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CEIOPS' Advice for Level 2 Implementing Measures on Solvency II:

Technical Provisions - Lines of business on the basis of which (re)insurance obligations are to be segmented

(former CP27)

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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 12th 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 paper aims at providing advice with regard to the lines of business on the basis of which insurance and reinsurance obligations are to be segmented in order to calculate technical provisions as requested in Article 86(e) of the Solvency II Level 1 text.[2]

1.3. (Re)insurance undertakings should segment (re)insurance obligations into **homogenous risk groups** when calculating technical provisions. Undertakings in different Member States and even undertakings in the same Member State offer insurance products covering different sets of risks. Therefore it is appropriate for each undertaking to define the homogenous risk group and the level of granularity most appropriate for their business.

1.4. In this advice CEIOPS refers only advice to the **minimum level of segmentation** – ie. lines of business - that undertakings need to consider when calculating their **technical provisions**.

2. Extract from Level 1 Text

2.1 Legal basis for implementing measure

Article 86 – Implementing measures

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

(e) the lines of business on the basis of which insurance and reinsurance obligations are to be segmented in order to calculate technical provisions.

2.2 Other relevant articles for providing background to the advice

Article 80- Segmentation

[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

Insurance and reinsurance undertakings shall segment their insurance and reinsurance obligations into homogenous risk group, and as a minimum by lines of business, when calculating their technical provisions.

3. Advice

3.1 Explanatory text

3.1.1. Introduction

3.1. The Level 1 text requires that (re)insurance obligations are segmented as a minimum by line of business in order to calculate technical provisions.

3.2. In order to ensure a robust and consistent approach for the calculation of technical provisions, (re)insurance undertakings should not necessarily be required to use the same segmentation for other components of the Solvency II framework, such as SCR, MCR or statutory reporting. The segmentation used for different purposes should depend upon what is best for that purposes.

3.3. Therefore the segmentation proposed for the purpose of calculating the technical provisions does not preclude CEIOPS from proposing a different segmentation for the purposes of SCR and MCR calculation or reporting.

3.4. (Re)insurance obligations shall be segmented according to the line of business that best reflects the nature of the underlying risks. Therefore, the current proposal does not follow the legal classes of non-life and life insurance activities used for the authorisation of insurance business (as mentioned in Annex I and II of the Level 1 text) or other accounting classifications.

3.1.2. Segmentation

3.5. The purpose of segmentation of (re)insurance obligations is to achieve an accurate valuation of technical provisions. For example, in order to ensure that appropriate assumptions are used, it is important that the assumptions are based on homogenous data to avoid introducing distortions which might arise from combining dissimilar business. Therefore, in general, business is managed in more granular homogeneous risk groups than the minimum segmentation proposed.

3.6. CEIOPS defines a **homogenous risk group** as a set of (re)insurance obligations which are managed together and which have similar risk characteristics in terms of, for example, underwriting policy, claims settlement patterns, risk profile of policyholders, likely policyholder behaviour, product features (including guarantees), future management actions and expense structure. The risks in each group should be sufficiently similar to allow for a reliable valuation of technical provisions (including a meaningful statistical analysis). The classification is undertaking-specific.

3.7. The approaches to the valuation of the life and non-life liabilities are typically different.

3.8. The future cash-flows for existing policies of non-life business are usually determined using aggregated figures and development patterns. Statistically significant homogenous groupings are needed to determine the cumulative development patterns.

3.9. The insurance liabilities for life business are typically calculated by performing policy by policy[3] calculations that project future individual cash-flows arising from lapses, deaths, sickness, etc. Having appropriate assumptions for these events are therefore a key determinant of life insurance liabilities.

3.10. There could be circumstances where, for a particular line of profit-sharing business (participating business), the insurance liabilities can in a first step not be calculated in isolation from those of the rest of the business. For example, an undertaking may have management rules such that bonus rates on one line of business can be reduced to recoup guaranteed costs on another line of business and/or where bonus rates depend on the overall solvency position of the undertaking. However, even in this case it should be possible to assign to each line of business a technical provision.

3.11. Due to the diversity of products sold and because undertakings have the best understanding of their business and how to segment it, CEIOPS gives advice only with regard to the lines of business that are prescribed. Undertakings are required to further segment their business in the manner needed to derive appropriate assumptions for the calculation of the best estimate.

3.12. In order to calculate technical provisions, (re)insurance undertakings should segment their insurance and reinsurance obligations into lines of business as defined in the following paragraphs.

