The Complexities of PAA

* For a more complete explanation of these challenges please refer to our whitepaper 'The Realities of Implementing the PAA Approach'

Premium Allocation Approach

The initial reaction to IFRS 17 was that most General Insurers (GIs) could, and probably should, elect to use the Premium Allocation Approach (PAA). PAA seemed to offer a way to reduce implementation costs for insurers while retaining useful information for users of financial statements. In theory, the PAA approach appears to be considerably simpler than the GMM and VFA approaches as no contractual service margin is required and the disclosures are less complex. However, our experiences with a number of general insurers have unearthed many operational challenges. This summary very briefly highlights these challenges.

The Challenges

Data granularity	Data remains the number one challenge – GI insurers tend to model on an aggregated level (e.g. loss reserving) and data is required at a much lower level of granularity for IFRS 17. This may require new, complex allocation processes to groupings prior to calculation which must be fully auditable and ideally automated.
LRC	Calculating the LRC under PAA appears similar to the current UPR calculations but there are significant differences to consider. UPR calculations often take the premium receivable and assess the unearned proportion prospectively. However, PAA takes a more transactional, retrospective approach – premium received less insurance revenue for the period based on expected premium receipts and the assumed pattern of exposure emergence, passage of time or other measure. So new LRC calculation processes are required.
LIC	For the LIC, insurers will probably have to adopt a GMM type approach which will involve discounting and a risk adjustment. This requires new data, processes and calculations. The impact this will have on an insurer's Combined Operating Ratio will also have to be assessed.
LIC - fulfilment cash flows	For the LIC claim payments, patterns are an important element – these basically forecast the future claims cash flows. Each type of risk/peril will have their own distinct payment pattern derived from historical claims data, loss development triangles etc. The generation of the subsequent fulfilment cash flows for the LIC is not straightforward and is based on an input payment pattern (variable by risk/peril) and the timing of the claim. Consequently, new calculation routines will be required to generate the fulfilment cash flows for the LIC which will need to be regenerated at each reporting period.
OCI option	There is an OCI option under PAA for changes in discount rates and this could have significant impact on data systems and processes as insurers will need to store discount rates at claim occurrence, calculate the impact of changes in discount and record the cumulative impact of rate changes over time. Using this option may drive volatility in the balance sheet and thus need serious consideration.