20th July 2011

Groupe Consultatif – comments on Contract Boundary Definition

The points below set out the Groupe Consultatif's position on contract boundaries. We would happy to help you further should you wish to explore any of the specific points we have raised.

Recommendations on contract boundaries

- Our view is that the contract boundary definition should be principles based and not overly prescriptive. It would be challenging (and possibly unproductive) to write a strict detailed set of rules capturing every possible configuration of product design across Europe. It should also be borne in mind that there is an element of judgement involved in interpreting the economic form of a contract boundary.

- Notwithstanding the above point, we would also observe that the way in which liabilities are valued and managed for life business, non-life and health business differs, and necessitates quite different contract boundaries in practice. For the drafting of the legal text, differentiating between long-term and short-term business could be one way of addressing this challenge.

- We would advocate the use of an economic approach to the setting of the contract boundary as opposed to a purely contractual approach. In many cases use of a contractual approach coincides with an economic approach, however there may be instances where the two could deviate. In such circumstances it is the economic approach which should take precedence.

- In practice there are situations where the undertaking cannot legally compel the policyholder to pay a premium, but the undertaking is obliged to accept the premium and provide cover if it is received (for example, a "recurring single premium" on a savings contract). In such situations a true best estimate economic valuation should take into account anticipated contributions or renewals from the customer. In this situation, historic experience would be relevant to assessing the expected future premiums, and the risk associated with the uncertainty surrounding that estimate should be allowed for in the SCR.

- Unbundling a contract and then applying different contract boundaries to the different constituent elements could lead to an internally inconsistent valuation of the obligation as a whole, due to the interdependence of different elements. For example, the cost of guaranteed minimum benefits ("GMxBs") associated with a US style variable annuity contracts are a function of the underlying account value of the pure investment content – if we assume different contract boundaries for the account value projections and the GMxB costing we end up with an incoherent valuation. Another example is rider benefits on UK style unit-linked pensions contracts – here the cost of the rider is sometimes linked to the account value (e.g. a life cover rider will pay out the excess of a fixed sum assured vs the account value). We would suggest that unbundling is only applied where practical and where it would not lead to an inconsistent valuation of the overall obligation as a whole.

- In assessing the economic form of the contract boundary it may be appropriate to distinguish between cases where termination of the contract/renewal requires negative action by the customer to initiate. (For example, some rider benefits may renew automatically unless the policyholder writes to the insurer to terminate.) This is quite distinct from the situation where the renewal requires the customer to take positive action initiated by the customer (otherwise it will be assumed to terminate). In situations where contracts automatically renews unless negative action is initiated by the customer, it would seem appropriate to allow for projected best estimate renewals in the contract boundary (assuming the undertaking is compelled to accept such renewals).

- Local rules in relation to customer protection (e.g. the UK concepts of "Treating Customers Fairly" (TCF) and "Policyholders Reasonable Expectations" (PRE)) are relevant in determining the economic form of the contract boundary. In practice, while the legal particulars of a contract might imply an unfettered ability to change the price, over-arching legal constructs such as PRE (which are not written explicitly in the contract particulars) will still act as a constraint. We would recommend that the rules on contract boundaries recognise this constraint (e.g. "in determining the contract boundary, undertakings shall take into account any overarching national regulations pertaining to the pricing and design of insurance products").

- We believe that in the case of long-term business, the ability to reprice contract terms at a portfolio level should not necessarily constrain the contract boundary. Re-pricing at portfolio level does in practice not always constitute an unlimited ability to change the terms of an individual contract. In practice, the undertaking will need to set the terms at a level that is appropriate for the portfolio as a whole taking into account competitive pressures and the need to retain customers.

- We should also take care to avoid any asymmetry in the treatment of contract boundaries. In some cases the option to renew or pay a recurring single premium will have value to the customer, but in other cases it may have value to the undertaking. We should also bear in mind that in practice the customer is more likely to take renewal action based on a comparison of the price vs the price offered by competitors, as opposed to the impact on the undertaking's technical provisions (which the policyholder will not have the ability to assess).

- From a practical standpoint, practitioners would benefit from having an approach that is consistent between various different financial reporting measures (e.g. Solvency II, Embedded Value, IFRS/GAAP). The implication of having different contract boundaries for different metrics is that it significantly increases the complexity of financial reporting processes, require multiple versions of the liability cashflow projection models.