3.13. The principle of substance over form should be followed in determining how contracts with risks from different lines of business should be treated. In other words, the segmentation should reflect the nature of the risks underlying the contract (substance), rather than the

[3] Calculation based on model points is an alternative approach.

legal form of the contract (form). For instance, where claims are payable in the form of an annuity, agreed claims should normally be part of life obligations.

3.14. The segmentation should be applied to both components of the technical provisions (best estimate and risk margin). Furthermore, in the case of non-life insurance, the segmentation applies both to gross premium provisions and gross claims provisions.

3.15. However, for the purposes of calculating the risk margin, (re)insurance undertakings should also consider the manner in which obligations may be transferred to a reference undertaking, in line with principles underlying the calculation of the risk margin. This may result in a more granular segmentation for the calculation of technical provisions than the minimum lines of business prescribed.

3.1.3. Non-life insurance obligations

3.16. The lines of business (LoB) for non-life obligations shall be defined as follows[4]:

- **Accident**
  This line of business includes obligations caused by accident or misadventure but excludes obligations considered as workers' compensation insurance;

- **Sickness**
  This line of business includes obligations caused by illness, but excludes obligations considered as workers' compensation insurance;

- **Workers' compensation**
  This line of business includes obligations covered with workers' compensation insurance which insures accident at work, industrial injury and occupational diseases;

- **Motor vehicle liability – Motor third party liability**
  This line of business includes obligations which cover all liabilities arising out of the use of motor vehicles operating on the land including carrier's liability;

- **Motor, other classes**
  This line of business includes obligations which cover all damage to or loss of land motor vehicles, land vehicles other than motor vehicles and railway rolling stock;

- **Marine, aviation and transport**
  This line of business includes obligations which cover all damage or loss to river, canal, lake and sea vessels, aircraft, and damage to or loss of goods in transit or baggage irrespective of the form of transport. This line of business also includes all liabilities arising out of use of aircraft, ships, vessels or boats on the sea, lakes, rivers or canals including carrier's liability irrespective of the form of transport.

- **Fire and other damage**
  This line of business includes obligations which cover all damage to or loss of property other than motor, marine aviation and transport due to fire, explosion, natural forces including storm, hail or frost, nuclear energy, land subsidence and any event such as theft;

- **General liability – Third party liability**
  This line of business includes obligations which cover all liabilities other than those included in motor vehicle liability and marine, aviation and transport;

- **Credit and suretyship**
  This line of business includes obligations which cover insolvency, export credit, instalment credit, mortgages, agricultural credit and direct and indirect suretyship;

- **Legal expenses**
  This line of business includes obligations which cover legal expenses and cost of litigation;

- **Assistance**
  This line of business includes obligations which cover assistance for persons who get into difficulties while travelling, while away from home or while away from their habitual residence;

- **Miscellaneous non-life insurance**
  This line of business includes obligations which cover employment risk, insufficiency of income, bad weather, loss of benefits, continuing general expenses, unforeseen trading expenses, loss of market value, loss of rent or revenue, indirect trading losses other than those mentioned before, other financial loss (not-trading) as well as any other risk of non-life insurance business not covered by the lines of business mentioned before.

3.1.4. Non-life reinsurance

3.17. This section only deals with <u>accepted</u> reinsurance.

3.18. With regard to accepted proportional reinsurance business, non-life obligations shall be segmented as a minimum according to the segmentation for non-life insurance obligations described in section 3.1.3 above.

3.19. With regard to accepted non-proportional reinsurance business, non-life obligations shall be segmented as a minimum into:

- Property business;
- Casualty business;
- Marine, aviation and transport business.

3.1.5. Life insurance and reinsurance obligations

3.20. Life insurance shall be segmented into 16 lines of business defined as follows:

- Contracts with profit participation clauses;
- Contract where policyholder bears the investment risk;
- Other contracts without profit participations clauses;

- Accepted reinsurance;

which should be further segmented into:

- Contracts where the main risk driver is **death**;
- Contracts where the main risk driver is **surviva**l;
- Contracts where the main risk driver is **disability/morbidity risk**;
- **Savings contracts**, i.e. contracts which resemble financial products providing negligible insurance protection relative to the aggregated risk profile.

3.21. Life insurance obligations shall be allocated to the line of business that best reflects the technical nature of the underlying risks. CEIOPS considers that it should be possible to assign a homogeneous group of life insurance obligations to a given line of business at inception on the basis of the **major risk driver** for that group. The major risk driver can be determined by considering the contribution of each risk to the best estimate of the liabilities for that homogeneous group of risks, where it is feasible, or by applying any other criteria the undertaking justifies as more appropriate.

