ECO-SLV-09-234

Comments on Consultation 30-09 Draft L2 Advice on TP - Treatment of Future Premiums	
Name company: CEA	
Reference	**Comment**
Introductory remarks	The CEA welcomes the opportunity to comment on the Consultation Paper (CP) No. 30 on TP - Treatment of Future Premiums. It should be noted that the comments in this document should be considered in the context of other publications by the CEA. Also, the comments in this document should be considered as a whole, i.e. they constitute a coherent package and as such, the rejection of elements of our positions may affect the remainder of our comments. These are CEA's views at the current stage of the project. As our work develops, these views may evolve depending in particular, on other elements of the framework which are not yet fixed.
Key comments	**The CEA supports the "Insurance Contract Boundaries" concept -** As stated in our correspondence with the IASB[1], the CEA's position on future premiums is as follows: "*The boundary of a given contract is defined by the cash in-flows that are expected to fall within the contract's term. For these purposes the term of a contract is the shorter of the contract's life and the point, if any, at which the policy can be freely re-priced by the insurer at the individual policyholder level ,(i.e. up until the point at which the insurer has the ability both to reassess the risk profile of the individual policyholder and change the price for an individual without contractual constraint.)* *Once the contract boundary has been established then the measurement of the insurance liability should take into account the expected value of the cash in-flows to be received within the contract's term. The claims and costs associated with the contract as defined should also be reflected in the liability valuation on an expected value basis."* **The treatment of options and guarantees for contract renewal should be symmetric** - The CEA strongly disagrees with the proposal by CEIOPS to include only the expected future cash flows from those options and guarantees for contract renewal that are expected to produce losses and ignore those that are expected to produce a profit. The reasons for this are as follows:

[1] http://www.cea.eu/uploads/DocumentsLibrary/documents/1241447091_joint-contract-boundaries-paper.pdf

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	• The assumption contracts Article 76 (2) of the Level 1 text, to require inclusion of all future expected cash in-flows and out-flows. • The assumption is not in line with the economic reality - which is thus against an economic approach and is not in line with the assumptions would be used by a 3rd party when pricing the insurer's business. • The SCR takes account of uncertainty in the Best Estimate – extra prudence should not be taken into account within the Best Estimate. • Experience shows that policyholders cannot be assumed not to take-up profit-making options - this should be taken into account in the BE. • This requirement may cause practical difficulties for insurers.
General comments	**The IASB paper was a preliminary view and may not be sustained** - CEIOPS is frequently referring to the preliminary views of the IASB as presented in their discussion paper on insurance contracts. This DP was issued in May 2007 and work has been developed deviating from their original opinions. CEIOPS should acknowledge this and be very careful in referrals to the DP. We note for example that the observer notes from the most recent IASB meeting in May state the following (although we should note that this position is tentative at this stage): *"Accounting for future premiums that depend on options: However, fully separating the existing contracts into buckets for those that are or will become onerous, those that are providing guaranteed insurability, and other seems virtually impossible. Cross-subsidization of net cash flow from onerous contracts with those from contracts that are not onerous is a fundamental aspect of insurance. Moreover, arguably the resulting measurement is not a representation of an economic phenomenon. Recognizing cash flows from both types of contracts as contract cash flows provides a better reflection of the economics of an insurance contract. Staff concludes that defining one single test for the boundaries of an existing contract is preferable to an approach that requires one test for an onerous contract and a different test for a contract that is not onerous."* [2] ⇨ The CEA requests that CEIOPS should acknowledge the fact that the IASB paper was a preliminary view and may not

[2] Para 18: http://www.iasb.org/NR/rdonlyres/60F9905C-C3DB-437E-BBED-DAD3BD6769A2/0/IC0905b16Aobs.pdf