Specific comments on the draft text (Feb 2011) of Article 13 of the delegated acts

- Regarding paragraphs 3 to 6, these deal with specific cases of applying the principle of substance over form and looking at the economic impact. This could be more efficiently captured in a single clause reiterating the principle of economic substance over form, as opposed to being as prescriptive as these paragraphs currently are. Our view on this is not dissimilar to recent comments by EIOPA on those paragraphs.

- Paragraph 1(c) appears to deal with a very specific subset of life business. We believe the contracts comprising this subset are long term retirement savings products in nature due to factors such as special taxation treatment, early surrender penalties and the way these contracts are marketed to consumers. We would comment that (i) the proposed treatment in 1(c) may be inappropriate to long-term savings contracts and (ii) it is probably unnecessary to have such a product specific clause. For long-term savings contracts it seems somewhat inappropriate to assume immediate termination of all future premiums.

- Paragraph 2 states that the ability to re-price at the portfolio level should be a condition sufficient to constitute a contract boundary for life assurance business. As mentioned, we disagree with this view and feel this paragraph should be amended.

Implications of adopting a non economic approach

- **Misaligned risk management incentives for regular premium term assurances:** Based on the current proposal, regular renewable term assurance business where re-pricing is possible at the portfolio level will have a contract boundary of less than one year. The result is that the majority of expected premiums and claims from this business will be excluded with large reductions to both own funds and capital requirements for this business (eg risks of mortality increases will be excluded). This is likely to create the incentive for companies in the future to instead lock-in premiums, and eliminate what is otherwise a sensible risk management tool to increase premiums in cases of portfolio wide mortality increases or expense increases. Some companies may also aim to securitise their existing business by reinsuring it outside the EU. This all seems to go against the fundamental principles of Solvency 2.

- **Unintended market risk impacts and misaligned hedging incentives:** If a large proportion of the expected cash flows from savings business and regular premium term business are excluded then this impacts on the asset:liability management position of the company. Companies currently manage their asset:liability matching position on an economic basis and often purchase derivatives to manage mismatch risk. Moving to a non economic definition of contract boundaries may artificially increase market risk as any derivatives would remain on the balance sheet and be subject to shocks but the value of technical provisions would no longer move in the same fashion following the various shocks. In response to an artificial increase in market risk, companies may be incentivised to change their derivative positions to hedge on a non economic basis, which would be clearly poor practice.

- **Misaligned assumption-setting incentives arising from unbundling of regular life business with riders**: Many long-term life policies include riders covering accident, dread diseases, disability, etc. Based on the current proposal, if part of a contract may be re-priced or cancelled by insurer it should be unbundled and treated separately. In many cases this will be very difficult to do as it is contrary to the economic nature and realities of the policy since it is priced, distributed and administered as one contract, and its parts often display the same lapse behaviour. Moreover, the unbundling would require setting separate assumptions for each part of the policy, which would be impracticable and rather artificial. For example for expenses, this creates artificial incentives to allocate more expenses to the parts of policy with the nearer contract boundary.

- **Issues associated with pure savings contracts**: The treatment of pure savings contracts in paragraph 1(c) implies modelling all of these contracts as immediately paid up. In this respect the amount of own funds excluded due to this contract boundary could be considered equivalent to the QIS5 calculation of EPIFP. Hence, this could be viewed as a mechanism to restrict the eligibility of EPIFP for such long-term contracts, which would seem at odds with the intention to treat EPIFP as Tier 1. Furthermore, some of the methodological problems associated with EPIFP calculations also apply with this contract boundary, including the issues of which expense and lapse assumptions to use and whether to apply any penalties for converting to paid up status.

- **Need for additional disclosures (such as VIF):** Under Solvency 2, all technical provisions should be on a best estimate basis with no prudence included. If technical provisions were based on a true best estimate, then there would be no need to assess a Value of In-Force business (“VIF”) as per current embedded value disclosures, which represents the prudent margins locked into statutory reserves that are yet to be released. However, an inappropriate definition of contract boundaries under Solvency 2 could introduce arbitrary prudence into the value of technical provisions – this would lead to a need to assess a VIF result. Investors and management will want to know what the true economic value of a company is and hence, companies may need to calculate and disclose a VIF based on an alternative economic definition of contract boundaries. This means calculations will have to be performed on two sets of contract boundaries which will add significantly to the burden for Solvency 2.

- **Difficulty meeting the Use Test:** It is hard to see how companies could prove that they use the results of the internal model for management decision making when the internal model is not consistent with the economic realities of the business.

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