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STAFF PAPER

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Project	**Insurance Contracts**		
Paper topic	Determination of interest expense in the premium-allocation approach		

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Purpose of this paper

1. This paper discusses how to determine interest expense for the liability for incurred claims in the premium-allocation approach. In particular, this paper considers whether the discount rate that is used to determine the interest expense should be the rate locked-in at the inception date of the contract, or a rate locked-in at the date when the claim was incurred.

Staff Recommendation

2. The staff recommend that, when an entity presents the effect of changes in discount rates in other comprehensive income, the discount rate that is used to determine the interest expense for the liability for incurred claims in the premium-allocation approach should be the rate locked-in at the date the claim was incurred.

Background

3. The 2013 ED proposed that an entity could measure some insurance contracts using a simplified model, ie the premium-allocation approach. Under the premium-allocation approach an entity can measure an insurance contract initially as if it comprised two elements:

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(a) a liability for the remaining coverage, which measures the entity's obligation to provide coverage to the policyholder during the remaining coverage period; and

(b) a liability for incurred claims, which measures the entity's obligation to investigate and pay claims for insured events that have already occurred, including incurred claims for events that have occurred but for which claims have not been reported. The liability for incurred claims is zero at initial recognition.

Liability for the incurred claims in the premium-allocation approach

4. Under the premium allocation approach, the insurer's obligation to pay claims for insured events that have already occurred (the liability for incurred claims) is measured in a manner consistent with the general model, which includes discounting using a current rate that reflects the characteristics of the liability.

5. According to the proposals in the 2013 Exposure Draft *Insurance Contracts* (2013 ED), if the liability for incurred claims is discounted:

   (a) interest expense presented in profit or loss would be based on a locked-in rate (the locked-in rate refers to the initial or base discount rate for comparison with the current discount rate); and

   (b) the effect of changes in discount rate on the measurement of the liability for incurred claims would be presented in other comprehensive income (OCI).

6. Under the general model and the premium-allocation approach, the liability in the balance sheet is measured using a current discount rate and hence, the measurement is the same. However, the two models vary in the presentation of claims and interest expense. In the general model the date of the inception of the contract is the date the insurance liability is recognised. Under the premium-allocation approach, there are two alternatives for the locked-in rate:

   (a) the discount rate at the inception of the contract; or

   (b) the discount rate at the date the claims included in the liability for incurred claim occur.

7. Before issuing the 2013 ED the IASB considered arguments that it would be more complex to lock-in the discount rate at the date of inception of the contract rather than the date the claim was incurred. However, feedback received at that time indicated mixed views on which of the two alternatives is more complex. In addition, the IASB noted that the date of inception would be more consistent with viewing the premium-allocation approach as a simplification to the general model. As noted in the Basis for Conclusions to the 2013 ED:

> "The premium allocation approach measures the insurance contract using estimates made at contract inception and does not update those estimates in the measurement of the liability for the remaining coverage unless the contract is onerous. Accordingly, the Exposure Draft proposes that the discount rate used to reflect the time value of money in the premium-allocation approach should be set when the contract is initially recognised. Consistently with that approach, interest expense in profit or loss for the liability for incurred claims would be measured using the rate that applied when the contract was initially recognised". (BCA124)

Feedback on proposals in the 2013 Exposure Draft

8. The majority of the constituents believed that presenting the effect of changes in discount rate in OCI should be optional rather than mandatory for both contracts accounted for under the premium-allocation approach and the general approach. This is because there could be circumstances when the costs of presentation of that effect in OCI could outweigh its benefits.

9. Of those that supported the segregation of the effect of changes in discount rates in OCI, many did not support the 2013 ED proposals for the discount rate for the liability for incurred claims to be locked-in at the inception of the contract. All of those who commented on this issue indicated that the rate at the date the claim is incurred should be the appropriate solution.

10. The main reason for respondents' preference for the locked-in rate at the date of the incurred claim over the locked-in rate at the contract inception date is the

operational complexity and prohibitive costs associated with changes in systems required to collect information about the locked-in rate at the date of contract inception. Those changes would be necessary because insurers usually do not collect and retain information on contract inception dates, and they manage their portfolios based on the nature of the incurred claims.

11. Other reasons for respondents' preference of the incurred claim rate for the locked-in discount rate for the presentation of interest expense are that:

    (a) the interest rate risk for the liability of incurred claims arises when a claim is incurred and therefore the interest expense presented in the statement of comprehensive income should be based on the rate at the date of the claim; and

    (b) because the liability for remaining coverage is not discounted, the discount rate should be locked-in at the date that the liability for incurred claims is recognised, given that discounting only arises at that point.

Relevant decisions on the presentation of interest expense

12. In March 2014 the IASB made a tentative decision that an entity should choose to present the effects of changes in discount rate in OCI or profit or loss. This decision applies to contracts under the general model, but because the premium allocation approach is a simplification of the general model, the option for presentation will apply to both models.

Staff Analysis

13. The main argument in favour of using the rate at the contract inception date for the presentation of interest expense for the liability of incurred claim is to achieve consistency with the general model, as noted in the Basis for Conclusions and reproduced in paragraph 7. However, the main argument in favour of using the rate at the date the claim was incurred is that using this rate is less complex than the rate at the inception of the contract for both users (discussed in paragraph 14) and preparers (discussed in paragraphs 15-17).

