



# With-profits governance, the role of actuaries in life insurers and certification of insurance returns

## Briefing

### Introduction

The FSA published its consultation paper CP167 “With-profits governance, the role of actuaries in life insurers, and certification of insurance returns” in January 2003. The consultation paper develops the proposals put forward in two feedback statements in May 2002 and includes draft rules and guidance.

The publication of CP167 was followed by two letters from the FSA to Chief Executive Officers of life insurers. These letters were concerned with the move to a realistic reporting approach for with-profits business, another of the proposals in last May’s feedback statements. The first letter, dated 31<sup>st</sup> January 2003, offered life insurers the ability to request a waiver from the current required minimum (solvency) margin requirements, subject to a move to a realistic assessment of liabilities. The second letter, dated 11<sup>th</sup> March 2003, set out in more detail the FSA’s thinking on the calculation of realistic liabilities and their approach to firms applying for a waiver.

This Briefing summarises the key points of CP167. It also takes into account the implications of the later letters on the timing and content of the proposals put forward in CP167. However, the move to a realistic reporting approach for with-profits business, which is discussed in the two letters, will be considered in more detail in a separate Briefing.

The key points of CP167 are as follows:

- The Appointed Actuary role will be abolished and in its place there will be actuarial and with-profits actuary functions.

These two functions will advise the firm’s governing body (i.e. the board of directors or, for a friendly society, the society’s Committee of Management). The ultimate responsibility for determining the firm’s actuarial liabilities and, where appropriate, making decisions on bonus rates will now fall squarely on the firm’s governing body;

- The actuarial liabilities will be signed off by the firm’s governing body in the FSA returns and will, for the first time, be subject to audit. The auditors will be required to take actuarial advice that is independent of both the firm and its actuarial function;
- With-profits firms will be required to define and make publicly available a statement of the Principles and Practices of Financial Management (PPFM);
- Such firms will have to certify adherence to the PPFM and their with-profits practices will be subject to independent review. For the larger firms, with with-profits liabilities of at least £250 million, the review will normally be carried out by a With-profits Committee (WPC) comprising non-executive directors and external non-directors; and
- There will be new, streamlined, certification to take into account the changes. The annual FSA return will be divided into financial statements, which will be fully audited, and a management report, where the auditors will only have to express an opinion that the report is consistent with the financial statements.

### Comment

The primary objectives of the consultation paper are to improve transparency and strengthen governance within life insurers. We fully support these objectives.

The detail of the consultation paper has come in for some comment. Many in the actuarial profession hold the view that:

- The actuarial liabilities should continue to be certified by a named actuary;
- There should only be one actuarial function i.e. the actuarial and with-profits functions should be combined;
- The role of the actuarial function should be widened to cover ongoing solvency;
- The PPFM is likely to be too complicated to be understood by most policyholders and so a summary is required;
- The use of discretion for non-profit policies should be covered by the PPFM; and
- The FSA have underestimated both the initial and ongoing work involved in their with-profits proposals.

### How can we help?

Golding Smith & Partners can:

- Provide an experienced non-executive for your board or WPC;
- Assist you in drawing up your PPFM;
- Give tailored training to your directors and senior management on their responsibilities following the regulatory changes; and
- Offer a wide range of other actuarial services.



## The role of actuaries in life insurers

### Key FSA proposals:

- The role of the Appointed Actuary will be abolished and replaced by actuarial and with-profits actuary functions. A firm will be able to appoint one person to fulfil both functions. The with-profits actuary (or any person holding a combined role) will not be allowed to hold the posts of chairman or chief executive or any other position that could give rise to significant conflicts of interest;
- The new actuarial functions will both be controlled functions. The new functions will provide advice to the firm's directors and senior management who will now demonstrably have direct responsibility for all actuarial aspects of the business;
- The overall responsibilities of the new actuarial functions will be reduced compared to those currently required of the Appointed Actuary. The remaining responsibilities could be allocated to the actuarial functions but this would be for each firm's directors to decide;
- The actuarial liabilities in the FSA returns will be signed-off by the life insurer's governing body – no formal sign-off by the new actuarial function is proposed. They will also be subject to audit, with the auditor required to seek actuarial advice independent of the firm being audited and its actuarial function; and
- The changes to the role of actuaries are now likely to come into effect at the same time as the Integrated Prudential Sourcebook which is planned for mid-2004, rather than the second half of 2003.

