CFO FORUM

The European Insurance CFO Forum
Solvency II Working Group
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CEIOPS-Secretariat
Committee of European Insurance and Occupational Pensions Supervisors
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1 June 2009

Dear Sir / Madam

CFO Forum responses to:
CEIOPS Consultation Paper 30: Technical Provisions – Treatment of Future Premiums; and
CEIOPS Consultation Paper 32: Technical Provisions – Assumptions about Future Management Actions

Please find attached the CFO Forum's responses to CP 30 and CP 32.

In relation to Treatment of Future Premiums, we highlight that CEIOPS advice is consistent with the views developed by the IASB in the Insurance Contracts Project Discussion Paper published in May 2007. Since then the IASB's has updated its thinking in relation to future premiums and its current thinking is more in line with the requirements of an economic valuation approach. The CEA and the CFO Forum have developed a basis for defining the boundaries of contracts for the purpose of indentifying which future premiums should be included in the measurement of technical provisions. The joint CEA and CFO Forum paper describing this approach is attached with our responses.

Yours sincerely

Amélie Breitburd
Chair
CFO Forum, Solvency II Working Group

Comments on Consultation 30-09 Draft L2 Advice on Technical Provisions - Treatment of Future Premiums

Name company: CFO Forum

Please insert your comments in the table below, and send it to secretariat@ceiops.eu in word format. In order to facilitate processing of your comments, we would appreciate if you could refer to the relevant section and/or paragraph in the Consultation Paper 30-09.

Reference	Comment
General comment	**We believe that all the future cash flows associated with a contract should be taken into account when determining the measurement of an insurance liability.** This is line with the level 1 framework which requires all cash in-flows and outflows to be included in the best estimate liability. The key judgement is to determine the boundary of an existing contract. We do not believe that the consultation has appropriately defined this boundary and the position adopted goes against the economic valuation principle underpinning Solvency II. We therefore believe that significant revisions are required to the consultation paper to better reflect the economic position. **The preliminary views of the IASB with respect to future premiums have been updated** - Within the consultation paper CEIOPS refers frequently to the preliminary views of the IASB as presented in their discussion paper on insurance contracts ("IDP"). As stated in its response to the IDP, the CFO Forum does not agree with these views. This IDP was issued in May 2007 and these views have now been reconsidered and updated, deviating from their original opinions. CEIOPS should acknowledge this and be very careful in referrals to the IDP. The latest update views are copied below, "The Board continued its discussion of how an insurer should measure its insurance contracts and decided tentatively:

- that the measurement should include the expected (i.e. probability-weighted) cash flows (future premiums and other cash flows resulting from those premiums, e.g. benefits and claims) resulting from those contracts, including those cash flows whose amount or timing depends on whether policyholders exercise options in the contracts.
- that to identify the boundary between existing contracts and new contracts, the starting point would be to consider whether the insurer can cancel the contract or change the pricing or other terms. The staff will develop more specific proposals for identifying the boundary.

In June, the Board will continue its discussion of the candidate measurement approaches for insurance contracts." – IASB Update May 2007

The CFO Forum's position on future premiums is set out in the position paper on "Insurance contract boundaries" sent to the IASB on 2008, December 18. The updated preliminary view of the IASB reflects points raised by the CFO Forum.

As will be pointed out in the CFO Forum response to CP35, whilst the CFO Forum supports the use of IFRS as a reference framework for the Solvency II balance sheet, IFRS does not always provide an economic valuation for all assets and liabilities. Solvency II should carefully consider references to IFRS when the appropriate IFRS standard is not based on sound economic principles.

The joint paper of the CFO Forum and the CEA titled "Insurance Contract Boundaries" is available on the CEA-Webpage under:

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

The paper should also refer to the Level 1 text requirements on future premiums within the SCR – The CFO Forum 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 articles in the Level 1 text, which are not mentioned 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.*"

