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Our Ref.: INS/HvD/LF/ID

Dear Mr. Montalvo Rebuelta,

**Re: FEE Comments to CEIOPS on Consultation Paper No. 39 Draft CEIOPS' Advice for Level 2 Implementing Measures on Solvency II: Technical provisions Article 85a Actuarial and statistical methodologies to calculate the best estimate**

- (1) FEE (the Federation of European Accountants) is pleased to provide you below with its comments on Consultation Paper No. 39 Draft CEIOPS' Advice for Level 2 Implementing Measures on Solvency II: Technical provisions Article 85a Actuarial and statistical methodologies to calculate the best estimate ("the Paper").

#### **General comments**

- (2) The Level 1 guidance requires to measure technical provisions at current exit value (see Article 75 (2)). However, we are under the impression that the Paper is not pursuing a Current Exit Value approach, as the approach in the Paper is based on entity-specific assumptions for the current insurer. Since this is an approach that we expect could be taken by the IASB for IFRS Insurance phase II, there will be greater consistency between Phase II and Solvency 2. It would be very helpful if CEIOPS could clarify that this is indeed the intention.

- (3) For example, one of the consequences of the above approach is that for insurers with very low cost rates, the result could be technical provisions that are lower than the amount needed to transfer the portfolio to another insurer, except if it is assumed that the administrative environment (such as IT systems, staff, equipment) is generally transferred as well. This would not be compatible with the current exit value approach, which assumes that only the portfolio is transferred. A pragmatic solution for solvency valuation might be, to require the use of entity specific expense assumptions, if they are less favourable than in the industry, otherwise to limit any favourable deviation, since it might not last in the long run. Run-off assumptions are to be used if that is a realistic perspective. As a consequence, entities with relatively high administrative cost would use entity-specific assumptions, since that results in higher technical provisions compared with industry-average cost assumptions. Entities with very low administrative cost would use merely industry-average, since in case of a transfer or run-off it cannot be assumed that lower administrative cost would arise.

### **Detailed comments**

#### ***Paragraph 3.1***

- (4) The wording “allow for” could be interpreted to include a margin for uncertainty while the best estimate is neutral rather than risk averse. It is important to distinguish between the uncertainty in the cash flows and the uncertainty in the estimation process. The latter could only be included in an additional margin or capital requirements.

#### ***Paragraph 3.7***

- (5) In the definition of portfolio specific, we agree that a key characteristic of portfolio-specific is that portfolio-specific data need not be undertaking-specific, i.e. that the characteristic would apply irrespective of which undertaking holds the liability.

#### ***Paragraph 3.12***

- (6) The definition should make clear, that choosing assumptions is always a matter of judgement between credible and current since both are practically mutually exclusive. To improve credibility, information from all periods is needed, but that information becomes less “current”. There are only very limited data, which can be seen as actually “current”.

***Paragraphs 3.18 and 3.53***

- (7) The definition of going concern is mainly an accounting definition. The accounting definition refers only to the continuation of operations, especially volume of activities, but does not specify that the type of activities remains the same. We understand that the regulatory perspective assumes that the type of activity, especially the general form of insurance business written, remains. That is not consistent with the accounting definition of going concern. The accounting definition allows a measurement attribute “current exit value”. Under a current exit value notion, it is assumed that the insurer might be selling its entire portfolio and doing other forms of business afterwards. For Solvency II, however, the assumption is that the insurer actually continues its specific insurance activities, new business, underwriting, etc. which is not easily to be seen in compliance with the current exit value notion.

***Paragraph 3.19***

- (8) This paragraph does not provide a definition but guidance about what the entity should consider in calculating the best estimate. A definition could be: “The unbiased estimate of the mean value of discounted cash flows, i.e. those which would be considered by market participants in valuing the insurance contract and using market interest rates where available.

***Paragraphs 3.22 and 3.24***

- (9) Since insurance risk is merely portfolio specific, “generally available data on insurance technical risk” should be considered only for the specific portfolio. “Generally available data on insurance technical risk” will usually consist of industry, national or population statistics that are not necessarily relevant information for a specific portfolio. The first step when using generally available data is to check their relevance to the characteristics of the portfolio.