### Background

For some time, the FSA have been concerned that life insurers have relied too heavily on the views of their appointed actuaries and have not made their own judgements. The proposals will demonstrably place responsibility on the directors and senior management and, for the first time, will make the actuarial liabilities subject to audit.

### Scope

The proposals apply to all UK life insurers except small, non-directive, friendly societies and Lloyd's syndicates. The proposals will not initially apply to UK branches of EEA life insurers but will apply to non-EEA firms.

On cost grounds, small, non-directive, friendly societies will be allowed to continue with the appropriate actuary regime and

Lloyd's syndicates with syndicate actuary regime.

UK branches of EEA life insurers will continue to be subject to Home State regulation. None of these branches currently write with-profits business. However, in the event that any started writing with-profits business, it is likely that the with-profits actuary regime would be extended to them.

### Proposals

#### The role of actuaries

The Appointed Actuary role will be abolished and there will be two new actuarial functions, the actuarial and with-profits actuary functions. Both of these positions will be controlled functions (CF12 and CF12A, respectively) and so subject to pre-notification and approval by

the FSA. There will be transitional provisions allowing existing Appointed Actuaries to move into the new actuarial functions without the need for fresh approval.

The new functions will provide advice to the life insurer's directors and senior management. Appointments may be in-house or external. The holders will be Fellows of the Faculty or Institute of Actuaries with appropriate experience and will be subject to professional standards (including the requirement to hold a practising certificate and to follow generally accepted actuarial best practice). Both functions are likely to have formal whistle-blowing powers under regulations proposed by HM Treasury.

The directors will sign-off the actuarial liabilities in the FSA

returns which, in future, will be subject to audit. The auditor will need to seek actuarial advice from an actuary independent of the firm being audited and that firm's actuarial function. This advice could come from the auditor's own in-house actuarial team.

Overall, the responsibilities of the two new actuarial functions will be less than those of the Appointed Actuary e.g. the new functions will have no formal responsibility for ongoing solvency or discretion in non-profits business. The life insurer's directors will assume formal responsibility for these additional duties and may allocate them to whosoever they think fit and not necessarily to either of the actuarial functions.

In some cases, there will be the potential for overlap between the actuarial and with-profits actuary functions. It will be for the firm's directors to decide and document where the responsibilities lie.

There will be no prohibition on one person carrying out both the actuarial and with-profits actuary functions, provided the firm is clear that no conflicts of interest arise. The FSA suggests that the absence of such conflicts is more likely to occur in a mutual life insurer.

### **The actuarial function**

The responsibilities of the actuarial function will be to:

- Advise the governing body on the methods and assumptions to be used in the valuation of policyholder liabilities;
- Calculate the liabilities using methods and assumptions determined by the governing body; and
- Provide a report to the governing body on the results of the calculations. The report will include commentary on the availability of surplus from which a distribution to policyholders and/or shareholders could be made.

The report will be available, on request, to the FSA.

The actuarial function will not formally sign-off any actuarial liability figures in the FSA returns. This responsibility will fall solely on the directors. Equally, the auditors in their audit statement will not include any formal sign-off from the independent actuary from whom they have taken advice.

There will be no prohibition on the actuarial function holding other positions within the life insurer, provided the holder does not also act as the with-profits actuary. It is not believed that there would be any conflicts of interests in such circumstances.

### **The with-profits actuary function**

Firms transacting with-profits business will need to appoint a with-profits actuary. The responsibilities of this function will be to:

- Advise the firm on the use of discretion within its with-profit funds;
- Report to the governing body at least once a year on the key aspects of discretion within its with-profits funds;
- Request necessary information from the firm to carry out these responsibilities; and
- Advise the firm on the data and systems required to provide that information.