Comments on Consultation 30-09 Draft L2 Advice on Technical Provisions - Treatment of Future Premiums	
Name company: CFO Forum	
	Article 105 (2):*"The Basic 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."* In the adopted texts to the Level 1 text it states, "(*27) The assessment of the financial position of insurance and reinsurance undertakings should rely on sound economic principles and make optimal use of the information provided by financial markets, as well as generally available data on insurance technical risks. In particular, solvency requirements should be based on an economic valuation of the whole balance-sheet."* The CFO Forum requests that these references are included within the Consultation Paper. **The Level 1 text clearly requires all future expected in-flows and out-flows to be included in the best estimate liability** – 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 best estimate. The CFO Forum would request that CEIOPS also refers to this paragraph of the Level 1 text in Para 3.15 and 3.19. The valuation principles (e.g. Para 3.30) therefore seem to be unduly prudent because future premiums are only assessed when they increase the best estimate. We highlight in this context that the valuation of the technical provision includes all future expected in-flows and out-flows arising from **existing** contracts only and not future contracts. The valuation of expected future contracts is covered in the CFO Forum's response to CP35 in relation to goodwill. **Options of the Insurance Undertaking also need to be considered** – The valuation of future premiums is mainly referred to in relation to the valuation of future premiums caused by policyholder options. It should be clarified, that the

Comments on Consultation 30-09 Draft L2 Advice on Technical Provisions - Treatment of Future Premiums	
Name company: CFO Forum	
	principles for valuation (Para 3.22 of Para 3.30) are also valid for future premiums caused by options of the insurance undertaking. Cross references to CP 32 (future management actions) should be made in this regard. For example, the premium adjustment clauses in private health insurance are a management action, so future premiums in a health insurance contract might not yet be appropriately covered by this consultation paper. More generally, in all cases where changes to future cash inflows are dependent upon or influenced by future management actions, it should be made clear that CP 32 dovetails with CP 30.
Para 1.2-1.3	**<u>The scope of the paper is limited</u>** – 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 such as "gross or net" or the "…circumstances in which technical provisions shall be calculated…as a sum of a best estimate and a risk margin…" These topics should be taken into account in CP 26-09 or another CP.
Include a new Para 2.3 before the existing Para 2.3	**<u>The Level 1 text implies that the future premiums in respect of an existing contract should be included</u>** – The 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 within Article 75 (2): "The value of technical provisions shall corresponding 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, therefore, be made to Article 75(2) of the Level 1 text. This reference is helpful when considering an economic valuation of liabilities either in the context of transfer or for fulfilment of those liabilities with the original policyholder, to confirm that all future premiums related to existing contracts should be taken into account and not only those increasing the best estimate: the amount that an acquirer would pay would indeed include all future expected premiums including those leading to future profits.
Para 3.4	**<u>Cash flows arising from the exercise of rights under a contract should be considered as being part of that</u>**

	<u>contract</u> – we would request that it 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 3.6	Please refer to the remark concerning IASB discussions in the "general comments" row above, the preliminary views of the IASB as set out in the May 2007 IDP have since been developed.
Para 3.12	**<u>Pre-agreed premium adjustments should not be recognized as a new contract</u>** <u>The CFO Forum requests that clarification is made on this point with the addition of the text</u>: *"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."*
Para 3.13	We do not agree with the principle that any contract where the company has a unilateral right to cancel any premium received beyond the point of possible cancellation does not belong to the contract. It is unclear what is meant by "possible cancellation" as it is possible to cancel most contracts at any time. This principle contradicts the principle of best estimate valuation with realistic assumptions and sound economic principles. For example, if an insurance undertaking has a unilateral right to cancel a contract but internal assessments show that only 10% of all contracts will be cancelled by the insurance undertaking, this principle would still assume a 100% cancellation and thus contradict the best estimate principles in CP 26. <u>The CFO Forum recommends that the valuation of technical provisions should include all cash in-flows that are expected to fall within the contract's term, where the contract's term 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</u>
Para 3.15 and 3.19 and 3.22	**<u>Expected future profits as well as losses should be taken into account in the best estimate</u>** – The CFO Forum strongly disagrees with the proposal by CEIOPS to include only the expected future cash flows from those options that are expected to produce losses. The reasons for this are set out below:

Comments on Consultation 30-09 Draft L2 Advice on Technical Provisions - Treatment of Future Premiums