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	be sustained. We also note that IFRS does not always provide an economic valuation for all assets and liabilities, therefore Solvency II should carefully consider references to IFRS when the appropriate IFRS standard is not based on sound economic principles. **The Level 1 text clearly requires all future expected in-flows and out-flows to be included in the Best Estimate**– The Solvency II philosophy is for best estimates to be realistic without extra prudence, while all extra prudence is allowed for via the capital requirements. This is a key philosophy of Solvency II. Reference is made in Para 2.2 to Article 76 (2) of the Level 1 text: "*The cash-flow projection used in the calculation of the best estimate shall take account of all the cash in- and out-flows required to settle the insurance and reinsurance obligations over the lifetime thereof*." Therefore, the Level 1 Directive clearly states that all expected in-flows and out-flows are included under the BE. ⇨ The CEA would request that CEIOPS also refers to this paragraph of the Level 1 text in Para 3.15 and 3.19. We should highlight that we expect all future in-flows and out-flows arising from existing contracts only to be included in the technical provisions and we do not expect to also include future contracts. The valuation of future contracts is considered as part of our response to CP35 on goodwill. **The paper should also refer to the Level 1 text requirements on future premiums within the SCR** - The CEA supports the restriction to existing contracts and the explicit linkage between the solvency balance sheet of existing contracts and the SCR in paragraph 3.17. However there are a couple of relevant article in the Level 1 text which are not mentionned in the CEIOPS paper. These are: Article 101 (3): "*The Solvency Capital Requirement ... shall cover existing business, as well as the new business expected to be written over the next twelve months*." Article 105 (2): "*The Basic Solvency Capital Requirement shall ... take account of the uncertainty in the results of insurance and reinsurance undertakings related to the existing insurance and reinsurance obligations as well as to the new business expected to be written over the forthcoming twelve months*."

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	⇨ Although the paper does not explicitly deal with the SCR, the CEA would request these references were included within the Consultation Paper. **The paper should also refer to the Level 1 text Para 75 (2):** "*The value of technical provisions shall correspond to the current amount insurance and reinsurance undertakings would have to pay if they were to transfer their insurance and reinsurance obligations immediately to another insurance or reinsurance undertaking.*" Therefore, as stated above, all future in-flows and out-flows arising from existing contracts should be included in the technical provisions.
Para 1.2 – 1.3	**The scope of the paper is limited** - It should be clarified that this CP is only dealing with future premiums within the context of best estimate but this CP is not dealing with other aspects of the best estimate like "gross or net" or the *"..circumstances in which TP shall be calculated … as a sum of a best estimate and a risk margin …"* These topics have to be taken into account in CP 26-09.
Add a new para 2.3 before existing para 2.3	**The Level 1 text implies that the future premiums in respect of an existing contract be included** - This whole CP is elaborating and clarifying the meaning of "existing" contracts but no link is given to the Level 1 text. This link can be found in Article 75 (2): "*The value of technical provisions shall correspond to the current amount insurance and reinsurance undertakings would have to pay if they were to transfer their insurance and reinsurance obligations immediately to another insurance or reinsurance undertaking.*" The "immediate" transfer principle implies that only existing contracts but no contracts from future business have to be taken into account. ⇨ An additional reference should be made to Article 75(2) of the Level 1 text.
Para 3.2	**Different types of future premiums -** This section tries to describe the various types and characteristics of future premiums, however it may not be exhaustive and should preclude alternatives in the future.

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	⇨ The CEA would request that "*Such premiums can be of different nature*" should be replaced by "*Without seeking to be exhaustive, such premiums can be in the following forms, among others*". "*Legally enforceable*" - See comments on Para 3.30 (e)
Para 3.4	**Cash flows arising from the exercise of rights under a contract should be considered as part of that contract** - The CEA agrees with the content of this paragraph, however: ⇨ The CEA would request that it should be expanded to include the text: *"Cash flows arising from the exercise of rights under a contract should be considered in the valuation of that contract*".
Para 3.12 and 3.13	**Pre-agreed premium adjustments should not be recognised as a new contract** ⇨ The CEA requests that clarification is made on this point with the addition of the text: *"Pre-arranged or agreed premium adjustments should not lead to the recognition of a new contract if the policyholder has no right to cancel the contract following such an adjustment."* "*Unlimited ability*" - See also comments to Para 3.30(a)
Para 3.14 and 3.22	**We strongly oppose these sections of the paper** - Please see comments to Para 3.30 (c)-(d)
Para 3.17	**This paragraph should also apply to expected future profits** - The CEA supports this paragraph. All expected losses should be included in the Best Estimate and any corresponding variability is these Best Estimates should be included in the Solvency Capital Requirements. ⇨ The CEA believes that the same should also be true for all expected profits. Please see comments to Para 3.30 (c) - (d)