***Paragraph 3.43***

- (10) Acquisition costs refer only to those costs, which – under a prospective approach – an entity is expected to incur for existing contracts, e.g. renewal commissions to agents or renewal cost for forwarding new documentation to policyholders as a consequence of renewal. It should be clarified that acquisition costs for future contracts are not contractual costs that should be included in the valuation of current contracts.
- (11) It is unclear why the terms “expenses” and “cost” are used. There is a conceptual difference between costs and expenses and it not clear why the two different terms are used.

***Paragraphs 3.45 and 3.90***

- (12) The Paper requires that overhead costs are to be considered as cash flows in the best estimate. It is not clear how overhead costs fit in the definition of a current exit value. A third party acquirer would not normally expect a compensation for overhead costs but require some additional profit which would not be part of the best estimate. In general, pricing is based on opportunity cost. Overhead costs and the entire required margin might vary significantly from entity to entity and the costs of the entity itself might not be relevant since the acquiring insurer may have a different cost base. The difference in overhead costs from entity to entity is not caused by the characteristics of the insurance contracts but merely historically or organisationally reasoned. That difference is consequently not relevant for a current exit value.
- (13) The split of overhead costs could significantly impact the total amount of best estimate since allocating most of the costs to short duration contracts would reduce the expected costs of future overheads significantly, while allocating the costs to long duration business would build in more years of future overheads thereby increasing the best estimate. Therefore that split can be very sensitive. For financial reporting purposes this issue will be covered by the additional margin.

***Paragraph 3.51***

- (14) Under the current exit value approach, it is questionable why newly established insurers should apply their own cost assumptions at all. The relevant costs should be those expected to be incurred by an acquiring insurer.

***Paragraph 3.62***

- (15) We believe that portfolios of significantly different risks should be valued separately.
- (16) We are not sure whether the Paper is proposing that there should be a conceptual difference between measuring contracts involving biometric risks and those involving other insurance risks. In fact, the practical techniques are different, considering the amount and type of available data and of contract durations, but the concept and objective are always the same, as long as, as now required, a prospective approach is to be applied, considering time value of money and margins. There is no difference in substance, just for practical reasons different techniques are needed and different simplifications are possible, as described in 3.75 and 3.76. However, it is in any case necessary to check the suitability of the simplification in the individual case. Consequently, the same principles should apply to all forms of insurance contracts and only the consideration of the individual circumstances might cause the possibility to apply simplifications. Those relevant individual circumstances cannot be directly derived from basic terms like "biometric" or "non-biometrical".

***Paragraph 3.65***

- (17) The differentiation between pre-claims and claims liabilities applies for life insurance, e.g. some cases of disability and health insurance have significant claims liabilities. Consequently, we do not believe, that a differentiation is adequate, between life and non-life regarding pre-claims and claims liabilities.
- (18) For life insurance, a split of expenses between premium and claims liability is necessary. In life insurance, the actual payment process (not the settlement process) often causes significant amounts to be considered in claims liabilities.
- (19) In case of pre-claims liabilities the approaches should as in non-life consider the probabilities of claim events explicitly. Technically, claims ratios that in life insurance are equivalent to mortality rates would be applied to determine the total amount of expected claims for pre-claim liabilities. The prospective approach associates typically cash flows with estimated probabilities.

***Paragraph 3.74***

- (20) The relevant criterion for scoping out certain products should not be the type of risk but the extent of insurance risk compared to financial risk. IFRS 4 does not distinguish between different types of insurance risk. The trigger in IFRS 4 is significant insurance risk. Unit-linked term insurance has significant insurance risk and therefore any other distinction other than significant insurance risk is not appropriate.

