Comments on calculation and disclosure of balance sheet impact of selective premium discontinuance

Groupe Consultatif acknowledges that, for the reasons outlined below, the implementation of Solvency II may require supervisors to be in a position to assess the risk to individual firms from selective discontinuance of payment of future regular premiums under in-force contracts. Our understanding is that it is this risk which has prompted consideration of the concept of 'Expected Profits in Future Premiums' (EPIFP) – a concept which is not recognised in any actuarial or accounting literature and which clearly is not the subject of any common understanding. Groupe Consultatif is unable to attribute any useful meaning to EPIFP and would prefer that this terminology be abandoned.

Insurance contract types and the implications of discontinuance

Insurance contracts, both life and non-life, may require the payment only of a single premium or may require the payment of a regular series of premiums at a defined frequency up until such time as the contract boundary is reached. In the latter case, the requirement is usually not legally enforceable on the policyholder and the contract will include provisions specifying what is to happen in the event of discontinuance (or reduction) of the regular premium payment. This may include a variety of options with different financial implications – lapsation without value, payment of a surrender value, making the contract paid-up, or other automatic non-forfeiture provisions. Actuarial practice in pricing and valuation recognises as important the consequences of discontinuance – assumptions as to rates of discontinuance and as to the options chosen in the event of discontinuance are important.

Treatment of discontinuance for solvency accounting purposes

Under Solvency 1 it was almost universally good actuarial practice to make provision for the implications of discontinuance on a 'worst case' basis – the explicit assumption was that if the value of the most onerous discontinuance option exceeded the technical provision otherwise calculated then the technical provision had to be increased to equal the value of the discontinuance option.

The Solvency II framework is different in that the technical provision is required to be a best estimate, including estimation of prospective rates of discontinuance and of the options chosen by policyholders in the event of discontinuance. It will not be unusual for the resulting technical provision to be less than the value of the (most onerous) discontinuation option. The relationship between these values will depend on several factors, for example:

- The product type – term assurance in some countries does not acquire a surrender/non-forfeiture value;
- The size of the policy – sustaining small paid-up policies with associated expenses can be onerous;

- The duration of the policy – for unit-linked policies with charges linked to the value of the accumulated fund the technical provision may converge only gradually with the surrender value over the life of the policy.

Thus under Solvency II most firms will have some exposure to risk of selective lapse in respect of part of their portfolio and should set aside resources to cover the consequences of extreme variation in this respect.

Treatment of lapse risk in Solvency II capital requirements

(We concentrate on those policies where the best estimate technical provision is lower than the value of exercising the most onerous discontinuance option.)

The standard formula for the Solvency Capital Requirement (SCR) includes two elements which in effect – and prior to allowance for risk diversification – set aside some resources to meet the risk of selective discontinuance as follows:

- There is a lapse risk SCR element (QIS 5 technical specification SCR 7.51) which is based on a 50% increase in the rate of exercise of the whole range of discontinuance options; and
- There is a mass lapse risk SCR element (QIS 5 technical specification 7.53) which is the combination of the following changes:
    - the surrender of 30% of the insurance policies with a positive surrender strain falling other than policies for non-retail business;
    - the surrender of 70% of the insurance policies with a positive surrender strain for non-retail business.

Groupe Consultatif commentary

If it were the case that the mass lapse risk shock were defined as the exercise of the most onerous discontinuance option by 100% of the policies for which the value of such option exceeded the best estimate technical provision and if this shock were regarded as correlated with all other shocks then clearly a sufficiency of assets to cover the most adverse discontinuance scenario would have been assured. However, such an extreme scenario would normally be regarded as much more onerous than a 1-in-200 probability event.

Such extreme assumptions would not be consistent with the generality of the Solvency II framework – there is an analogy with assuming that some unimaginable disaster gives rise to 100% mortality. Nevertheless Groupe Consultatif can see that there are reasonable grounds for legitimate supervisory interest in the consequences of exceptional discontinuance experience – particularly where undertakings are relatively undiversified in their product mix and/or where the excess of the value of discontinuance options over technical provisions is substantial in relation to the SCR.

There have been some practical difficulties with the requirement to consider lapse risk capital requirements policy-by-policy. More work is required to assess the feasibility of alternative approaches using more limited numbers of model points.

Recommendations

Groupe Consultatif recommends as follows:

- The mass lapse shock element of the SCR standard formula be redesigned as a "mass discontinuance" shock have regard to the most onerous option following premium discontinuance rather than only to surrender;
- The report to supervisors (RTS) should be required to disclose purely as an information item the hypothetical effect on both technical provisions and on undiversified and diversified SCR of 100% selective discontinuance. For most firms the outcome will be a hypothetical increase in technical provisions offset by a usually rather smaller hypothetical decrease in SCR. For most firms these quantities are expected to be relatively immaterial;
- Further joint work as between EIOPA and the Groupe should continue in order to offer guidance on reasonable approximate modelling approaches to allow the foregoing calculations to be accomplished.