Name company: CFO Forum

- **<u>The assumption contradicts Article 76 (2) of the Level 1 text</u>** – Which requires all expected in-flows and out-flows to be included in the Best Estimate.
- **<u>The assumption is not in line with the economic reality</u>** – If expected profit caused by policyholder options is not included, yet expected losses are included, the result will be an asymmetric calculation which is therefore against an economic approach and is not in line with the assumptions that would be used by a 3rd party when pricing the insurer's business. This is also not in line with Article 75 (2) of the Level 1 text. A clear distinction between the right to cancel the contract and the treatment of future premiums should be made; otherwise principles like 3.19 could be misinterpreted, as the policyholder usually has the right to cancel the contract.
- **<u>The SCR takes account of uncertainty in the best estimate</u>** – Extra prudence should not be taken into account within the Best Estimate, the additional prudence required over and above the best estimate is allowed for via the SCR. This is returning to Solvency 1 type requirements. 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 the Best Estimate.
- **<u>Policyholders will decide whether to take up an option based on their own circumstances rather than whether the insurer is expected to give rise to a profit or a loss</u>** – Insurers have policyholder experience that shows that policyholders do exercise options which also give rise to profits for insurers, not just those that give rise to losses. In the majority of cases the policyholder will not have the information needed to determine whether or not an insurer expects to make a profit and this information is often irrelevant to the policyholder's decision. 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 policy holder neither loses nor gains. Therefore, an assumption that the take-up rate of these options is zero may not be consistent with normal policyholder behaviour. 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.
- **<u>This requirement may cause practical difficulties</u>** – An undertaking may not know which policies produce an economic loss or 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; the scope of the Best Estimate will have to be updated.

Comments on Consultation 30-09 Draft L2 Advice on Technical Provisions - Treatment of Future Premiums	
Name company: CFO Forum	
Para 3.17	**<u>This paragraph should also apply to expected future profits</u>** – The CFO Forum supports this paragraph. All expected losses should be included in a best estimate and any corresponding variability in these best estimates should be included in the Solvency Capital Requirements. The CFO Forum believes that the same should also be true for all expected profits.
Para 3.20	**<u>A best estimate should reflect the economic reality, prudence is reflected in the SCR</u>** – The CFO Forum rejects this narrow evaluation of the situation. The company should reflect the expected take up rate and the conditions resulting from such take, recognising that the take up may be skewed towards a particular subset of policyholders e.g. those in poor health. If such an assessment results in a positive value that is the economic reality and should be reflected. Prudence is accounted for within 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 CFO Forum 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 and do not exist for insurer A. The Technical Provisions should reflect the economic value of the contracts. Consider, for example a third party that is 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 its best estimate assessment. Any variability in the expected option take-up rates would be expected to be taken into account in the risk margin. Furthermore, we would like to point out that the argument of "same policy, same best estimate value" is non-economic and therefore inconsistent with the Framework Directive. 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 experience will be different. <u>The CFO Forum requests that this section be 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.</u>

Comments on Consultation 30-09 Draft L2 Advice on Technical Provisions - Treatment of Future Premiums	
Name company: CFO Forum	
Para 3.21	**<u>Insurers will consider past experience when determining take-up rates</u>** - The CFO Forum disagrees with the comment: *"an undertaking with a portfolio of type A contracts could easily lower its best estimate provisions by granting the existing policyholders a renewal option."* Where such a new benefit is attached to an existing policy there will be no evidence for the take-up rate. The insurer would not assume an arbitrary take-up rate in its technical provisions without first being able to justify this with respect to their past experience. <u>Therefore the CFO Forum requests that this paragraph is removed or redrafted.</u>
Para 3.23	**<u>The link to CP35 and the value of customer intangible assets needs to be considered</u>** - CEIOPS is referring to paragraph 154 of the IASB Discussion Paper on Insurance Contracts (May 2007). As noted in our general comments, this work has since been developed and so CEIOPS should not take this as the final position of the IASB. Further, whilst the CFO Forum supports the use of IFRS as a reference framework for the Solvency II balance sheet, IFRS does not always provide an economic valuation for all assets and liabilities. Solvency II should not refer to IFRS when the appropriate IFRS standard is not based on sound economic principles.
Para 3.27	The CFO Forum fully agrees with this principle and believe is should be the core of the valuation of future premiums. Both outflows and inflows should be included.
Para 3.28	The CFO Forum agrees with this basis for derecognition, which is consistent with the proposals for IFRS Insurance Contracts Project Phase II.
Para 3.29	The CFO Forum agrees with this basis for derecognition, which is consistent with current IFRS.
Para 3.30 (a)	We agree with this position, however, we would request clarification as follows: **<u>The key criteria should be whether or not the insurer can re-underwrite the risks at individual policy level (as</u>**

