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A2: IFRS17 Complexity in Practice: PAA and Onerous Contracts

Alice Boreman, IFRS 17 Working Party

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Objectives

This workshop will be a facilitated group discussion of how companies may approach and develop practical approaches to some of the more complex and technical areas of IFRS17. This session will focus on:

- identifying premium allocation approach eligibility; and
- onerous contract testing.

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Premium Allocation Approach

When can it apply?

PAA Eligibility Decision

For each portfolio/cohort of contracts

Do all contracts within the portfolio/cohort have a coverage period of 12 months or less?

YES →
- The portfolio/cohort automatically applies for the PAA.
- No need to demonstrate eligibility.
- Auditors may request evidence that the portfolio/cohort fulfils the criteria.

NO ↓

Can it be reasonably expected that the LRC under the PAA would not differ materially from the GM?

YES →
- The portfolio is likely to be eligible for the PAA.
- Auditors are likely however require justification.
- Need to define what '*reasonably expects*' and '*differs materially*' means for the reporting entity.
- May require modelling of future stresses/scenarios to demonstrate immateriality in a range of outcomes.

NO ↓

Is the portfolio/cohort and associated deviation in the LRC immaterial for the reporting entity?

YES →
- This consideration is outside the scope of IFRS 17.
- Broader accounting/materiality question – see IASB Practice Statement 2 "*Making Materiality Judgements*".
- Will need to carefully monitor the materiality of the portfolio's/cohort's which are not eligible (based on the above steps) over time.

NO ↓

It is unlikely that the PAA will be available to the portfolio/cohort.

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the period before a claim is incurred. Variability in the fulfilment cash flows increases

coverage period of the group of contracts."

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PAA eligibility

What matters?

- Long coverage periods
- Material differences in the **coverage pattern and the risk incidence pattern** where there is a significant level of expected profitability
- Long-tail claims settlement and the potential for discount movements (not offset with inflation movements) to driver differences between PAA and general model
- Volatility in unearned assumptions

Contract Boundaries

Coverage Units

PAA Eligibility Testing

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PAA eligibility

What matters?

Contract boundaries

How long is the contract?

Within the boundary:

- Insurer can **compel policyholder to pay the premium**, or
- Has **substantive obligation** to provide policyholder with services

Beginning of contract boundary

The earliest of**:**

- Beginning of coverage period
- Date first payment from p/h due
- If facts and circumstances indicate that the **group is onerous**, later of:
  - Date facts and circumstances indicate the group is onerous
  - Date entity is bound by the terms of the contract

End of contract boundary

Substantive obligation ends when:

- Insurer has the **right or practical ability to reassess the risks** and, as a result, can **set a price** or level of benefits to fully reflect the risks; and
- Pricing of the premiums for coverage up to the date when risks are reassessed does not take into account the risks that relate to periods after the reassessment date

Discussion

Contract boundaries paper.

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PAA eligibility

What matters?

Coverage Units

How to earn the contract under each model?

CSM under General Model – Earn out of CSM reflects coverage units

CSM for a group of insurance contracts should reflect the 'services provided under the group of insurance contracts in that period … determined by identifying coverage units'. (Therefore, amortisation of CSM can differ from the pattern of the release from risk.)

Coverage Units = 'quantity of coverage provided by the contracts in the group'

Coverage units have been interpreted as the representation of the quantity of benefits to policyholders, such as the economic value of the contractual obligation, which takes into account remaining policyholders' capacity to benefit from coverage based on the economic value covered by their policies. QBE has documented their view that measurement of policyholder economic value represents the practically available "quantity of the benefits provided". The QBE approach has been validated in the IASB Transition Resource Group which has confirmed that the ability of the policyholder to make a **valid claim** (i.e. have an economic exposure) is a relevant factor in measuring coverage units.

The interpretation of coverage units was a significant feature of recent IASB TRG and AASB TRG discussions. Position for general insurance products is now clearer and papers presented have clarified how to determine coverage units and significantly reduced risk around PAA eligibility.

Discussion

Coverage units paper.

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PAA eligibility

What matters?

PAA Eligibility Testing

How to test eligibility?

Possible approach:

- Identify all, or representative sample, of at-risk contracts to model. Highest risk might entail products with:
    - Long coverage periods
    - Material differences in the **coverage pattern and the risk incidence pattern** where there is a significant level of expected profitability
    - Long-tail claims settlement and the potential for discount movements (not offset with inflation movements) to driver differences between PAA and general model
    - Volatility in unearned assumptions
- Model sample contracts under "plausible scenarios" across both models over all reporting periods with unearned coverage to determine if PAA eligibility held under conditions of significant variability
- Determine materiality of any failing contracts
- Identify at-risk factors based on model output to set accounting policy

Discussion

PAA eligibility paper.

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Onerous Contract Testing

Step 1: Identify portfolios
= insurance contracts subject to similar risks and managed together as a single pool

Contracts in different products lines would be in different portfolios.

- *contracts issued within the same 12-month period*
- *information about the contracts' resilience (considered on a gross basis)*
- *consistent with internal reporting*
- *exemption for regulatory pricing*

Fulfilment cash flows may be estimated at a **higher level of aggregation** than the group or portfolio => then need to **allocate estimates to groups of contracts**

Profitable contracts		Contracts that at inception have no significant possibility of becoming onerous subsequently, if any	Unearned profit is recognised as liability and is released as insurance services are provided
		Other profitable contracts, if any	
Onerous contracts		Contracts that are onerous at inception, if any	A loss is recognised in P/L

PAA:
At inception:
Assume no contracts in the portfolio are onerous, unless **facts and circumstances** indicate otherwise

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Onerous Contract Testing

- Identifying onerous contracts – GM
  - Can use “reasonable and supportable” information to conclude that a set of contracts belong to the same group (onerous / other)
    - e.g. business plans
    - e.g. pricing models/structures
  - In the absence of this, the expectation is the test is done on individual contract and assign to group on that basis
- Identifying onerous contracts – PAA
  - PAA contracts are assumed to **not be** onerous unless “facts and circumstances” indicate otherwise.
  - This may set a lower threshold of evidence for identifying contracts however would we be basing reviews on similar information
    - e.g. business plan
    - e.g. pricing models/structures
    - e.g. monthly management MI of key KPI’s, GWP, LR% COR%...

Discussion

What are “facts and circumstances” and how low might you go?

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Questions

Comments

Expressions of individual views by members of the Institute and Faculty of Actuaries and its staff are encouraged.

The views expressed in this presentation are those of the presenter.

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