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Para 3.20	**The Best Estimate should reflect the economic reality and not include additional margins for uncertainty** - The CEA rejects this narrow evaluation of the situation. The company should reflect the expected take up rate. If such an assessment results in a positive value then that is the economic reality. The Best Estimate should reflect the expected value of future cash flows and should not include additional margins for uncertainty which would be taken into account in the market value risk margin and the SCR. The example states that if the Best Estimate of contract B was lower than contract A, then this is not an appropriate reflection of the economic situation, stating that the insurer selling B is not in a better position than A. The CEA completely disagrees with this comment. Insurer B is certainly in a better position than A as insurer B has potentially profitable options which could be exercised which do not exist for insurer A. The Technical Provisions should reflect the Fair Value or the Exit Value of the contracts i.e. the price that a 3rd party would be willing to pay to take over the business, or the costs to settle the business within the insurer. Any 3rd party considering purchasing the contracts would certainly not ignore the potential profits arising from insurer B's options and would take into account the expected take-up rate of these options in their assessment of the Best Estimate. Any variability in the expected option take-up rates would be expected to be taken into account in the Market Value Risk Margin. Furthermore, we would like to point out that the argument of "same policy, same BEL" is non-economic and therefore inconsistent with the Framework Directive – the requirement should be "same risks, same BEL". Company A and B could sell identical policies but if one targets high socio-economic groups and the other low then they will get different economic results because the risks and the experience will be different. Taking into account expected future experience is a key component of an economic approach. ⇨ The CEA would request that this section was re-drafted to include an equal treatment of expected future profits and losses. The economic reality of the entity should be reflected in the Technical Provisions. Please see comments to Para 3.30 (c) - (d)
Para 3.21	Please see comments to Para 3.30 (c) - (d)
Para 3.24	Please see comments to Para 3.31
Para 3.26	**These requirements are excessively complex** - We are not sure if CEIOPS understands the complexity of the calculations that is being requested in this paragraph. It makes no sense to consider certain future premiums in the

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	calculation of the SCR and not consider them in the calculation of the Best Estimate. Insurance companies should either consider a certain cash flow for both calculations or not consider it at all.
Para 3.30 (a)	We agree with this position, however, we would request clarification as follows: **The key criteria should be whether or not the insurer can re-underwrite the risks at individual policy level (as would be the case for new business)** - We would request a review of the phrase a "*unilateral right to cancel the contract, a unilateral right to reject the premium or an unlimited ability for the insurer to amend the premium or benefits (or otherwise re-underwrite the risk)*". As laid out in our letter on "Future Contract Boundaries" and referred to in our "general comments" above, we believe that the key criteria should be that future premiums are included as "existing" contracts if the insurer cannot re-underwrite at individual policy level i.e. if the insurer is obliged, if the policyholder wishes, to take on a policy without being able to re-assess the individual policyholder's risks. The insurer should be able to change the premium of an existing contract based on, for example, their assessment of the experience of the whole portfolio of risks and this should continue to be treated as an existing contract as the insurer is not able to re-asses the individual risk situation of the policyholder and so price as it would for new business. There could also exist other external factors which may cause the insurer to be able to re-price the contract, which should not cause the premiums to be classified as part of a new contract. In this respect "*an unlimited ability to amend the premium or benefits*",as set out in the CP, is not clear. Furthermore, even if the insurer has a unilateral right to cancel the contract this does not mean that the insurer will do so in practice. As realistic assumptions should be used to calculate the best estimate, an assumption of 100% cancellation, which the CP assumes, may not in line with these assumptions. It may be that the insurer only actually cancels a proportion of these policies in practice and as such the insurer should be able to use their own experience assessment in the calculation of the proportion of future premiums included in the best estimate. Therefore we do not support the wording "*unilateral right to cancel the contract, a unilateral right to reject the premium".* ⇨ The CEA would request that the text was clarified in line with the previous CEA position on Insurance Contract Boundaries as referred to in our "general comments" section.

