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CEIOPS' Advice for Level 2 Implementing Measures on Solvency II: Technical Provisions - Treatment of Future Premiums

(former CP30)

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1. Introduction

1.1. In its letter of 19 July 2007, the European Commission requested CEIOPS to provide final, fully consulted advice on Level 2 implementing measures by October 2009 and recommended CEIOPS to develop Level 3 guidance on certain areas to foster supervisory convergence. On 12 June 2009 the European Commission sent a letter with further guidance regarding the Solvency II project, including the list of implementing measures and timetable until implementation.[1]

1.2. This consultation paper aims at providing advice with regard to the treatment of future premiums in the assessment of technical provisions as requested in Article 86 of the Solvency II Level 1 text.[2]

1.3. The assessment of insurance liabilities according to the Article 77 of the Level 1 text is based on the projection of all expected future cash in- and out-flows required to settle the insurance and reinsurance obligations over the lifetime thereof. The Level 2 implementing measures should give advice on the recognition of an insurance or reinsurance obligation as well as on the boundaries of these obligations.

2. Extract from Level 1 Text

2.1 Legal basis for implementing measure

2.1. According to the guiding principles referred to in the Commission's letter, the legal basis for the advice presented in this paper is primarily found in Article 86 of the Level 1 text which states:

"The Commission shall adopt implementing measures laying down the following:

a. Actuarial and statistical methodologies to calculate the best estimate referred to in Article 77(2); […] "

2.2 Other relevant articles for providing background to the advice

2.2. Article 76 of the Level 1 text states the general provisions for the valuation of insurance and reinsurance liabilities:

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[1] See http://www.ceiops.eu/content/view/5/5/

[2] Latest version from 19 October 2009 available at http://register.consilium.europa.eu/pdf/en/09/st03/st03643-re01.en09.pdf

"1. Member States shall ensure that insurance and reinsurance undertakings establish technical provisions with respect to all of their insurance and reinsurance obligations towards policyholders and beneficiaries of insurance or reinsurance contracts.

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.

3. The calculation of technical provisions shall make use of and be consistent with information provided by the financial markets and generally available data on underwriting risks (market consistency).

4. Technical provisions shall be calculated in a prudent, reliable and objective manner. […]"

2.3. Article 77(2) of Level 1 text gives information in respect of the requirements for any actuarial or statistical method. In particular, this Article requires that:

"[…] the best estimate shall correspond to the probability-weighted average of future cash-flows, taking account of the time value of money (expected present value of future cash-flows), using the relevant risk-free interest rate term structure.

The calculation of the best estimate shall be based upon up-to date and credible information and realistic assumptions and be performed using adequate actuarial and statistical methods.

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."

2.4. The valuation of financial guarantees and contractual options included in the existing insurance and reinsurance contracts is further described in Article 79:

"When calculating technical provisions, insurance and reinsurance undertakings shall take account of the value of financial guarantees and any contractual options included in insurance and reinsurance policies.

Any assumptions made by insurance and reinsurance undertakings with respect to the likelihood that policyholders will exercise contractual options, including lapses and surrenders, shall be realistic and based on current and credible information. The assumptions shall take account, either explicitly or implicitly, of the impact that future changes in financial and non-financial conditions may have on the exercise of those options."

3. Advice

3.1 Explanatory text

3.1.1. Future premiums

3.1. The assessment of insurance liabilities according to the Level 1 text is based on the projection of all expected future cash in- and out-flows required to settle the insurance and reinsurance obligations over the lifetime thereof. Future premiums can be defined as future cash in-flows that are expected to be paid by policyholders. Payment of a future premium (or the agreement to pay a future premium) generally gives rise to rights for the policyholder; the future cash in-flows that stem from a future premium are hence generally linked to future cash out-flows, in particular benefit payments and expense payments.

3.2. There exists a wide variety of future premiums that can have very different characteristics. Some future premiums are explicitly mentioned in the contractual terms of existing contracts. Without seeking to be exhaustive, such premiums can be in the following forms, among others:

- The amount of premium can be predetermined in the contract or not.
- The payment of the premium can be legally enforceable by the insurance undertaking or can be only at the discretion of the policyholder.
- The premium can provide a right to increase the insurance cover or to extend the coverage period.
- The undertaking can have a right to reject the payment of the premium or not.
- The undertaking can have a right to re-underwrite a policy, that is to say to modify the guarantees related to the future premium or to modify the amount of the future premium, or not.

3.3. Implementing measures should describe which future premiums relate to the settlement of the existing obligation and which future premiums relate to the settlement of future obligations. Only the cash-flows relating to existing obligations should be recognised in the solvency balance sheet.

