ACTUARIAL SOCIETY OF SOUTH AFRICA

Quantifying Risk, Enabling Opportunity.

Practical concepts on how to assess PAA Eligibility

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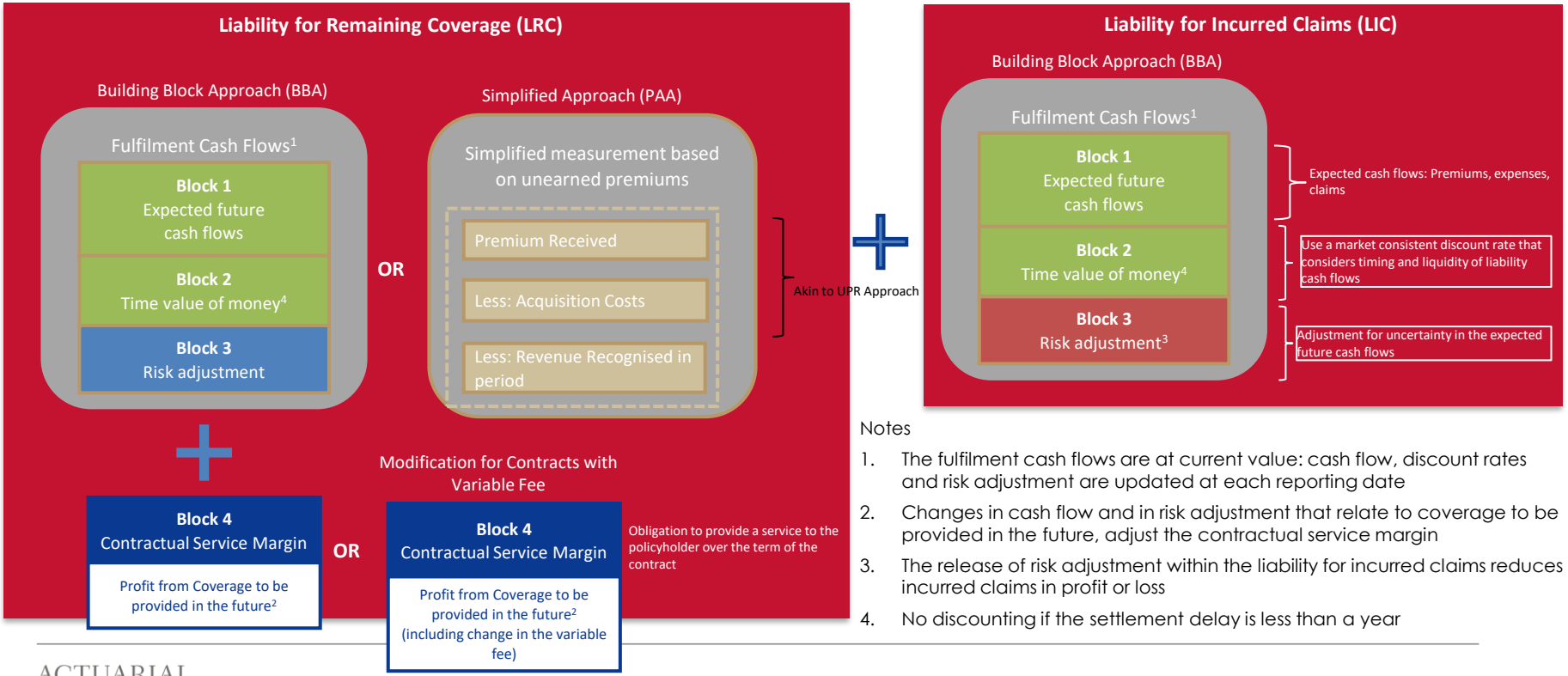
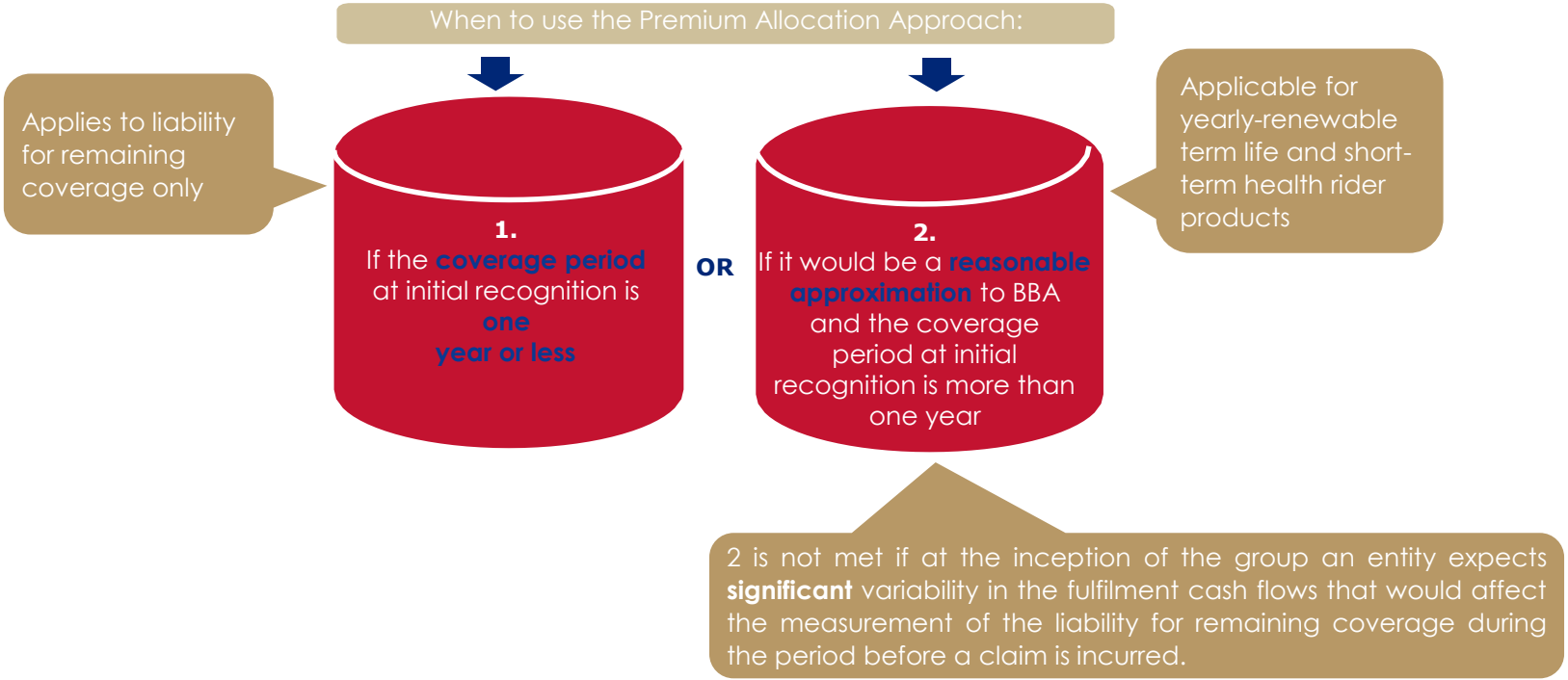
IFRS17 Insurance Contract Liability Framework