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Para 3.30 (c) - (d)	**Expected future profits as well as losses should be taken into account in the Best Estimate if they relate to existing contracts** – The CEA strongly disagrees with the proposal by CEIOPS to include only the expected future cash flows from those options that are expected to produce losses. These sections should be modified substantially to establish that future premiums resulting from options and guarantees on renewal should be included in cash flow projections irrespective of whether the insurance undertaking expects or forecasts that it will make a profit or loss on these options/guarantees. The reasons for this are set out below: • **The assumption contradicts Article 76 (2) of the Level 1 text** – This requires the inclusion of all expected in-flows and out-flows in the Best Estimate. • **The assumption is not in line with the economic reality** – If expected profit caused by policyholder options is not included but expected loss is included, the result will be an asymmetric calculation which is thus against an economic approach and is not in line with the assumptions would be used by a 3rd party when pricing the insurer's business. This breach of the economic approach can be clearly appreciated in the regulation proposed when it states that if a contract includes a policyholder option to increase the future premiums and the undertaking expects a profit from the additional future premiums then this profit does not relate to the existing contract and such future premiums should not be included in the Best Estimate. On the contrary, if the undertaking expects a loss from the additional future premiums then this loss relates to the existing contract and such future premiums should be included in the Best Estimate. This is also not in line with Article 75(2) of the Level 1 text. • As a result, in accordance with the terms of the Consultation Paper, only those future premiums (and their benefits, expenses, etc) related to options or guarantees granted to policyholders which increase the Best Estimate will be included (but not those which decrease the Best Estimate). This could not be more contrary to the economic focus, as it proposes asymmetrical treatment which is in no way supported by level 1 regulation. • **The Best Estimate should not include additional margins** – Extra margins for prudence should not be taken into account over and above what is already included within the SCR and the Market Value Risk Margin. This is returning to Solvency 1-type requirements. The additional prudence required over and above the Best Estimate is allowed for via the SCR. Any assumption that an insurer makes regarding the take-up of future options should be stressed under the SCR and so the uncertainty in this assumption would result in capital requirements under the SCR, not under the Best Estimate. • **Policyholders will decide whether to take up an option based on their own circumstances rather than**

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	whether the insurer is expected to give rise to a profit or a loss – Insurers have policyholder experience to show that policyholders do exercise options which also give rise to profits for insurers, not just those that give rise to losses to insurers. Whether the insurer expects to make a profit or a loss on the exercise of the option is irrelevant in determining whether the policyholder will continue the contract or not. For example, if a policyholder in good health extends a policy using an extension option they will get the same terms and conditions as a healthy new customer. The profit the insurer makes arises from not incurring the cost of underwriting and possibly not paying commission whereas the policyholder neither loses nor gains. Therefore, an assumption that the take-up rate of these options is zero is not realistic. If an insurer has experience data for the expected take-up for options, then the undertaking should assess the appropriateness for use of this data in the calculation of the Best Estimate. In an Internal Model the undertaking can base assumptions on historic evidence of all expected policyholder behaviour. • **This requirement may cause practical difficulties -** A priori an insurer may not know which policies produce an economic loss or a profit, so the undertaking would have to analyse at a certain level of granularity each time and in each central/stressed scenario. These requirements could therefore produce technical and operational issues for companies as from one year to another and depending on the market conditions as the scope of the Best Estimate will have to be updated. We note, as mentioned in our "general comments" above that the recent IASB work on this topic has recognised that separating contracts into those that are expected to give a profit and those that are expected to give a loss is "*virtually impossible*" and "*the resulting measurement is not a representation of an economic phenomenon*". Therefore "*defining one single test for the boundaries of an existing contract is preferable to an approach that requires one test for an onerous contract and a different test for a contract that is not onerous*". ⇨ The CEA strongly believes that these paragraphs should be removed from the CEIOPS advice.
Para 3.30 (e)	**"*Legally enforceable*" is not usually applicable in an insurance context** - This is superfluous as (a) to (d) already exclude premiums not deemed enforceable, so introducing this seemingly "new" requirement could cause confusion. Insurance premiums can normally not be forced to be paid. In the majority of cases the insurance undertaking is not able to legally enforce the payment of the premium; instead, in the event of non-payment, the undertaking may, depending on the circumstances, exercise its right to reduce the amount insured, or even suspend the coverage or terminate the contract. ⇨ The CEA would request that the CEIOPS remove the sentence "*In particular, future premiums should be included if their payment by the policyholder is legally enforceable*".