***Paragraphs 3.171 to 3.182***

- (21) The definitions in 3.180 may be unnecessarily complex in its application. Whereas the definition and the following guidance to calculate the best estimate may be suitable for some kind of products, there exists a wide group of contracts with participating features, that fall under the definition of "conditional discretionary benefits" but for which the level of discretion is of negligible relevance. According to the principle of substance over form, such contracts should be treated in the same way as a contract without any discretion (e.g. a unit-linked contract). The Paper lacks guidance on the treatment of an enforceable obligation to forward a specific share of surplus to policyholders.
- (22) Many insurance contracts contain both benefits that are subject to an enforceable obligation to forward specific parts of surplus to policyholders, and benefits that are entirely voluntary, in an additive manner. Other insurance contracts contain benefits that are based on an enforceable obligation to share policyholders in surplus, but the insurer might be able to execute some discretionary influence on that process. In all cases it is necessary to identify the economic substance of the features and to apply the correct approach.

- (23) In order to do so, it needs to be investigated, what the reasoning of the insurer might be to pay more than apparently required or enforceable. The reasons might significantly affect the current exit value, depending whether they apply as well for the acquirer or not.

***Paragraph 3.127***

- (24) Options are obligations, which allow the counterparty to choose between different paths of cash flows, which each result in a guarantee. From an accounting perspective, it is necessary to identify whether the execution of the option is part of the current contract or creates a new contract. If an option requires the consent of the insurer or the resulting rights can be significantly influenced by the insurer, those options might not be included in the initial contract but possibilities to extent bilaterally the existing contract by a second contractual agreement. Legally, any need to consent about execution of an option is actually a new agreement. Furthermore, the current stage of the IASB project considers only those renewals or contract modifications, of which the terms and conditions are contractually pre-determined, i.e. do not require again the consent of the parties.

***Paragraphs 3.148 and 3.159***

- (25) If consideration of irrational behaviour is permitted in measurement, the amount of potential losses arising assuming rational behaviour is reduced but an additional quality of risk, namely irrationality, is added. Irrationality is not a financial risk but merely a cumulative risk, since it may result in mass phenomena. Irrationality is not statistically describable and not explainable through market theory. Therefore significant guidance is needed to ensure a robust and comparable measurement of irrationality within the margins as well.

***Paragraphs 3.203 to 3.205***

- (26) There is a significant conceptual difference between a contractual reference directly to the losses affecting the counter-party and a reference to indices, which might (or might not) affect the counter-party. In the first kind, any benefit determined based on the losses incurred to the counter-party is actually a compensation. For accounting purposes under IFRS 4, a compensation is a necessary condition. A reinsurance contract is not a stand-alone relationship but a contract, which transfers cash flows or risks specifically of the cedant to the cessionary, i.e. it is a cession and as such directly contractually referring to the specific business of the cedant. Here, the contract refers directly to the losses incurred by the cedant. If there is no compensation, i.e. the determination of the benefit does not refer directly to losses incurred by the cedant but to an index which might or might not affect the counter-party, the benefit is a derivative which may provide hedging, i.e. to combine intentionally two different negatively correlated items.

- (27) As a first principle, any cession needs to be measured consistently with the ceded item (just considering default risk of the cessionary in addition) to reflect the nature of that business adequately. If the first approach in 3.205 is taken, care is needed that all assumptions are entirely consistent with the measurement of the technical provision of the ceded business. Except in case of proportional reinsurance, the complexity of the reinsurance arrangement might cause a need to use the second method. The indirect method is conceptually the most appropriate and should be the default method.
- (28) It is important to analyse the reinsurance contract and identify which parts are actually a cession, (referring to losses of the cedant), which parts are actually only hedging, e.g. referring to indices which might as well affect the cedant, and which parts are guarantees or options which are independent from gains or losses of the cedant. The last two (the hedging and the guarantees or options) parts of the reinsurance contract need to be measured separately, applying the same principles as apply for any other asset or liability of an insurer.

***Paragraph 3.210***

- (29) The reference to “market risk” appears to be too narrow. The measurement should follow the principle that the cession features are measured consistently with the gross technical provision, the other features as if they were stand-alone. Especially if the payments are double triggered (both by a cession and by other factors), it will not be possible to separately disclose both parts.

***Paragraph 3.246***

- (30) Inflation index is not market information as stated, but it is a population or national information (a statistical information about markets not from markets). It is not a market price.

For further information on this letter, please contact Ms. Saskia Slomp, Technical Director.

Yours sincerely,



Hans van Damme  
President