Users

14. If the rate at inception of the contract is used, a catch-up adjustment must be recognised in OCI to reflect the effect of changes in discount rates between the date of contract inception and the date when the claim is incurred. This catch-up adjustment may be difficult to explain because no gains or losses would otherwise be separately recognised in the statement of comprehensive income relating to any changes in assumptions between the date at inception of the contract and the date the claim is incurred. This is illustrated by an example in Appendix A. In the staff's view, this catch-up adjustment would mean that using a discount rate locked-in on a date other than the date the claim is incurred would add complexity for users to understand financial statements without bringing significant benefits.

Preparers

15. The staff note that the key rationale behind the premium-allocation approach is that it is a simplified model that arrives at approximately the same results as the general model but at a lower cost.

16. Many of the comment letters indicated significant concerns about the complexity of locking-in the discount rate at the date of inception of a contract. However, according to the recent tentative decisions mentioned in paragraph 12, entities could avoid the complexity of presenting interest expense using a locked-in rate by electing to present the effects of discount rate changes in profit or loss. Nonetheless, the staff notes that, if the costs of applying the OCI approach outweigh the benefits, then entities are unlikely to present discount rate changes in OCI at all. The IASB has previously noted that presenting the effects of discount rate changes in OCI could provide useful information in some circumstances.

17. In the staff's view, applying a simplified model should not burden entities with high costs and operational complexity to the extent that the costs of presenting the effects of discount rate changes in OCI may outweigh the benefits. With this in mind, and because locking in the rate at the inception of the contract may not result in significant benefits as discussed in paragraph 17, the staff recommend that the IASB require that under the premium-allocation approach, the locked-in

discount rate for the liability for incurred claims should be the rate at the date the claim was incurred.

Onerous contracts

18. The discussion on the appropriate rate for the presentation of interest expense for the liability for the claims incurred under the premium allocation approach applies equally to the onerous liability recognised in the coverage period. The 2013 ED proposed that, when applying the premium allocation approach, the entity would recognise an onerous contracts liability in the coverage period if facts and circumstances indicate that the portfolio of contracts containing the contract is onerous. The IASB viewed the recognition of the onerous liability as an acceleration of the recognition of the liability of incurred claims. Consequently under the 2013 ED, the measurement and the presentation of the interest expense for the onerous liability is consistent with the liability for incurred claims. If the IASB agrees with the staff recommendation that the locked-in discount rate for the presentation of interest expense for the liability for incurred claim is the rate on the date the claim is incurred, staff note that the locked-in discount rate for the presentation of interest expense for any onerous liability recognised would also be the rate on the date the onerous liability is recognised.

Question 1: Presenting interest expense for the liability for incurred claims
Does the IASB agree that, when an entity presents the effect of changes in discount rates in other comprehensive income, the discount rate that is used to determine the interest expense for the liability for incurred claims in the premium-allocation approach should be the rate locked-in at the date the claim was incurred?

Appendix A: Example of the catch-up adjustment recognised in OCI when the locked-in rate is the rate at contract inception date

Premiums for one year coverage = CU 12,000 and are earned rateably over the year (ie CU 3,000 per quarter)

Expected losses are CU 9,600 or CU 2,400 per quarter (ie an expected loss ratio of 80%). Assume claims are paid one-year after they are incurred

Discount rate at the inception of the contract is 4%.

First quarter

At the end of the first quarter the insurer has reduced the liability for remaining coverage by CU 3,000 and recognized that as insurance contract revenue.

Assume the liability for incurred claims is discounted and at the date the liability for incurred claims is recognised the discount rate is 5%. Using *the rate at the date the liability for incurred claims is recognised* the insurer would recognize an expense for the liability for incurred claims of CU 2,286 (CU 2,400 discounted at 5%) and establish the liability at the same amount. The profit recognised would be CU 714 (CU 3000 – CU 2286 = CU 714).

Using *the rate at inception of the contract* of 4%, an expense for the liability for incurred claims would be recognised of CU 2,308 (CU 2,400 discounted at 4%), and the profit recognised would be CU 692 (CU 3000 – CU 2308 = CU 692). However, the liability on the statement of financial position would be CU 2,286 (CU 2,400 discounted at 5%) and therefore a difference of CU 22 (CU 2,286 – CU 2,308) would be recognised in OCI.

Second quarter

At the end of the second quarter the insurer again has reduced the liability for remaining coverage by CU 3,000 and recognized this as insurance contract revenue. However, assume that the current discount rate at that date has changed to 3%. Using *the rate at the date the liability for incurred claims is recognised* (i.e. 3%), the insurer would recognise an expense for the liability for incurred claims of CU 2,330 (CU 2,400 discounted at 3%) (and profit of CU 670).

Using *the rate at the inception of the contract* of 4%, an expense for the liability for incurred claims would be recognised of CU 2,308 (and the profit recognised would be CU 692). However the liability on the statement of financial position would be CU 2,330 and therefore a difference of CU 22 (2,330-2,308) would be recognised in OCI.