The with-profits actuary's advice on the use of discretion would be expected to cover issues such as the bonus rates, investment policy, surrender value methodology, new business plans and premium rates, allocation of expenses to with-profits business, changes to the PPFM and communication with policyholders.

The firm will have a formal responsibility to the holder of the with-profits actuary function to:

- Keep the holder informed of the firm's business plans and, where relevant, those of related firms;
- Provide the holder with sufficient resources;
- Hold such data and establish such systems as the holder may reasonably require;
- Request advice from the holder about the likely effect of material changes in the firm's business plans, practices or other circumstances on the fair treatment of with-profits policyholders; and
- Pay due regard to the holder's advice, whether provided in response to a request or as a result of the holder's own initiative, including allowing the holder to present his advice directly to the firm's governing body.

The with-profits actuary will not be allowed to be the firm's chairman or chief executive or hold other posts where there could be significant conflicts of interests. Such other posts might include the roles of sales and marketing directors or, in a proprietary company, the role of finance director.

It is considered that in some instances the with-profits actuary's remuneration might give rise to conflicts of interest. Rather than setting down detailed rules, it is proposed that the remuneration of the with-profits actuary should be disclosed in the FSA returns.

### **Timing**

The original proposal in CP167 was that these changes should come into effect the second half of 2003. However, as a result of the significant work being carried out by life insurers on realistic reporting, John Tiner, Managing Director, FSA indicated in a speech in February 2003 that implementation is now likely to coincide with the introduction of the Integrated Prudential Sourcebook. This is planned for mid-2004.



## With-profits governance

### Key FSA proposals:

- Firms will define and make publicly available the PPFM applying to their with-profits business. The directors will make an annual statement of compliance with the PPFM;
- The *principles* within the PPFM will be enduring statements of the standards and business model used by the firm in its with-profits business. Three months' notice will be given to with-profit policyholders on changes to the *principles*;
- The *practices* within the PPFM will describe the firm's current approach to managing its with-profits business. Policyholders will be informed of any changes in the *practices* but no notice will be required;
- Firms with with-profits liabilities of at least £250 million will normally set up a WPC comprising independent non-executive directors and external non-directors (also called 'appointed members');
- The WPC will monitor the firm's use of discretion in its with-profits business and provide a report which will be annexed to the director's annual report to with-profits policyholders on compliance with the PPFM;
- Smaller firms will normally put in place alternative arrangements e.g. a report from an independent non-executive; and
- The original proposals were that the PPFM should be drafted during the second half of 2003 and become publicly available during 2004. WPC's (or an alternative) were scheduled to come into effect by Spring 2004.

### Background

With-profits business has received considerable criticism over recent years because of its lack of transparency and poor consumer understanding. The proposals provide additional, publicly available, information and strengthened governance arrangements. Their purpose is to provide greater consistency and transparency in the use of discretion by firms and to aid consumer understanding of with-profits policies.

### Scope

The proposals apply to all UK life insurers writing with-profits business except, on cost grounds, small, non-directive friendly societies. 'Holloway' sickness business which is primarily for

sickness protection rather than savings is excluded. Both open and closed funds are included within the scope of the proposals.

The proposals will not initially apply to UK branches of EEA life insurers (but will apply to non-EEA firms). As stated before, no branches of EEA firms currently write with-profits business. However, in the event that any started writing with-profits business, it is likely that the with-profits governance regime (as well as the requirement to have a with-profits actuary) would be extended to them.

### Proposals

#### Principles and Practices of Financial Management

Firms will be required to establish, maintain and record the principles

and practices of the financial management applying to their with-profits funds. Where a firm has a number of with-profit funds, it could have one PPFM covering all its funds or separate PPFM's for some or all of the funds. Firms will be required to maintain a full history of changes to their PPFM's.

Where a firm has with-profits business that results from an earlier business transfer, the PPFM should incorporate any requirements of the transfer documentation to ensure that earlier undertakings are met.

The PPFM will be sent out to new policyholders and will be available to existing policyholders and others on request. The life insurer may make a reasonable charge for issuing the PPFM to a person who is not a with-profits policyholder. Existing policyholders will be

informed of the availability of the PPFM in an annual report (see below).