3.4. An insurance or reinsurance obligation always arises from an insurance or reinsurance contract. Therefore, the definition of an existing insurance or reinsurance obligation is equivalent to the definition of an existing insurance or reinsurance contract. The calculation of the best estimate should only include future cash-flows associated with existing insurance and reinsurance contracts.

3.1.2. Recognition of existing contracts

3.5. A reinsurance or insurance contract should be initially recognized by insurance or reinsurance undertakings as an existing contract when the undertaking becomes a party of the contract.

3.6. This approach is in line with the recognition of financial assets and liabilities according to International Accounting Standard 39 (IAS 39) and coincides with the preliminary position taken by the International Accounting Standard Board (IASB) in its May 2007 discussion paper "Preliminary views on insurance contracts".

3.7. Usually, the undertaking becomes a party of the contract when the contract between undertaking and policyholder is legally formalized. In particular, the recognition may take place earlier than the inception of insurance cover, because from an economic point of view the obligation to provide cover already exists and has an economic value before the inception.

3.8. It is common for tacit renewal policies that policyholders may, at some pre-defined time before each anniversary date, cancel the policy. If the renewal of the policy is not cancelled before this date the policy is automatically prolonged at the reporting date for another period. For contracts with tacit renewals where the cancellation period has already expired at the reporting date, even though the renewed contract may enter into force only some time after the reporting date, the renewal has actually taken place when the cancellation period expired and is already effective. According to the principle stated in paragraph 3.5, the renewed contract is an existing contract and the future cash-inflows as well as the corresponding cash-outflows should be taken into account when valuing the liability.

3.9. A contract should be derecognized as an existing contract when, and only when, the obligation specified in the contract is discharged or cancelled or expires. Again, this approach is consistent with international accounting standards(IAS 39 regarding financial liabilities and International Financial Reporting Standard 4 regarding insurance liabilities).

3.1.3. Boundaries of an existing contract

3.10. Where the terms and conditions of an insurance or reinsurance contract invariably and completely specify the premiums to be paid by the policyholder and the benefits granted in return, the boundary of the contract is determined in a clear and distinct way. The valuation of the contract should account for all the future-cash flows which are specified in the terms and conditions.

3.11. The situation is not that straightforward if the insurance contract includes options or guarantees to the policyholder which may give rise to additional future premiums if they are applied. In this case, in order to define a clear boundary a decision needs to be made whether the future premiums are part of the existing contract or whether the option or guarantee gives rise to a new contract and the future premiums relate to the new and not the existing contract.

3.12. Insurance undertakings across the European market are offering different types of such options and guarantees, for example:

- The policyholder may have the option to renew the policy or extend its period at predefined terms.

- The policyholder may have the option to increase the premiums in return for a predefined increase of the insurance coverage.

- Upon expiry of a savings contract the policyholder has the option to receive an annuity according to predefined rates instead of a lump sum payment.

- The policyholder may have an option to extend the insurance cover to another person without underwriting or re-pricing, for instance in case of marriage or birth.

3.13. Some contracts mention the possibility for the policyholder to pay a future premium in order to modify a guarantee, but also allow the insurance or reinsurance undertaking to reject the payment. Since the undertaking has a right to choose whether or not he will accept this new premium, this future premium is not related to the initial obligation. Similarly, if the undertaking has a right to re-underwrite the contract, that is to say to modify the guarantees related to the future premium or to modify the amount of the future premium, then the future premium does not relate to the original obligation. In both cases, the policyholder option bears no risk for the undertaking.

3.14. Therefore, where the insurance or reinsurance undertaking has a unilateral right to cancel the contract, a unilateral right to reject the premium or an unlimited ability to amend the premium or the benefits (or otherwise re-underwrite the risk) 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.

3.15. The principle stated in paragraph 3.14 does not imply that a pre-arranged or agreed premium adjustment automatically leads to the recognition of a new contract. The condition of "unlimited ability to amend the premium" was only met if the arrangement or agreement did not substantially or objectively restrict the value of the future premium. For example, if the ability to amend the premium is completely linked to general market experience without a reassessment of the individual policyholder's risk profile, without the ability to increase the profit margin in the premium or without any other subjective influence on the premium, then the ability to amend the premium is limited.

3.16. If a contract includes a policyholder option to increase the future premiums by means of an option to renew the contract, to extend the insurance coverage to another person, to extend the insurance period, to increase the insurance coverage or to establish new insurance cover, and the insurance or reinsurance undertaking cannot react in one of the ways described above, the situation requires further analysis.

3.17. If in the situation defined in paragraph 3.16 the undertaking expects a loss from the additional future premiums then this loss relates to the existing contract because the obligation to pay the benefits which lead to the loss is already part of the existing contract.