Notes

1. The fulfilment cash flows are at current value: cash flow, discount rates and risk adjustment are updated at each reporting date
2. Changes in cash flow and in risk adjustment that relate to coverage to be provided in the future, adjust the contractual service margin
3. The release of risk adjustment within the liability for incurred claims reduces incurred claims in profit or loss
4. No discounting if the settlement delay is less than a year

Premium Allocation Approach (PAA) - Criteria



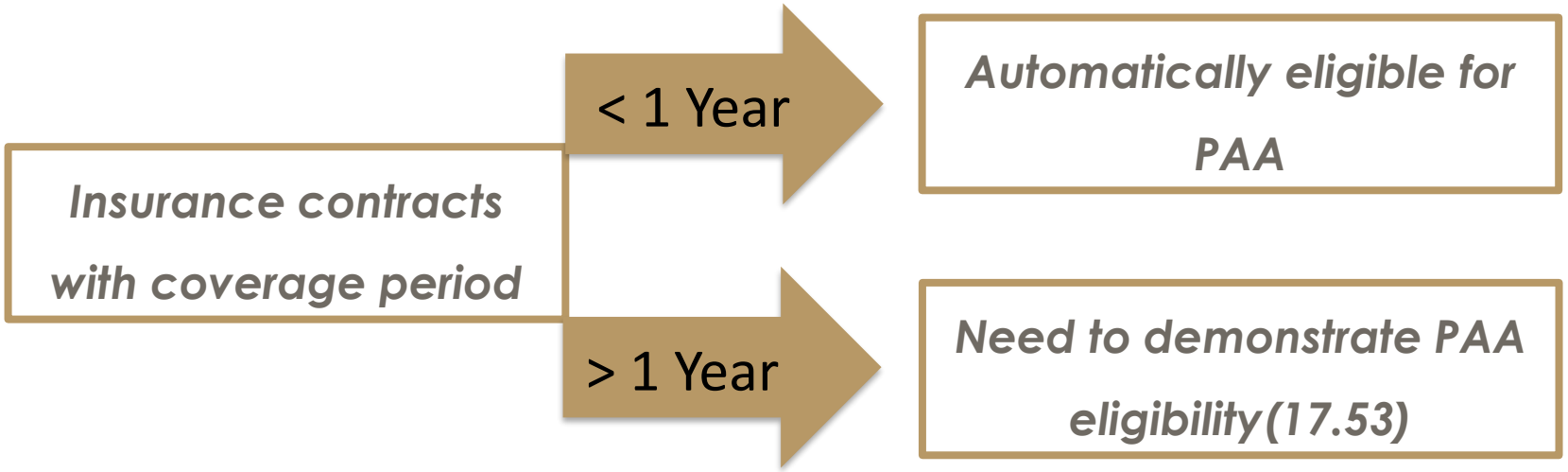
Premium Allocation Approach (PAA) - Specifics

Requirement	Description	Impact
Premium Allocation Approach	• PAA is a simplification that can be elected as a measurement for a group of insurance contracts when certain conditions are met • It only applies over the **coverage period**, not over the settlement period • Use of PAA is an option which is permitted for contracts with coverage of 1 year or less or otherwise where the entity can demonstrate it is a reasonable approximation to BBA • Accrete interest unless the term from coverage to incurred loss event is less than 1 year.	• The primary impact of this is that it allows non-life insurers to continue to use their process and systems for calculating unearned premiums amounts • It will still be necessary to set up processes to calculate BBA for claims reserves • Key consideration is whether PAA can apply to all business in coverage period and whether it is preferable to use PAA or move all contracts to BBA, which will require a new process for CSM.
Onerous contracts	• An insurer will need to hold **an additional liability** for onerous contracts where PAA is used over the coverage period and for signed but not yet incepted contracts that are onerous • An insurance contract is **onerous** if the fulfillment cash-flows (PV of the future cash-flows from the insurance contract plus RA) is greater (>) the carrying amount of the liability for the remaining coverage period under the PAA, if any	• Evolution of existing approach to assessing unexpired risk reserves • New measurement of onerous contracts based on Fulfillment cash-flows (BEL + RA) • Applies for groups measured using PAA and for signed but not yet incepted contracts that are onerous

Why PAA for Non-Life insurers

- *Simpler to calculate than the BBA*
- *Do not require a CSM engine*
- *Disclosure requirements are expected to be less onerous under PAA than under BBA*
- *Under PAA, valuation of Unearned proportion of liability can be seen as similar to the calculation under current accounting standards (current UPR & DAC calculation)*

Length of Coverage



IFRS 17 does not specify how the testing for PAA eligibility must be conducted but typically this would be done qualitatively and/or quantitively.

IASB amended IFRS 17 to establish that the one-year eligibility criterion for the PAA is assessed by considering insurance coverage and an investment related services, if any.

Variability of Cashflows

IFRS 17 considers variability in cash flows related to future service to be an indicator that PAA eligibility will not be met. (17.54)

Qualitative Assessment:
A qualitative assessment of the likelihood of the variability in cash flows can be made.

Quantitative Assessment:
Further testing will need to be performed by defining a base case and through the use of reasonable stress scenarios introducing variability in cash flows that may plausibly arise.