### The with-profits principles

The with-profits *principles* within the PPFM will:

- Be enduring statements of the overarching standards the firm adopts in managing its with-profits funds; and
- Describe the business model used by the firm in meeting its duties to with-profits policyholders and in responding to *longer-term* changes in the business and economic environment.

The with-profits *principles* would not be expected to change very often but should be informative enough for, amongst others, the directors, with-profits actuary and any WPC to judge whether the existing, or potential, with-profits *practices* of the firm were appropriate. The firm must give with-profits policyholders three months' notice in writing of any changes to the with-profits *principles*. Any changes to the with-profits *principles* would normally also require notification to the FSA.

### The with-profits practices

The with-profits *practices* within the PPFM will:

- Describe the firm's approach to managing with-profits funds and responding to changes in the business and economic environment in the *shorter-term*; and
- Contain sufficient detail to enable a knowledgeable observer to understand the possible risks and rewards from effecting or maintaining a policy with the firm.

The with-profits *practices* are expected to change along with the business environment every few years. A firm must advise its with-profits policyholders in writing

about changes to its with-profits *practices* but no notice is required. The advice may be in annual (bonus) statements to with-profits policyholders, rather than in a separate notification.

### Details of the PPFM

The PPFM should "cover any issue that has, or may have, a significant impact on the firm's management of its with-profits funds". The draft handbook text gives a significant amount of detail on the issues that should be considered and how they should be dealt with in the with-profits *principles* and *practices*.

The draft handbook text includes the following 'headline' rules which must be covered in the PPFM:

- The methods used by the firm to guide its determination of the amount that it is appropriate to pay individual policyholders;
- The approach used to set annual bonus rates;
- The approach used to set final bonus rates;
- The approach used to smooth the value of with-profits contracts;
- Significant aspects of the investment policy for with-profits business;
- The exposure of with-profits business to business risk;
- The way in which the firm applies charges and apports expenses to its with-profits business;
- The way the firm manages its inherited estate and the uses to which the firm puts that estate;
- The practice for reviewing limits on the quantity and type of new with-profits business taken on and the actions that would be taken if the firm ceased to take on a significant amount of new with-profits business; and
- Where applicable, the approach used to achieve a balance between the interests of with-profits policyholders and shareholders.

Beneath these proposed 'headline' rules, there is a considerable amount of further detail in additional, clarifying, rules and guidance.

### Potential issues

As drafted, the rules and guidance appear in some cases to put commercially sensitive information into the public domain e.g. in relation to new business volumes and the possibility of closure of the with-profits fund. They could also require firms to disclose practices in the PPFM which more knowledgeable investors could use to their advantage to the detriment of other policyholders.

In general, the significant detail of the draft rules and guidance is likely to make the PPFM very lengthy and, for a layman, difficult to understand. Although apparently unintended, it could be construed that the draft wording requires detailed information which would cause firms to amend their *practices* every year rather than every few years e.g. in relation to disclosure of parameters used in asset share calculations.

In addition, no standard template (or model code) is proposed for PPFM's. The existence of a template would aid comparison of the PPFM's of with-profits firms.

### Ongoing compliance with the PPFM and annual report to with-profits policyholders

A life insurer will be required to ensure ongoing compliance with its PPFM in the conduct of its with-profits business. It will also have to produce an annual report to its with-profits policyholders stating whether or not it believes that it has complied with its PPFM obligations.

The annual report will set out the firm's evidence and reasons for its belief. In doing this, the firm will have to address all material issues, including how it has used (or

refrained from using) its discretion and how the interests of competing groups of policyholders and, where relevant, the interests of shareholders have been taken into account.

The annual report must take into account the report from the with-profits actuary on the use of discretion. Any independent report from a WPC or alternative governance arrangement (see below) should be annexed to the report.

A copy of the annual report should be deposited by the firm with its FSA returns or as soon as possible thereafter. In addition, the directors will have to certify compliance with the PPFM in their FSA returns.