3.1.6. Health insurance obligations

3.22. As defined in CEIOPS' Advice on the health underwriting risk module[5], health insurance obligations shall be segmented into:

- Health insurance obligations pursued on a similar technical basis to that of life insurance (**SLT Health**); and
- Health insurance obligations pursued on a similar technical basis to that of non-life insurance (**Non-SLT Health**).

3.23. SLT health obligations should be further segmented, as a minimum, according to the segmentation for life insurance obligations described in section 3.1.5 above.

3.24. Non-SLT health obligations should be further segmented, as a minimum, according to the segmentation for non-life insurance obligations described in section 3.1.3 above (accident, sickness, workers' compensation).

3.1.7. Contracts covering multiple risks

3.25. Unbundling of insurance obligations is of major importance to achieve an appropriate and suitable segmentation for the assessment of technical provisions.

3.26. Where a contract covers risks across non-life and life (re)insurance, these contracts should be unbundled into their life and non-life parts.

3.27. Where a contract covers risks across different lines of business, these contracts should be unbundled into the appropriate lines of business.

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[55] CEIOPS DOC-43-09, see http://www.ceiops.eu//content/view/17/21/ (former CP50)

3.28. A contract covering life (re)insurance business should always be unbundled according to the top-level segmentation defined above.

3.29. With regard to the second level of segmentation, unbundling should be applied to life (re)insurance contracts where those contracts:

- Cover a combination of risks relating to different lines of business; and
- Could be constructed as stand-alone contracts covering each of the different risks.

3.30. For example, consider a contract which pays a benefit both in the event of sickness and death. This contract could be constructed as a contract which pays a benefit on sickness together with a separate contract which pays a benefit on death. This contract should therefore be unbundled. However, if the contract paid only one benefit on the earlier of sickness or death it would not be possible to unbundle the contract.

3.31. Notwithstanding the above, unbundling may not be required where only one of the risks covered by a contract is material. In this case, the contract may be allocated according to the major risk driver.

3.32. Note that the principle of substance over form should be applied in order to determine how each of the unbundled components of a given contract should be allocated to different lines of business.

3.33. If necessary for the sake of harmonization, CEIOPS might develop level 3 guidance regarding the unbundling of insurance contracts where various risks are covered and the premium is assessed in such a manner that it is not immediate and objective to see which amount corresponds to each risk.

3.1.6. Cross-border activities

3.34. CEIOPS is aware that, in the case of cross border activities, risks belonging to the same line of business may have substantially different characteristics, for example due to different local regulations, market practices or social and economic conditions. CEIOPS therefore considers that, in the case of cross-border activities, the undertaking shall first segment its (re)insurance obligations by country and then according to the requirements of this advice.

3.2. CEIOPS' Advice

A. General principles of segmentation

3.35. The Level 1 text requires that (re)insurance obligations are segmented as a minimum by line of business in order to calculate technical provisions. Insurance and reinsurance undertakings should further segment prescribed lines of business into more homogenous risk groups according to the risk profile of the obligations.

3.36. CEIOPS defines a homogenous risk group as a set of (re)insurance obligations which are managed together and which have similar risk characteristics in terms of, for example, underwriting policy, claims settlement patterns, risk profile of policyholders, likely policyholder behaviour, product features (including guarantees), future management actions and expense structure. The risks in each group should be sufficiently similar to allow for a reliable valuation of technical provisions. The classification is undertaking-specific

3.37. The principle of substance over form should be followed in determining how contracts with risks from different lines of business should be treated. In other words, the segmentation should reflect the nature of the risks underlying the contract (substance), rather than the legal form of the contract (form).

