a whole. A comprehensive framework for insurance contracts that reflects the significant features of any given contract at any given time avoids that problem because it does not create the sudden discontinuities that would occur if different models were used to reflect the different features.

The IASB acknowledges that, in some circumstances, the unearned premium is a reasonable approximation of the present value of the fulfilment cash flows plus the residual margin and achieves a similar result at a lower cost. However, because the IASB is convinced about the benefits of a single model for all insurance contracts, the IASB decided to permit the premium-allocation approach only when it produces measurements that are a reasonable approximation to those that would be produced by the building block approach.

## Mechanics

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 and 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.

The table below compares the proposals in the ED with the simplifications that the IASB has proposed after considering those concerns.

Issue	ED proposal	Simplification in the IASB's tentative decisions
<b>Time value of money: liability for remaining coverage</b>	Reflect the time value of money by accreting interest on the liability for remaining coverage.	Discounting and interest accretion: <ul style="list-style-type: none"> <li>required only for contracts that have a significant financing component; but</li> <li>not required if the period between premiums being due and the provision of coverage is one year or less.</li> </ul>
<b>Time value of money: liability for incurred claims</b>	Apply the building block to the liability for incurred claims, ie using discounted estimates of future cash flows.	Discounting not required for incurred claims that are expected to be paid within 1 year.
<b>Onerous contracts</b>	Recognise an additional liability if the contracts are onerous.  Determine whether contracts are onerous by comparing the present value of the fulfilment cash flows relating to future claims (measured by applying the building block approach and including a risk adjustment) exceeds the carrying amount of the obligation for remaining coverage.	Onerous contract test is needed only when facts and circumstances indicate that contracts have become onerous in the coverage period.  [The IASB confirmed that measurement in the onerous contract test should include a risk adjustment.]
<b>Acquisition costs</b>	Account for acquisition costs in the same way as if the insurer applied the building block approach.	For contracts with a coverage period of one year or less, permit insurers to recognise all acquisition costs as an expense when incurred. (The IASB has not completed its discussions on acquisition costs.)

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## Comparison with FASB decisions

The IASB and the FASB have come to different conclusions about:

- (a) which contracts should be eligible for the premium-allocation approach for the measurement of the liability for remaining coverage; and
- (b) how insurers should measure the liability for incurred claims for those contracts.

The main differences are summarised in the table. However, the staff believes that in many cases, insurers would apply the premium allocation approach to the same contracts under both the FASB criteria and the IASB criteria.

	FASB tentative decision	IASB tentative decision
<b>Use of the premium-allocation approach</b>	Required for contracts meeting the specified criteria.	Permitted if contracts meet the specified criteria, but not required.
<b>Eligibility criteria: insurance contract liabilities</b>	<p>Required when:</p> <ul style="list-style-type: none"> <li>• coverage period is one year or less; or</li> <li>• neither of the following applies: <ul style="list-style-type: none"> <li>○ it is likely that, during the period before a claim is incurred, there will be a significant change in the expectations of net cash flows required to fulfil contract; or</li> <li>○ significant judgement is required to allocate the premium to the insurer's obligation to each reporting period.</li> </ul> </li> </ul>	<p>Approach produces measurements that are a reasonable approximation to those that would be produced by the building block approach.</p> <p>This principle would be met if:</p> <ul style="list-style-type: none"> <li>• the coverage period is one year or less.</li> <li>• neither of the following applies: <ul style="list-style-type: none"> <li>○ it is likely that, during the period before a claim is incurred, there will be a significant change in the expectations of net cash flows required to fulfil contract; and</li> <li>○ significant judgement is required to allocate the premium to the insurer's obligation to each reporting period.</li> </ul> </li> </ul>
	FASB tentative decision	IASB tentative decision
<b>Eligibility criteria:</b>	Use the same approach that was used to account for underlying	Eligible if the approach produces measurements that are a reasonable approximation to those that

<p><b>reinsurance assets</b></p>	<p>direct insurance contracts.</p> <p>Reinsurance contracts that reinsure both insurance contracts measured using the building block approach and insurance contracts measured using the premium-allocation approach should be separated on the basis of the underlying contract measurement model, with each component being accounted for using the same approach used to account for the underlying direct insurance contracts.</p>	<p>would be produced by the building block approach.</p>
<p><b>Measurement of liability for incurred claims</b></p>	<p>Expected present value of future cash outflows less future cash inflows that will arise as the insurer fulfils the insurance contracts.</p> <p>An insurer need not discount incurred claims that are expected to be paid within 1 year.</p>	<p>Expected present value of future cash outflows less future cash inflows that will arise as the insurer fulfils the insurance contracts, <i>adjusted to reflect the effects of uncertainty about the amount and timing of those future cash flows.</i></p> <p>An insurer need not discount incurred claims that are expected to be paid within 1 year.</p>