### Independent review

As part of the governance arrangements for with-profits business firms with with-profits liabilities of at least £250 million would be expected to set up a WPC comprising independent non-executive directors and external non-directors (or 'appointed members'). Such a committee would have a monitoring and advisory role, including publishing an annual report to with-profits policyholders on its work and the firm's compliance with PPFM. The committee would normally be constituted as a committee of the firm's governing body with formal terms of reference and sufficient delegated authority to carry out its work. An insurance group with a number of with-profits firms would be allowed to set up a single WPC covering all its firms.

On cost grounds, the FSA does not expect smaller firms with with-profits liabilities of less than £250 million to set up a WPC, although they could do so if they wished. An alternative approach is suggested which is to ask an independent non-executive director or external non-director to provide a report to the firm's governing body on compliance with its PPFM.

### Formal structure of a WPC

The draft handbook text provides guidance on the constitution, membership and structure of a WPC. The key points are as follows:

- The role of the WPC will be purely advisory with the governing body retaining full responsibility for the use of discretion in with-profits business;
- In its advisory role, the WPC should monitor and consider all relevant issues and information including:
  - a) The rights, interests or expectations of different classes and generations of with-profits policyholders;
  - b) The way in which the firm uses its discretion;
  - c) The way in which the firm addresses any competing or conflicting rights, interests and expectations of with-profit policyholders (or groups of policyholders) and shareholders (or groups of shareholders);
  - d) The firm's compliance with any applicable PPFM; and
  - e) Any proposed changes to the PPFM which might affect the rights, interests or expectations of the firm's with-profits policyholders;
- For a proprietary firm, there should be a balanced mix between non-executive directors and 'appointed members';
- The 'appointed members' of the WPC should *collectively* have skills and experience relevant to the conduct of with-profits business and the fair treatment of policyholders. The position of an 'appointed member' will be a controlled function (CF2, as for a non-executive director);
- The FSA considers that although there is less reason for a mutual to have 'appointed members' on its WPC, it still represents good practice, especially for larger mutuals;

- No member of a WPC should hold an executive position in the firm's group or have acted within the year prior to appointment as a professional adviser to the firm.

The WPC will make an annual report to with-profit policyholders. The report will cover the work of the WPC and any other issues it considers relevant. It should take into account the with-profits actuary's report on the use of discretion. It is expected that the report will be quite brief. The report will be annexed to the firm's annual report to with-profits policyholders.

### Further consultations

The FSA issued a further consultation paper on disclosure at the point of sale in February 2003 and:

- Will be issuing a consultation paper on post-sale disclosure in Winter 2003; and
- Is considering issuing a consultation paper giving guidance on what the obligation to treat customers fairly means in relation to with-profits business.

All these papers will have an impact on the way firms treat their with-profits policyholders.

### Timing

CP167 proposed that PPFM's should be defined by the end of 2003 and be publicly available during 2004. WPC's or an alternative governance arrangement would come into effect by Spring 2004, after a nine month transitional period following the implementation of the rules.

There is no indication from the FSA that the timetable has changed. Indeed, as part of the move to realistic reporting, they are encouraging the early definition of PPFM's.



## Certification in insurance returns

### Key FSA proposals:

- A new, streamlined, approach to insurance certification;
- The changes will apply to all insurers, not just life insurers;
- The changes reflect the FSA's longer term aim of placing greater responsibility on senior management for compliance with FSA principles and requirements;
- Under the new regime, the FSA returns will be divided into financial statements and a management report;
- The financial statements will include balance sheet and solvency information currently included in the Appointed Actuary's report. The wording of the directors' certificate accompanying the financial statements will be more streamlined than the current directors' certificate and, by nature, more akin to the current actuarial certificate. The financial statements will be subject to full audit;
- The management report by the directors will be comprised of text and statistical/analytical data that was previously in the Appointed Actuary's report. The auditors will review the management report and express an opinion about whether it is consistent with the financial statements;
- Firms will have to make other reports available to the FSA, including the annual report to with-profit policyholders and a risk assessment report (which should include matters previously covered in a firm's Financial Condition Report); and
- The changes are now likely to come into effect from 2004, rather than end 2003.