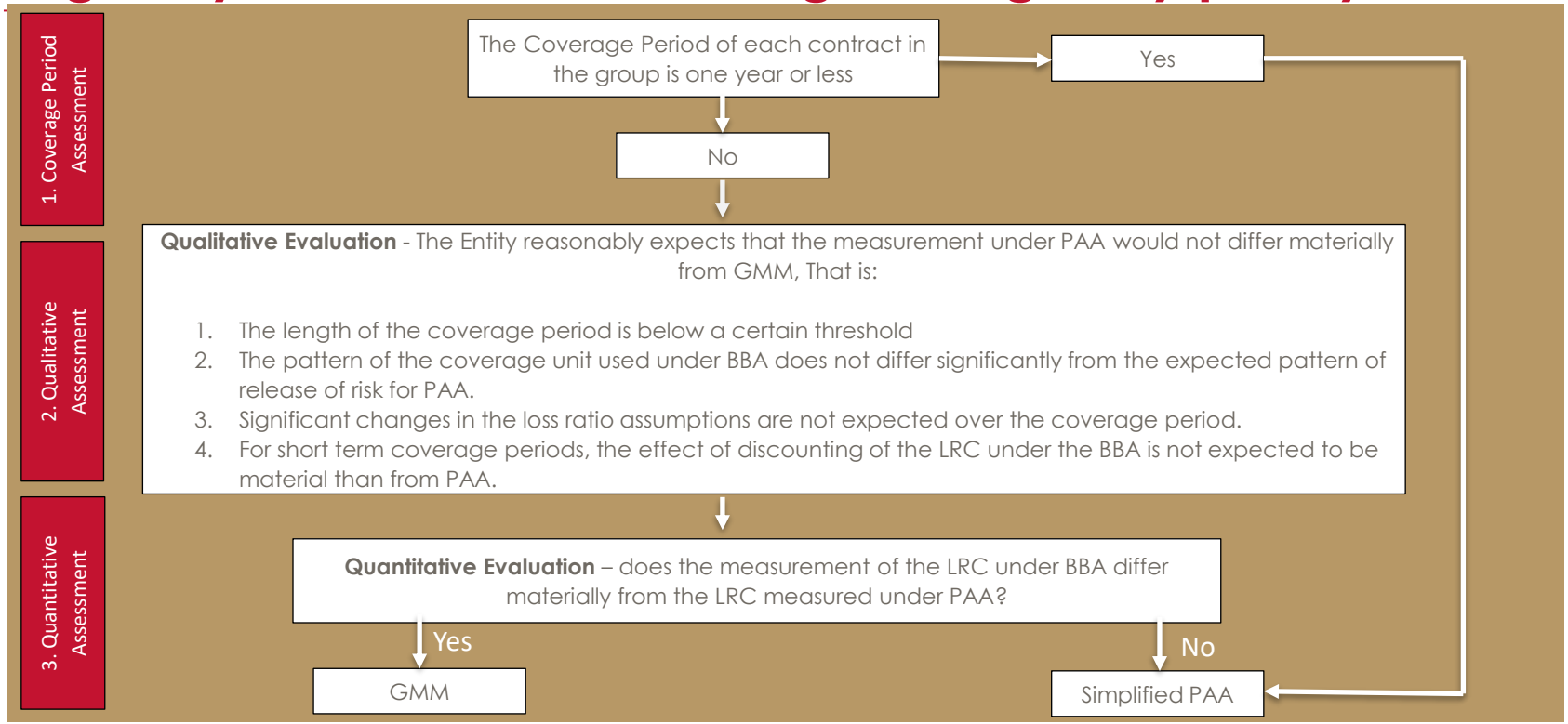
Eligibility Assessment: Frequency

PAA eligibility is determined at inception and an entity is not required or permitted to reassess a group's eligibility for the PAA subsequently.

Transition Resource Group ("TRG") April 2019 Agenda paper (S123)

"As required by paragraph 53 of IFRS 17 the criteria are assessed for each group and the election is made for each group meeting the criteria. Given the eligibility criteria are assessed at inception, the standard does not require or permit reassessment of the eligibility criteria or the election to apply the approach."

Eligibility Assessment: Defining an eligibility policy



Step 1: Coverage Period Assessment

1) Analyze the entity's insurance contracts across all products by GWP, coverage period and other relevant factors such as whether the product is long or short-tail.
2) Identify all contracts with coverage of one year or less and the portfolios they belong too.
3) These contracts do not require testing for PAA eligibility but this data is needed to establish the relative % of contracts with coverage in excess of one year in each portfolio.

Step 2: Qualitative Assessment

Purpose:
Identify key features of the groups of contracts for which the results under the PAA will be similar to the results under GMM.

For contracts where the coverage period > 1 year determining whether they are likely to fail or pass PAA Eligibility based on the nature of the product.