B. Segmentation of non-life insurance obligations

3.38. The lines of business (LoB) for non-life obligations shall be defined as follows :

- **Accident**

  This line of business includes obligations caused by accident or misadventure but excludes obligations considered as workers compensation insurance;
- **Sickness**

  This line of business includes obligations caused by illness, but excludes obligations considered as workers compensation insurance;
- **Workers' compensation**

  This line of business includes obligations covered with workers compensation insurance which insures accident at work, industrial injury and occupational diseases;
- **Motor vehicle liability - – Motor third party liability**

  This line of business includes obligations which cover all liabilities arising out of the use of motor vehicles operating on the land including carrier's liability;
- **Motor, other classes**

  This line of business includes obligations which cover all damage to or loss of land motor vehicles, land vehicles other than motor vehicles and railway rolling stock;
- **Marine, aviation and transport**

  This line of business includes obligations which cover all damage or loss to river, canal, lake and sea vessels, aircraft, and damage to or loss of goods in transit or baggage irrespective of the form of transport. This line of business also includes all liabilities arising out of use of aircraft, ships, vessels or boats on the sea, lakes, rivers or canals including carrier's liability irrespective of the form of transport.
- **Fire and other damage**

  This line of business includes obligations which cover all damage to or loss of property other than motor, marine aviation and transport due to fire, explosion, natural forces including storm, hail or frost, nuclear energy, land subsidence and any event such as theft;

- **General liability - Third party liability**

  This line of business includes obligations which cover all liabilities other than those included in motor vehicle liability and marine, aviation and transport;

- **Credit and suretyship**

  This line of business includes obligations which cover insolvency, export credit, instalment credit, mortgages, agricultural credit and direct and indirect suretyship;

- **Legal expenses**

  This line of business includes obligations which cover legal expenses and cost of litigation;

- **Assistance**

  This line of business includes obligations which cover assistance for persons who get into difficulties while travelling, while away from home or while away from their habitual residence;

- **Miscellaneous non-life insurance**

  This line of business includes obligations which cover employment risk, insufficiency of income, bad weather, loss of benefits, continuing general expenses, unforeseen trading expenses, loss of market value, loss of rent or revenue, indirect trading losses other than those mentioned before, other financial loss (not-trading) as well as any other risk of non-life insurance business not covered by the lines of business mentioned before.

3.39. With regard to accepted proportional reinsurance business, non-life obligations shall be segmented as a minimum according to the segmentation for non-life insurance obligations described above.

3.40. With regard to accepted non-proportional reinsurance business, non-life obligations shall be segmented as a minimum into:

- Property business;
- Casualty business;
- Marine, aviation and transport business.

C. Segmentation of life insurance obligations

3.41. Life insurance and reinsurance business shall be segmented into 16 lines of business as follows:

- Contracts with profit participation clauses
- Contract where policyholder bears the investment risk
- Other contracts without profit participations clauses
- Accepted reinsurance

which should be further segmented into:

- Contracts where the main risk driver is death;
- Contract where the main risk driver is survival;
- Contracts where the main risk driver is disability/morbidity risk;
- Savings contracts, i.e. contracts that resemble financial products providing no or negligible insurance protection relative to the aggregated risk profile.

3.42. Life insurance obligations shall be allocated to the line of business that best reflects the technical nature of the underlying risks. CEIOPS considers that it should be possible to assign a homogeneous group of life insurance obligations to a given line of business at inception on the basis of the major risk driver for that group.

D. Segmentation of health insurance obligations

3.43. As defined in CEIOPS' Advice on the health underwriting risk, health insurance obligations shall be segmented into:

- Health insurance obligations pursued on a similar technical basis to that of life insurance (**SLT Health**)
- Health insurance obligations pursued on a similar technical basis to that of non-life insurance (**Non-SLT Health**).

3.44. SLT health obligations should be further segmented, as a minimum, according to the segmentation for life insurance obligations described above.

3.45. Non-SLT health obligations should be further segmented, as a minimum, according to the segmentation for non-life insurance obligations described above (accident, sickness, workers compensation).

E. Unbundling insurance obligations

3.46. Where a contract covers risks across non-life and life (re)insurance, these contracts should be unbundled into their life and non-life parts.

3.47. Where a contract covers risks across different lines of business, these contracts should be unbundled into the appropriate lines of business.

3.48. A contract covering life (re)insurance business should always be unbundled according to the top-level segmentation defined above.

3.49. With regard to the second level of segmentation, unbundling should be applied to life (re)insurance contracts where those contracts:

- Cover a combination of risks relating to different lines of business; and
- Could be constructed as stand-alone contracts covering each of the different risks.

3.50. Notwithstanding the above, unbundling may not be required where only one of the risks covered by a contract is material. In this case, the contract may be allocated according to the major risk driver.

3.51. The principle of substance over form should also be applied in order to determine how each of the unbundled components of a given contract should be allocated to different lines of business.

F. Cross-border activities

3.52. In the case of cross-border activities, (re)insurance undertakings shall first segment their (re)insurance obligations by country and then according to the requirements of this advice.