Aptitude SOFTWARE

Premium Allocation Approach

5 unexpected challenges of implementing PAA

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PAA: An unexpected and unwanted challenge for General Insurers

Aptitude's experience working with insurers delivering IFRS 17 indicates that General Insurers (GIs) have underestimated the complexity of implementing the new requirements and the technology capabilities they will need to deliver a low-cost compliant solution. In their initial IFRS 17 assessment, GIs took the view that they would follow PAA (the Premium Allocation Approach) which has been designed for shorter duration insurance contracts and which would be simpler than the GMM approach (General Measurement Method) in two key ways. Firstly, they would not be required to calculate a CSM (Contract Service Margin) and perform the initial and subsequent measurement of the CSM. Secondly, the changes to their reporting and disclosure requirements would not be significant. However, the identification of new complexities underlying PAA has resulted in GIs reassessing their proposed IFRS 17 solution and how they will resolve them.

The unexpected challenge

In their initial assessment of IFRS 17, General Insurers broadly made the conclusion that they would avoid many of the new complex requirements given the nature of their business and products. IFRS 17 introduces a new requirement for insurers to calculate a CSM, which is broadly defined as the deferred income of an insurance contract. The CSM needs to be measured at each reporting period and unwound as the contract is serviced. The PAA approach allows insurers who meet the criteria to avoid having to calculate a CSM and the need to perform discounting and the associated complexities. However, in starting to define their IFRS 17 delivery solutions GIs have identified 5 unexpected issues.

Data granularity requirements

In some key areas, GIs have identified that the data they require under PAA to calculate the LIC (Liability for Incurred Claims) and LRC (Liability for Remaining Coverage) is not easily accessible through their existing platforms that are used to meet the current IFRS 4 standard through the Unearned Premium Approach (UPR). Under UPR, business and contract data is typically aggregated at a relatively high level whereas PAA is a transactional approach requiring contract data at a lower level of detail. Whilst Life Insurers are typically more familiar with managing their data at this more detailed level due to the longer-term nature of the risks involved, GIs are less familiar and as a result need to define how to map their existing data to this new requirement. Some examples of these types of data are outlined below.

a. LRC, LIC and premium data: Under IFRS 17 the PAA calculation should be on a "premium received" basis whereas UPR is based on "premium receivable". GIs generally retain their premium data at an aggregated level (e.g.: due from 3rd party intermediaries) and therefore face the challenge of sourcing their future premium cashflows at a gross and contract level and then integrating this data into the LRC and LIC calculations.

b. Portfolio and contract level data: IFRS 17 requires the LRC and LIC calculations to be performed at the cohort and contract level and for the resulting disclosures and reporting to also be performed at this level. GI's often only have their contracts at an aggregate portfolio or loss reserving level under IFRS 4. They are therefore currently performing analysis to identify how to source this data and integrate it into their IFRS 17 calculations.

c. LRC, LIC and expected future cashflows: Under the current standard GIs typically do not use the concept of expected future cashflows and payment patterns given the short duration of the contracts in their business. Under IFRS 17, they will be required to define future payment patterns relating to future claims. These future payment patterns will need to be applied to define the expected future claims cashflows and then discounted back.

Discounting and Risk Adjustment requirement for LIC and LRC

Under their earlier assumptions, GI's did not expect to have to perform discounting under IFRS 17 due to the short duration of their contracts. However, under the standard, the criteria is that all claims must be "expected to be paid within one year" of their incurrence. Those claims that are not settled in a 12-month period need to be recorded in the LIC Balance Sheet line and discounted at the appropriate discount rate along with a Risk Adjustment, similar to the GMM approach. For this reason, whilst GIs do not need to perform a full CSM calculation, they do need to be able to have a discounting capability, calculate a risk adjustment and manage the associated Balance Sheet and P&L/OCI entries. Many GI insurers are unfamiliar with the technicalities of discounting and the associated accounting, reporting and disclosure requirements.

Potential need to perform a CSM calculation

As above, the initial assumption of GIs was that they would not need to perform a CSM calculation and there is an automatic assumption that no contracts would be onerous at initial recognition "unless facts indicate otherwise". This wording indicates that GIs will need to design and implement a process on how to react in the event of such facts emerging and what to do once they identify onerous contracts. Hence there is the potential that they will need a CSM calculation in these circumstances.

Not all the GI product lines meets the PAA criteria

Many GI insurers are finding that the proportion of their business meeting the PAA criteria is smaller than originally expected. Multi year contracts will not typically qualify for the PAA approach and will need to be carefully assessed before deciding which method to use. For example, GIs with long term direct contracts such as construction and engineering contracts or long-term reinsurance contracts will need to build a GMM capability for these businesses line alongside their PAA platform.

Acquired portfolios may not meet the PAA criteria

The standard allows PAA to be applied to acquired policies written by a GI that move into its settlement period but not to those policies acquired by the insurer that are already in its settlement period. It is possible that GIs intending to apply PAA to all contracts they issue will have to build a GMM capability purely to account for contracts they expect to acquire during their settlement periods.

Other challenges (common to GMM):

PAA shares with GMM several challenges that we are working with our clients to resolve. They are typically finding these challenges are best met by an accounting engine and sub-ledger that is familiar with the accounting and reporting needs:

- Intra Group Reporting
- Multi-Currency reporting and FX management
- Reinsurance
- Cost and Income allocations
- Manual journals

How to meet these challenges

Aptitude and it's IFRS 17 solution are well set up to meet these challenges.

1. **We understand the PAA problem**
   We have been working with several EU and Asian based GIs to design their PAA solution. As a result, we are familiar with the challenges and the optimal solutions.

2. **We know the data requirements**
   We have a Target Data Model for PAA which defines the minimum data requirements for GIs to meet the standard.

3. **Pre-configured calculation engine**
   Once the data has been sourced, our accounting engine and sub-ledger work together to define the required accounting entries and enrich the data to meet the disclosure requirements.

4. **Discounting**
   The AICE engine (Aptitude Insurance Calculation Engine) can perform the discounting requirements for the LIC and Risk Adjustments and link the unwinding to the required accounting entries.