The following criteria may result in contracts being ineligible for the PAA:

- For **multi-years contracts**, if the expected pattern of release of risk during the coverage period under PAA differs significantly from the pattern of service expected to be adopted to determine coverage units and recognition of CSM under the BBA
- Contracts where the **claims payout period is long** enough that the discounting effect of the LRC under the BBA could result in a materially different answer from that under the PAA
- For a new product with long coverage periods or late start of the coverage where **limited information on expected losses** at inception is available, changes in expected loss ratios during the coverage period are probable and therefore should be tested

Step 3: Quantitative Assessment

If it is expected that there may be material differences in LRC between BBA and PAA during the qualitative assessment, quantitative assessments are required to assess PAA eligibility:

1 **Select the contracts/groups most likely to fail PAA Eligibility testing based on:**

- Expected pattern of release of risk vs CSM release
- Discounting
- Longer coverage period
- High levels of CSM
- Skewed patterns of release of risk
- Long payout patterns for future claims

2 PAA Eligibility is determined at **inception date**, so it's important to use **inception date assumptions** for determining the LRC (under both PAA and BBA).

3 **Test selected** contracts or groups of contracts using cash flows and assumptions that **represents the group of contracts** and determine if they **pass PAA eligibility**.

4 Test the contract or groups of contracts **under plausible sensitivity scenarios** to ensure that **reasonable deviations in assumptions** would not cause the product to fail PAA eligibility.

Materiality

Materiality for the purpose of assessing PAA Eligibility must be **defined** and **determined** to assess where material differences exists.

Example of PAA Eligibility materiality benchmark:

Consider the difference between the PAA and the BBA LRC as a **percentage of the BBA LRC** as denominator at each future reporting date (e.g. annual/quarterly as appropriate) and compare this percentage to a materiality threshold of 10%.

Where the absolute amount of BBA LRC becomes insignificant compared to the initial BBA LRC, consider the difference between the PAA and the BBA LRCs **at each future reporting date** as a percentage of the initial BBA LRC as denominator and look for <5% for a pass.

This approach can be used to test the worst products in a group and not the whole group.

If the **worst products pass → entity can move forward assuming the group is PAA eligible.**

If the **worst products fail → entity still has the opportunity to consider the broader group**.

When contracts/groups of contracts fail PAA eligibility the entity still may have recourse to consider **entity level materiality.**

In this event, care should be taken to consider the **aggregate of the groups which failed PAA eligibility** rather than each separate failed group.

Product example: Extended Warranty

Extended Warranty

Provides **cover** for
- Repair
- replacement costs
- residual value reimbursement

after statutory guarantee expired
(2 years after purchase)

If customer can prove at least 6 months after the delivery that the product is not in conformity, but can't prove that defect existed at time of purchase, the guarantee will extend.

Sum Insured =
2.5 x Annual Premium

Coverage Period:

The insurer's obligations cover claims submitted up to 5 years after the policy has expired (will vary with underlying risks).

Product Deep dive: Cash Back benefit (1)

Cash backs are a **benefit** provided to the policyholder where a predetermined amount of premium is **refunded** to the policyholder should they meet certain requirements. Examples include

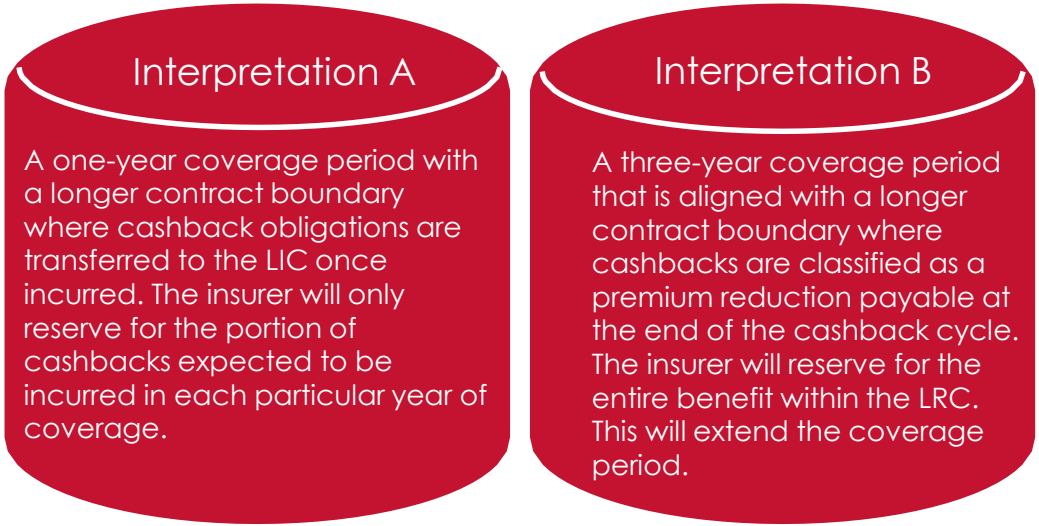
- Refunds on premiums after a certain number of claim free periods
- Refunds on the continued uninterrupted payment of premium for a specified period.