3.18. This is also the result of IASB's analysis in the discussion paper "Preliminary views on insurance contracts". In paragraph 122 of the paper the following is stated:

"An insurer expects a net economic loss if the expected premium inflows are less than the resulting expected benefit payments to the same class of policyholders. The insurer has a contractual obligation to stand ready to provide the insurance coverage if it receives the premiums. Therefore, estimated cash flows used in measuring the insurance liability should include the premiums from that class of policyholders and the resulting additional policyholder benefits. That conclusion is not likely to be contentious."

3.19. If the expected losses from such additional premiums were not included in the technical provisions, then an expected and unavoidable loss of the undertaking would not be included in its solvency balance sheet (and consequently neither in the SCR). The solvency balance sheet would misreflect the economic situation of the insurance undertaking and would not be an appropriate basis of the supervisory assessment of the solvency situation.

3.20. In particular, if the term of the insurance contract defined the boundary of the existing contract, the expected and unavoidable loss from unprofitable renewals would be missed in the valuation of the liabilities. The resulting technical provisions would not be appropriate from a supervisory perspective.

3.21. On the other hand, if in the situation defined in paragraph 3.16 the undertaking expects a profit from the additional future premiums, then this profit does not relate to the existing contract as the existing contract does not include a policyholder obligation to pay the future premium. Stakeholder comments and guidance from the Commission point out an inconsistency of this treatment with the economic approach of Solvency II. Nevertheless, the majority of CEIOPS' Members considers the proposed treatment be consistent with Solvency II. CEIOPS stands ready to lead further work on this issue on the basis of a precise mandate from the European Commission. Further work will necessarily include an assessment of changes to previous advice from CEIOPS on SCR and own funds.

3.22. In order to illustrate this conclusion consider two annual term insurance contracts A and B. Let A and B be identical with the only exception that B includes a unilateral policyholder option to renew the contract for one year with predetermined premiums and benefits. Let the expected cash-in flow relating to the option be bigger than the expected cash-out flow for that option, so that the option is profitable. According to paragraph 3.21 the best estimates for contract A and contract B are equal. On the other hand, if profitable future premiums were included in the valuation of the existing contract, then the best estimate for contract B would be lower than for contract A. This would not be an appropriate reflection of the economic situation of the insurance undertakings offering these types of contracts. As contract B grants an additional right to the policyholder, the economic position of the insurance undertaking of contract B is certainly not better than the position of the insurance undertaking of contract A.

3.23. Moreover, if the future premiums from the renewal option of contract B was included in the valuation, an undertaking with a portfolio of type A contracts could easily lower its best estimate provisions by granting the existing policyholders a renewal option. It should be noted that in most jurisdictions this change of the terms of contracts in force can be achieved by a unilateral declaration of the undertaking and does not involve the agreement of the policyholder.

3.24. Summing up the conclusions in paragraph 3.17 and 3.21, it can be said that future premiums and any resulting benefit payments to policyholders, expenses etc., which relate to an option or guarantee that provides rights under which the policyholder can renew the contract, extend the insurance coverage to another person, extend the insurance period, increase the insurance coverage or establish new insurance cover, belong to the existing contract if, and only if, the inclusion of the renewals increase the best estimate.

3.25. Consequently, the treatment of renewal options and similar options is not symmetrical in relation to the profitability of the future premiums. The asymmetrical treatment of these options reflects their asymmetrical economic nature. If, as part of a contractual relationship between two parties 1 and 2, party 1 has an option to change the contractual relation, then the situation is asymmetrical. Because party 1 has a right to change the contract and party 2 must accept the choice of party 1. The roles of the parties 1 and 2 are obviously quite different. The situation would only be symmetrical if both parties had the right to change the contract. (This would effectively mean that in case one party requests a change of the contract, the other party has the right to reject the request.)

3.26. Compared to a situation where party 1 has no option, the legal and economic position of party 1 is improved (or at least it is the same if the option is considered to be worthless). The legal and economic situation of party 2 is impaired by the existence of the option of party 1 (or at least it is the same if the option is considered to be worthless). This is reflected in the valuation. An assignment of a profit to the option of party 1 in the accounts of party 2 would contradict the economic reality. If the valuation would follow such an approach, party 2 could become richer by granting options to other parties although this would actually lower its own legal and economical position.

3.27. This position is consistent with the preliminary view of the IASB as expressed in paragraph 154 of the discussion paper "Preliminary views on insurance contracts". A vast majority of CEIOPS members fully endorse this proposal. The rest of members have, for the time being, some reservations about the content of the letters (c) and (d) of the paragraph 4.4 of this advice.

3.28. The assessment of the boundary of insurance and reinsurance contracts should be made, in principle, per contract. Nevertheless where this approach is not workable, a higher level of granularity may be applied if this assessment does not lead to materially different results than an assessment per contract. The granularity should be maintained at least at the minimum level required in the CEIOPS' Draft Level 2 Advice on Segmentation.[3] For reinsurance, an assessment on the level of the reinsurance contract is likely to be proportionate.