	would be the case for new business) - We would request clarification of the terminology an "*unlimited ability for the insurer to amend the premium or benefits (or otherwise re-underwrite the risk)*". The current guidance is unclear: The key criteria, as laid out by the CEA and the CFO Forum in their letter on "Future Contract Boundaries"[1] is that future premiums should be included under "existing" contracts if the insurer cannot re-underwrite at individual policy level i.e. if the insurer is obliged, if the policyholder wishes, to continue a policy without being able to re-assess the individual policyholder's risks. The insurer may however be able to change the premium based on, for example, a change in price that would be applicable to their whole portfolio. The use of the term "*unlimited ability*" is not clear. Rather the CFO Forum believes that the constraint should be whether or not the insurer can re-underwrite at an individual policyholder level. The CFO Forum would request that the text was clarified as follows: "Where the insurance or reinsurance undertaking has a unilateral right to cancel the contract, a unilateral right to reject the premium or an *(...)* ability for the insurer to amend the premium or benefits *by* re-underwrit*ing* the risk *at an individual policy level* at some point in the future, any premiums received beyond that point (and any resulting benefit payments to policyholders, expenses etc.) do not belong to the existing contract." **The Consultation Paper does not appear to be applicable to all types of insurance contract** - In particular we would request clarification of the most appropriate treatment of specific types of products, such as: - Group insurance products - Savings contracts, which do not undergo underwriting at inception. In this regard, the CFO Forum believes it would be appropriate to specify examples in the background text of the paper. Furthermore we would request that the re-worded advice, as specified above, be extended to include the following statement: "*Where the contract is not underwritten at individual policy level, for example group-life contracts or individual savings contracts, the boundary of the existing contract should be considered as the point at which a new contract is signed."*

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

Comments on Consultation 30-09 Draft L2 Advice on Technical Provisions - Treatment of Future Premiums	
Name company: CFO Forum	
Para 3.30 (c) - (d)	**<u>Premiums associated with options that give profits as well as losses should be included</u>** – The CFO Forum strongly believes that all future premiums, which are associated to options in insurance contracts, subject to the restriction that these relate to the current contracts, should be included in the calculation of best estimate. The CFO Forum does not agree, therefore, with the restriction which is expressed in Para 3.30 (c)-(d) that only premiums which are associated to options, whose inclusion leads to an increase in best estimate, should be regarded. Options could very well be overpriced, for example insurers would often add a safety margin in their premium calculations. Not including premiums associated with those options when calculating best estimate, is, as we see it not reasonable and is not in line with an "economic approach" as specified in the CEIOPS paper as the reasoning for this decision. CEIOPS' proposal moves away from best estimate valuation for the balance sheet items and introduces margins of prudence into the balance sheet that should be expressed in the Solvency Capital Requirement. • All expected economic value should be recognised (i.e. all future profits and losses of the current policy) as per the requirements of the Framework Directive. • Technical provisions should not allow for any additional margins or require arbitrary take-up rate assumptions for options which do not represent expected future experience. Please see also comments to Para 3.15 and 3.19
Para 3.30 (e)	**<u>"*Legally enforceable*" is not usually applicable in an insurance context</u>** - 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. Only including legally enforceable cash-flows is not consistent with the economics of those contracts and hence is not consistent with the principle of economic valuation, which underlies Solvency II. The CFO Forum would request that the CEIOPS remove the sentence *"In particular, future premiums should be included if their payment by the policyholder is legally enforceable."*
Para 3.31	**<u>Measurement of insurance contracts requires a portfolio approach</u>** – for most insurance contracts the individual expected cash flows are uncertain and it is difficult to form a reliable estimate at an individual contract level. when those

Comments on Consultation 30-09 Draft L2 Advice on Technical Provisions - Treatment of Future Premiums	
Name company: CFO Forum	
	contracts are considered as part of a portfolio of contracts that are managed together, assumptions for future cash flows can be reliably estimated. Indeed this is the very essence of insurance business. It is not appropriate to set the criterion that an assessment at a higher level of granularity *"does not lead to a materially different result"* since the contract by contract assessment is likely to be a less reliable best estimate measurement. This paragraph should be redrafted to require insurance to consider the expected future inflows and outflows on all contracts in a portfolio of contracts that are managed together. Variability associated with the measurement of future cash flows is reflected in the risk margin.
Para 3.32	The CFO Forum is in agreement.