### Background

Revised insurance certification automatically flows from the FSA's proposals on changes to the role of actuaries and strengthened with-profits governance. However, on reviewing the current certification, the FSA concluded that a new approach was needed for all insurers, not just life insurers. The proposed new approach is more streamlined and ensures greater consistency in approach with the Companies Act accounts. It also aims to place more explicit responsibility on the senior management of firms.

Under the proposals, the FSA returns will be divided into financial statements and a management report. Both parts will be subject to sign-off by the directors. As discussed earlier, there no formal sign-off from an actuary is proposed under the new regime.

Within the new-style FSA returns, only the financial statements will be subject to a full audit. The auditors will simply have to express an opinion on the management report that it is consistent with the financial statements.

### Financial statements

The financial statements will include all the forms currently included in the audited balance sheet and revenue accounts. In addition, the following forms will be transferred from the Appointed Actuary's report:

- Forms 48 and 49 which analyse the assets backing non-linked business and their expected income;

- Forms 55 and 56 which analyse the assets matching unit-linked and index-linked liabilities;
- Form 58 which shows the valuation result and the distribution of surplus; and
- Form 60 which shows the required minimum (solvency) margin calculation.

### Management report

The management report will comprise the following from the current Appointed Actuary's report:

- The text of the report, subject to suitable wording changes;
- Forms 46 and 46A which summarise the movements in the business in force;
- Form 47 which analyses the new business taken on by product type;

- Forms 51 to 54 which summarise the valuation of policy liabilities; and
- Form 57 which shows the matching rectangles.

Initially, the management report will only apply to life insurers. However, the FSA have indicated that the concept may well be extended. They will be issuing a consultation paper in Spring 2003 on wider reforms in insurance regulatory reporting that are likely to apply from 2005 onwards.

### Directors' certificate

The new directors' certificate will cover:

- Proper preparation of the FSA return in accordance with the requirements in Interim Prudential Sourcebook for Insurers, IPRU(INS), which will include the proper assessment of policyholder liabilities in line with the FSA's requirements ;
- Compliance with the rules and guidance in SYSC (Senior Management Arrangements, Systems and Controls), PRIN (Principles for Businesses) and IPRU (INS);
- The adequacy of premium rates for new business taken on during the year; and

- Where applicable, that with-profits funds have been managed in accordance with the PPFM.

### Auditors' certificate

This will be in two parts:

- The first part will give the auditors' opinion on the proper preparation of the financial statements (Forms 9 to 17, 20 to 45, 48, 49, 55, 56, 58, 60 and 61 and the rule 9.25 to 9.27 statements for general insurance companies on major reinsurance arrangements); and
- The second part will give the auditors' opinion on whether information in the management report is consistent with the financial statements.

### Information on the with-profits actuary

A life insurer writing with-profits business must disclose the remuneration of its with-profits actuary (or actuaries) during the financial year in its FSA return. The same information is currently given for individuals who have been the Appointed Actuary. However, the Appointed Actuary has formal sign-off responsibilities in the FSA returns which the with-profits actuary will not have. As a result, it does appear somewhat incongruous

to provide this information, especially in the FSA returns.

### Other reports

A life insurer will have to provide the FSA with a copy of its annual report to with-profits policyholders at the same time as its FSA Returns, or as soon as possible thereafter.

In addition, the directors will be required to produce a *risk assessment report*, including information currently included in the Appointed Actuary's Financial Condition Report (FCR). This report will have to be provided to the FSA but, as for the FCR, will not be in the public domain on the grounds of commercial sensitivity.

### Timing

CP167 proposed that the new certification would come into effect from end 2003. However, John Tiner, Managing Director, FSA indicated in his February 2003 speech that revised certification is now likely to come into effect in 2004 at the same time as the changes to the role of actuaries and implementation of the Integrated Prudential Sourcebook. In the meantime, there will be some changes to reporting and certification for the end 2003 returns to cover sign-off of additional realistic reporting by the Appointed Actuary.



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