3.29. Where future premiums relating to a policyholder option belong to the existing contracts, the option exercise rates shall be realistic and based on current and credible information as stipulated in Article 78 of the Level 1 text. The choice of the rates usually requires an assessment of actual experiences and anticipated future experiences. According to Article 78 of the Level 1 text the assumptions on the option exercise rates shall take account, either explicitly or implicitly, of the impact that future changes in financial and non-financial conditions may have on the exercise of those options.[4]

3.30. The exclusion of certain profitable future premiums from the existing contract does not imply that the risk connected to these potential premiums is not taken into account. The SCR should allow for the risk that if circumstances change the future premiums relating to an option may become unprofitable and the undertaking may incur a loss. If, for example, in a scenario assessment of the SCR calculation the assumptions on benefit payments change in such a way that profitable future premiums turn unprofitable and belong to the existing contract, then the corresponding loss is reflected in the change of net asset value of the scenario.

3.31. Finally, should it be necessary for the sake of harmonization, CEIOPS may develop appropriate level 3 guidance in respect of any eventual case where the application of this advice is not sufficiently clear.

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[3] CEIOPS-DOC-22/09 (October 2009), see http://www.ceiops.eu//content/view/17/21/ (former CP27)

[4] See CEIOPS' Advice on Article 86a regarding the valuation of options and guarantees.

3.2. CEIOPS' advice

3.32. The calculation of the best estimate should only include future cash-flows associated with existing insurance and reinsurance contracts, being these all the cash in- and out-flows required to settle the insurance and reinsurance obligations over the lifetime thereof.

3.33. A reinsurance or insurance contract should be initially recognized by insurance or reinsurance undertakings as an existing contract when the undertaking becomes a party of the contract. In particular, tacit renewals which have already taken place at the reporting date should lead to the recognition of the renewed contract.

3.34. A contract should be derecognized as an existing contract when, and only when, the obligation specified in the contract is discharged or cancelled or expires.

3.35. For the calculation of the best estimate, the boundaries of an existing insurance or reinsurance contract should be defined as follows:

(a) Where the insurance or reinsurance undertaking has a unilateral right to cancel the contract, a unilateral right to reject the premium or an unlimited ability to amend the premium or the benefits (or otherwise re-underwrite the risk) 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.

(b) Where the undertaking's right to cancel the contract or to reject the premium or the ability to amend the premium or the benefits relates only to a part of the contract, the same principle as defined in ((a)) should be applied to the part in question.

(c) Future premiums and any resulting benefit payments to policyholders, expenses etc. which relate to an option or guarantee that provides rights under which the policyholder can renew the contract (or a part of the contract) belong to the existing contract if, and only if, the inclusion of the renewals increase the best estimate. Stakeholder comments and guidance from the Commission point out an inconsistency of this treatment with the economic approach of Solvency II. CEIOPS stands ready to lead further work on this issue on the basis of clear guidance from the European Commission. Further work will necessarily include an assessment of changes to previous advice from CEIOPS, namely on SCR and own funds.

(d) The same principle as defined in (c) is applied to options or guarantees which allow the policyholder to extend the insurance coverage to another person, to extend the insurance period, to increase the insurance coverage or to establish new insurance cover.

(e) All other cash-flows relating to the contract should be included in the calculation of the best estimate. In particular, future premiums (and any other resulting benefit payments to policyholders, expenses, etc) should be included if their payment by the policyholder is legally enforceable.

A vast majority of CEIOPS members fully endorse this proposal. The rest of members have, for the time being, some reservations about the content of the letters (c) and (d) of this paragraph.

3.36. The assessment of the boundary of insurance and reinsurance contracts should be made, in principle, per contract. Nevertheless where this approach is not workable, a higher level of granularity may be applied if this assessment does not lead to materially different results than an assessment per contract. The granularity should be maintained at least at the minimum level required in the CEIOPS' Draft Level 2 Advice on Segmentation.[5]

3.37. Where future cash-flows relating to a policyholder option belong to the existing contract and are included in the best estimate, the option exercise rates for the valuation shall be realistic and based on current and credible information and be chosen with an assessment of actual experiences and anticipated future experiences. The assumptions on the option exercise rates shall take account, either explicitly or implicitly, of the impact that future changes in financial and non-financial conditions may have on the exercise of those options.

3.38. The exclusion of certain profitable future premiums from the existing contract does not imply that the risk connected to these potential premiums is not taken into account. The SCR should allow for the risk that if circumstances change the future premiums relating to an option may become unprofitable and the undertaking may incur a loss.

[5] CEIOPS DOC-22/09 - L2 Advice on TP- Segmentation, CEIOPS- (October 2009), see http://www.ceiops.eu//content/view/17/21/ (former CP27)