Example:

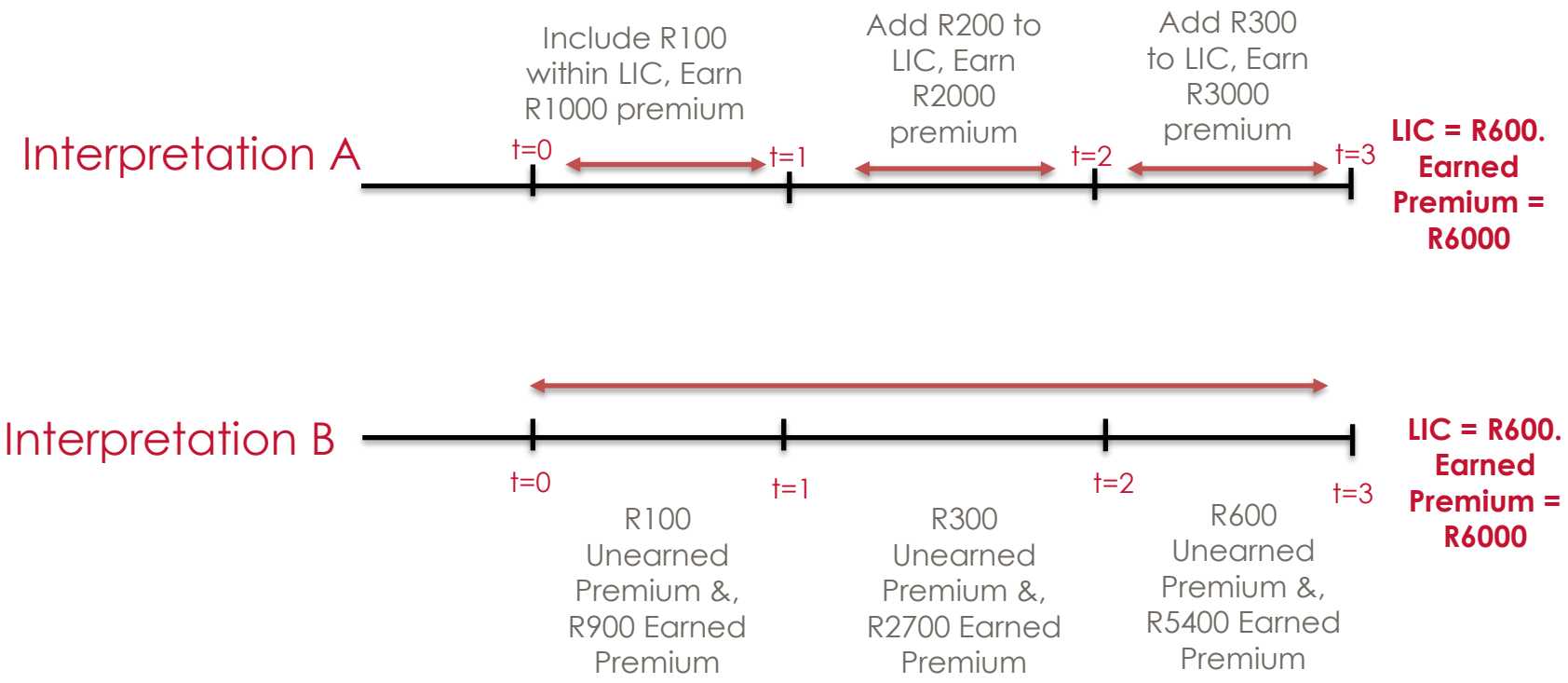
Suppose we have a product with the following features:

- A short-term product with a **one-year coverage period**.
- The insurer has the ability to reprice the contract **annually.**
- The contact includes a cashback benefit that provides a specified percentage, say **10%, of total premiums paid** over a term of three years (provided that the policyholder remains claim free).
- Suppose that premium receipts over three years are expected to be R1 000, R2000 and R3 000.
- The expected cashback benefit payment, if any, is therefore R600 (ignoring the probability of payment)

Product Deep dive: Cash Back benefit (2)



Product Deep dive: Cash Back benefit (3)



Thank you!

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