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## Working draft

*A working draft of the wording for the IFRS is as follows (changes from the ED are marked). New text is underlined and deleted text is struck through. This draft has been prepared by IASB staff and has not been reviewed by the IASB. Official pronouncements of the IASB are published only after it has completed its full due process, including appropriate public consultation and formal voting procedures.*

## Standard

### **Pre-claims liability for short-duration contracts** **Premium-allocation approach for measuring the liability for remaining coverage**

54 An insurer may apply paragraphs 55–60 to insurance contracts when:

- (a) doing so would produce measurements that are a reasonable approximation to those that would be produced applying the requirements in paragraphs 17–53; or that meet both of the following conditions:
- (b)(a) The coverage period of the insurance contract is approximately one year or less.
- (b) The contract does not contain embedded options or other derivatives that significantly affect the variability of cash flows, after unbundling any embedded derivatives in accordance with paragraph 12.

55 For those contracts, an insurer shall:

- (a) measure its ~~pre-claims~~ liability for remaining coverage by allocating premiums over the coverage period as described in paragraphs 56–60.
- (b) measure its ~~claims~~ liability for incurred claims at the present value of the fulfilment cash flows, in accordance with paragraphs 22–46. However, the insurer need not discount liabilities for incurred claims that are expected to be paid within 1 year.

56 The ~~pre-claims~~ liability is the ~~pre-claims~~ (as described in paragraphs 57 and 58), less the expected present value of future premiums, if any, that are within the boundary of the existing contract.

57 For insurance contracts specified in paragraph 54, an insurer shall measure its liability for remaining coverage ~~pre-claims obligation~~ at initial recognition as

- (a) the premium, if any, received at initial recognition, ~~plus the expected present value of future premiums, if any, that are within the boundary of the existing contract,~~ less
- (b) the incremental eligible acquisition costs (see paragraph B61(f), unless the contract has a coverage period of one year or less and the insurer elects to recognise acquisition costs when incurred.

58 Subsequently, the insurer shall:

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(a) ~~reduce the measurement of the pre-claims obligation liability for the remaining coverage~~ over the coverage period in a systematic way that best reflects the exposure from providing insurance coverage, as follows:

- (a) on the basis of the passage of time, but
- (b) on the basis of the expected timing of incurred claims and benefits, if that pattern differs significantly from the passage of time.

(b) increase the measurement of the liability for the remaining coverage when additional premiums are received.

59 An insurer shall accrete interest on the carrying amount of the ~~pre-claims liability for the remaining coverage, but need not do so if the contract does not provide significant financing. A contract provides financing if, and only if, the pattern and timing of coverage differs from the pattern and timing of premiums. As a practical expedient, if each part of the coverage is within 1 year before or after the time when the related part of the premium is due, the financing is not significant. The using the discount rate used to accrete interest is the same as the discount rate specified in paragraph 30 updated in each reporting period.~~

59A The application of paragraphs 55–60 would not produce a reasonable approximation to the measurements that result from the requirements in paragraphs 17–53 if:

- (a) there are likely to be significant changes in the expectations of net cash flows required to fulfil the contract during the period before a claim is incurred; or
- (b) significant judgement is required to recognise a premium in each reporting period that reflects the satisfaction of the insurer's obligations in that period.

### **Onerous contracts**

60 When facts and circumstances indicate that a portfolio of An insurance contracts is onerous, the insurer shall assess whether if, at initial recognition or subsequently, the present value of the fulfilment cash flows exceeds the liability for remaining coverage. relating to future insured claims that are within the boundary of an existing contract exceeds the carrying amount of the pre-claims obligation. If so, a contract is 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 liability for remaining coverage and the present value of the fulfilment cash flows. To determine whether insurance contracts are onerous and, if applicable, to measure the amount of the additional liability, the insurer shall aggregate the insurance contracts into a portfolio and, within a portfolio, by similar date of inception. An insurer shall update the measurement of that additional liability at the end of each reporting period and reverse it to the extent that the insurance contract is no longer onerous.

## Appendix A Defined terms

**Acquisition costs** The direct ~~and indirect~~ costs of selling, underwriting and initiating an **insurance contract**.

**Incremental acquisition costs** ~~The costs of selling, underwriting and initiating an insurance contract that would not have been incurred if the insurer had not issued that particular contract, but no other direct and indirect costs.~~

**claims liability for incurred claims** The liability to pay valid claims for **insured events** that have already occurred, including claims incurred but not reported (IBNR).

**pre-claims liability for remaining coverage** An **insurer's** stand-ready obligation to pay valid claims for future **insured events** arising under existing contracts (ie the obligation relating to the unexpired portion of risk coverage).

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