



Determining the With-Profits Insurance Capital Component

The UK Actuarial Profession's Life Board issued an [exposure draft \(EXD 61\)](#) in September 2005 covering changes to GN45, the profession's guidance note on determining the with-profits insurance capital component. The exposure draft is subject to formal consultation, with the ability to make verbal comments at meetings to be held in Edinburgh and London on 11 and 12 October 2005, respectively. Written comments must be sent to the profession by 2 November 2005. Following the consultation process, the aim is to issue a revised version of GN45 by the year end.

The revised document includes additional guidance as well as changes to improve the clarity and precision of the wording. The main changes from the existing version of GN45 (version 1.1 issued in December 2004) are as follows:

- **Paragraph 2 – the realistic value of assets.**

- 2.1 To add clarity, there is a new introductory paragraph which is derived from PRU 7.4.33 and sets out the components of the *realistic value of assets*.
- 2.2 The section on *excess admissible assets* has been revised to make it clear that, whilst the *market risk* and *counterparty* exposure limits do not apply in calculating the *realistic value of assets*, it is not possible to place a value on an asset that does not have an admissible value, unless the asset is a *derivative*. [Note: there is an incorrect cross-reference in paragraph 2.2.1 of the exposure draft to paragraph 2.7, rather than paragraph 2.5, of the guidance note.]
- 2.3 The section on the present value of future profits (or losses) on non-profit insurance business (PVFPNP) has some important changes. Paragraph 2.3.1 makes it clear that the amount of assets to be allocated to *non-profit insurance business* should cover not just the *mathematical reserves* (as stated in the existing guidance note) but also an appropriate allocation of the *firm's long-term insurance capital requirement* and *resilience capital requirement*. Paragraph 2.3.2.3, which covers the use of aggregate margins for (reasonable) prudence in calculating the PVFPNP, rather than the use of individual margins, states that, in addition to the existing requirement that the PVFPNP should not be overstated under an aggregate method, a material understatement of the PVFPNP should not occur. Paragraph 2.3.3.3 makes it clear that any credit taken for a liquidity premium on corporate bonds must allow for the possibility that assets might have to be unexpectedly sold (because of normal random fluctuations in claims). More favourably, a new paragraph, 2.3.3.6, makes it clear that it is possible to assume a liquidity premium on the future reinvestment of income, if it is proposed to maintain investment in similar assets in the future. [Note the proposed wording in 2.3.3.6 refers to maintaining the same asset mix, which seems rather restrictive.]
- 2.4 The section on stress testing the PVFPNP for calculating the *risk capital margin* has been expanded. Paragraph 2.4.1 makes it clear that, although it is necessary to revalue the assets backing the PVFPNP when stress-testing, it is not necessary to reallocate assets. There is a new paragraph 2.4.2 which covers the need to recalculate the *mathematical reserves* used in the calculation of the PVFPNP under the scenarios being considered and to include any excess or deficiency of the value of the assets over the *mathematical reserves* in the PVFPNP. A further new paragraph, 2.4.3, covers the incidence of any release of the *long-term insurance capital requirement* and the *resilience capital requirement* (attributable to *non-profit insurance business* in the *with-profits fund*) which is allowed for in calculating the PVFPNP. [Note that there is an incorrect cross reference in paragraph 2.4.3 to paragraph 2.3.5 of the guidance note, rather than to paragraph 2.3.1.5.]
- 2.5 A new section has been added on the value of derivatives and quasi-derivatives in the with-profits fund. The main point is that inadmissible *derivatives* should be valued at market value and included in the *realistic value of assets*, where positive, or in the *realistic current liabilities*, if negative. Where mark to market is not possible then mark to model should be used.

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2.6 A further new section has been added on the value of shares in related undertakings, although this section is essentially a direct cross reference to PRU 7.4.33 (and, indirectly, to other parts of the guidance note).

- **Paragraph 3 – the realistic value of liabilities.**

3.3.2 The section on past miscellaneous surplus (or deficit) planned to be attributed to the with-profits benefit reserve makes it clear that any items included under this heading should be ones which could be removed in adverse circumstances. If this is not the case, and so the items are intended to give rise to more permanent additions to policyholder benefits, then they should be allowed for in the calculation of the *with-profits benefit reserve*.

3.3.3 The section on planned enhancements to the with-profits benefits reserve has some major changes. Paragraph 3.3.3.2 covers the distribution of inherited estate in a with-profits fund. It makes the point that in a closed fund if the whole estate is distributed over time this would result in the (unexpected result) that the working capital and *realistic excess capital* (as shown in Form 19, the realistic balance sheet) would both be zero. This is because the planned enhancements to bonuses (to distribute the inherited estate) should use up the remaining (realistic) assets. This is clearly a contentious area from a presentational standpoint, as the level of working capital and *realistic excess capital* are often looked at by commentators as a measure of the strength of an office. Paragraph 3.3.3.3 covers the position of an open with-profits office planning to distribute part of its inherited estate. There is no need for such an office to recognise planned enhancements to benefits if no allocation of the inherited estate has yet been made. Paragraph 3.3.3.5 is a new paragraph which covers whether the PVFPNP needs to be included within planned enhancements to the *with-profits benefit reserve*. The paragraph makes it clear that this would be the case where the PPFM states that non-profit surplus is automatically passed on but, in other circumstances, would depend on policyholders' expectations.

3.3.11 There is an additional paragraph, 3.3.11.1, in the section on other *long-term insurance liabilities*. This paragraph covers accounting tax provisions and makes it clear that on a realistic basis it may be necessary to amend these provisions e.g. because there is no discounting of tax on unrealised capital gains, or allowance for carried forward expenses and/or deferred acquisition expenses.

- **Paragraph 4 – the value of guarantees, options and smoothing.**

4.1.3 The paragraph on the determination of the risk-free yields has one significant change. Previously, it stated that it was possible, although conservative, to calibrate to gilt yields. This wording has now been changed to state that it is acceptable to calibrate to gilt yields and, thus, avoid any analysis of the “gap” between gilt yields and risk-free yields.

4.4 This is a new section on guaranteed annuity rates (“GARs”) which has been moved from GN47 on Stochastic Modelling. It was considered that this guidance on GARs, more correctly falls within GN45.

- **Paragraph 5 – the risk capital margin.**

5.1.4 A paragraph has been added on the inclusion of the PVFPNP written outside the *with-profits fund*. This paragraph reflects the rules and guidance within PRU that restrict the maximum value permitted for inclusion to 50% of the calculated value and which do not require stress tests to be applied to the value (as it has already been reduced by 50%).

5.4 The section on the persistency risk scenario has some changes. The new wording in paragraph 5.4.1 makes it clear that the persistency risk adjustment must not be applied where conditions (1) and (2) of PRU 7.4.101 apply i.e. on a date where the *policyholder* has an option to take a guaranteed amount or a benefit without a market value adjustment applying. However, as covered in section 5.6 on policyholder behaviour, and specifically in a new paragraph, 5.6.2, the firm should adjust termination rates within market risk scenarios as well as persistency risk scenarios. Thus, it would be correct to adjust termination rates where such options are available to reflect assumed market conditions within the *market risk* scenarios and, in such circumstances, the *persistency risk* adjustments would apply on top of the *market risk* adjustments.

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11 October 2005

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