SAM focus

Helping insurers understand and manage change

Contract boundaries under SAM

Contract boundaries for technical provisions have been a hotly debated topic under SAM. Recent developments may be a welcome change for some insurers.

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In determining the measurement of technical provisions it needs to be established when to start measuring the contract cash flows and, critically, when to stop measuring the contract cash flows. These start and end points define the contract boundary.

Implications of a Solvency II contract boundary

1. Under Solvency II the contract boundary is set at the point where the insurer can unilaterally terminate the contract, refuse to accept a premium; or amend the benefit or premium without limit. Any premiums received after that date do not form part of the existing contract and should be excluded from the technical provisions.
2. The consequence of this definition is a short contract boundary for many non-guaranteed investment contracts. Cash flow projections and Solvency Capital Requirement (SCR) models will be simple and changes in surplus over time can be more easily analysed.
3. Insurers that sell only non-guaranteed investment products (particularly unit linked) are likely to be satisfied with this approach as the short contract boundary is largely consistent with how the business is managed. Corporate investment products are also often treated this way under current guidance.
4. Traditional life insurers selling recurring premium non-guaranteed investment products will have shorter contract boundaries, higher technical provisions and lower capital requirements than with a longer boundary. This is different to the current practice and may conflict with how the business is managed and prove problematic for the "Use Test".

Emerging SAM proposals

5. The existing definition under Solvency II and the current SAM proposed Level 1 legislature, is inconsistent with the economic approach.
6. The SAM technical provisions task group considered three possibilities for contract boundaries:
   - Solvency II proposals
   - Economic contract boundaries
   - The higher of Solvency II or management's view of the contract boundary
7. Under the economic contract boundary approach, all future cash flows arising from a contract are valued on a best estimate basis. The boundary ends only if the individual policyholder can be re-underwritten and have the premium or charges adjusted for his or her particular risk.
8. Renewal premiums will not be within the contract boundary (as typical for short-term insurers) unless the renewal terms are guaranteed by the existing contract.
9. The longer boundary requires more complicated cash flow projection models, more complicated SCR models, complex decisions about risk mitigation and management actions allowed for in various shock scenarios and is inconsistent with Solvency II.
10. The longer boundary will match how some insurers view their business and manage their risk. It will result in higher free surplus in most cases since the decrease in technical provisions will be greater than the increase in capital requirements.
11. The approach to allow for management's view of the contract boundary ensures no conflicts with the "Use Test" and fewer changes with current industry practice.
12. This flexibility will limit comparability across companies, and potentially

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even within insurers as insurers might be able to elect different approaches for different types of business for example recurring premium investment contracts.

13. It will be difficult to calibrate a standard formula for the SCR that adequately addresses different contract boundaries in a reliable manner and might encourage cherry picking.

14. Given the subjectivity of the proposed contract boundary (i.e. the economic or management's view), it is proposed that the contract boundaries applied by an insurer be incorporated in the disclosure requirements under SAM.

15. QIS2 will test different contract boundaries and capture qualitative information about insurers' views and preferences on contract boundaries and for which products the contract boundary definition is problematic.

16. For short term insurance, the contract boundary discussion is less significant as the boundary is likely to be the same as the contract term under all of the proposals.

17. Similarly for contracts with significant insurance risk or embedded guarantees, contract boundaries across the industry are likely to be consistent with current practice.

18. 3rd Country Equivalence hurdles will need to be met under the chosen approach.

Implications for reinsurers and reinsurance

19. Annually renewable reinsurance, where the reinsurer has the ability to re-price, must either attract an explicit capital charge for the risk of the reinsurer increasing rates, or exclude the risk mitigating benefit and cash flows from reinsurance beyond the annual contract boundary.

20. The SAM structures are still developing a recommendation on reinsurance contract boundaries, but if the capital benefit of annually renewable reinsurance is significantly reduced, reinsurers might consider alternative forms of treaties, taking on risk for longer periods.

21. Differences in contract boundaries and treatment of reinsurance boundaries could open the door to regulatory arbitrage between reinsurers in South African and their parents in Europe and elsewhere.

Divergence will be unavoidable

22. In terms of current practice in South Africa, cash flows payable in respect of long term insurance contracts (i.e. risk and investment products) should be included in the Financial Soundness Valuation (FSV) under Professional Guidance Note (PGN) 104.

23. Under PGN 104 expected profits should not be recognised in respect of future options to be exercised (e.g. automatic premium increases), but expected losses in respect of future options should be recognised. Solvency II, however, requires all expected future cash flows, including future options that fall within the contract boundary should be recognised. In addition the allowance for discretionary margins under PGN 104 allows for more flexibility.

24. Looking ahead at the accounting developments, the IASB deliberations indicate that for insurance contracts, IFRS 4 Phase II sets the boundary at the point where the insurer is no longer required to provide coverage or where the existing contract does not confer any substantive rights to the policyholder. For contracts where the pricing of the premium does not include risks relating to future periods (i.e. a financing element), it's not a substantive right when the insurer can reassess the risk of the portfolio the contract belongs to, and as a result can set a price that fully reflects risk of that portfolio.

25. The current SAM proposals (i.e. the economic or management's view) will further result in differences between the application of contract boundaries for regulatory and accounting purposes, for example investment contracts, which are accounted for as financial instruments.

What should you do?

26. Insurers should have an understanding of the proposals under SAM in order to provide input and potentially lobby for a particular view.
27. In doing this, insurers should weigh up impacts on technical provisions and the SCR to determine the complete impact.
28. System development needs to cater for SAM, IFRS 4 Phase II (in time) and IFRS9 as well as any internal management and Asset Liability Matching (ALM) views on appropriate contract boundaries.
29. Insurers should consider how effective their existing reinsurance programme will be. Reinsurers may need to adjust their offerings to meet the needs of cedants.
30. (Re)insurers part of international groups must consider how consolidation will work with multiple contract boundaries in force.

If you wish to discuss how we can help you, please call your regular contact or alternatively:

Christiaan Nel
christiaan.nel@za.pwc.com
021 529 2519
Wikus Luus
wikus.luus@za.pwc.com
021 529 2016
Francois Kruger
francois.kruger@za.pwc.com
011 797 4717

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