



With-profits governance and the role of actuaries in life insurers

Briefing Update

Introduction

At the end of June 2003, the FSA published a policy statement providing feedback on the responses made to consultation paper CP167 "With-profits governance, the role of actuaries in life insurers, and certification of insurance returns".

The policy statement also set out proposed changes to the handbook text in relation to with-profits governance and the role of actuaries in life insurers. Revised text on the certification of insurance returns will be provided in a Consultation Paper on insurance annual returns to be published later in Summer 2003.

This Briefing Update looks at the key changes and provides updated summaries on with-profits governance and the role of actuaries in life insurers.

Key changes

The key changes in the policy statement are as follows:

Principles and Practices of Financial Management

- The Principles and Practices of Financial Management (PPFM) will not have to be sent automatically to all new policyholders. Normally, they will only be available on request;
- Firms will have to signpost the availability of the PPFM in their annual (bonus) statements to policyholders. Firms will be encouraged to put the PPFM (and their annual report on compliance with PPFM) on their website;
- It has been accepted that the PPFM are likely to be too complicated for most policyholders to understand. The FSA is looking at consumer friendly delivery of the PPFM;

- Work on consumer friendly delivery will be carried out by the FSA, probably alongside changes that it is considering making to with-profits guides for 2004. The FSA are likely to specify some of the format for any consumer friendly delivery of the PPFM; and
- The PPFM's will now have to be defined by end March 2004, rather than in the latter half of 2003.

The role of actuaries

- The actuarial function role has been widened to cover ongoing monitoring of the firm's financial condition and advice to the firm on capital requirements;
- The with-profits actuary (or any person holding both actuarial roles) will not be allowed to be a board member. The previous proposal allowed board membership subject to significant restrictions; and
- The with-profits actuary will now make an annual report to with-profits policyholders on their firm's compliance with the PPFM. This report will be annexed to the annual report to with-profits policyholders made by the firm itself.

With-profits governance

- The FSA have moved away from their previous With-profits Committee (WPC) proposals. This board committee structure is now only one of the options;
- Firms now have a choice between the WPC structure, commissioning reports from an independent person or, mainly for small firms, relying on reports from a non-executive director. Other structures could also be considered provided they are appropriate for the scale and

complexity of the with-profits business and involve some independent judgement;

- There is no longer a requirement for a WPC to be comprised of non-executive directors and external non-directors. So a WPC comprising executive and independent non-executive directors (and/or non-directors) would be satisfactory; and
- The WPC, or other arrangement providing independent judgement, will not have to produce an automatic report to policyholders, although the FSA still recommend this approach.

Audit and certification

- There will now be a formal actuarial sign-off of the actuarial liabilities by the reviewing actuary who advises the auditor. This will be a personal opinion in the public domain and will be published alongside the auditor's report; and
- The audit and certification changes will be introduced during 2004 at the same time as the Integrated Prudential Sourcebook (PSB), rather than from end 2003.

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;
- Produce independent reports on the conduct of your with-profits business for your board and/or your policyholders ;
- 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 able to become a member of their firm's governing body. More generally, the holders of the new actuarial functions will not be allowed to carry out the role of chairman or chief executive or any other position that could give rise to significant conflicts of interest. Where the holders are employees, their remuneration should not be disproportionate, or exceptional, relative to employees of equivalent seniority;
- 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 formal 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 being required to seek actuarial advice from a reviewing actuary who is independent of the firm being audited and its actuarial function. The reviewing actuary will provide a personal opinion which will be published alongside the auditor's report; and
- The changes to the role of actuaries will come into effect at the same time as the Integrated Prudential Sourcebook which is planned for mid-2004.

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 also apply to UK branches of non-EEA

life insurers but not those of 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. However, the FSA will be making proposals in a Miscellaneous Consultation Paper later in Summer 2003 to extend with-profit governance arrangements to such branches.

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. They will be subject to professional standards, including the requirement to hold a practising certificate and to follow generally accepted actuarial best practice. Both functions will have formal whistle-blowing powers under regulations recently made by HM Treasury.

The actuarial functions will not sign-off the actuarial liabilities in the FSA returns. This responsibility will fall on the directors with the actuarial liabilities now being subject to audit. In respect of the actuarial liabilities, the auditor will need to seek actuarial advice from a reviewing 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 formal responsibilities of the two new actuarial functions will be less than those of the Appointed Actuary e.g. the new actuarial function will have no formal responsibility for advising the firm on the data and systems required for financial and risk analysis purposes or on the use of discretion for 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 functions will not be allowed to combine their role with that of the firm's chairman or chief executive, or with other positions which could give rise to significant conflicts of interest.

The FSA consider that significant conflicts of interest are more likely to occur for the with-profits actuary. As a result, the with-profits actuary will not be allowed to be a member of the firm's governing body (i.e. to be a member of the board, or, for a friendly society, the society's Committee of Management). Other posts which could cause conflicts for the with-profits actuary include senior roles in sales or marketing, and, in a proprietary company, the firm's finance department.

Significant conflicts of interest are less likely to occur for the actuarial function. Apart from the restrictions on being chairman or chief executive, the holder of the actuarial function could be a member of their firm's governing body, provided they do not also act as the firm's with-profits actuary.

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;
- 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;
- Advise the firm's management on the risks that they run insofar as they may have a material impact on the firm's

ability to meet policyholder liabilities as they fall due; and

- Monitor those risks and inform the firm's management of any material concerns or good reason to believe that the firm:
 - a) Is not meeting policyholder liabilities as they fall due, or may not be doing so, or might not have done so in the past, or might, in reasonably foreseeable circumstances, not do so in the future;
 - b) Is, or may be, effecting new long-term policies on inadequate terms; or
 - c) Does not, or may not, have sufficient financial resources to meet policyholder liabilities (including reasonable bonus expectations) as they fall due or, if the firm currently has sufficient resources, might, in reasonably foreseeable circumstances, not continue to have them.

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;
- Provide an annual written report to with-profits policyholders, to accompany the firm's annual report, giving an opinion as to whether the firm has taken into account the interests of those policyholders in a reasonable and proportionate manner;
- 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 reviewing actuary

The reviewing actuary will provide a formal actuarial sign-off of the liabilities providing an opinion in the public domain that:

- The methods and assumptions used were reasonable;
- The calculation was carried out in accordance with those methods and assumptions;
- The mathematical reserves make proper provision for policyholder liabilities in

accordance with the regulatory requirements; and

- Confirming the amount of the required minimum margin of solvency.

Other matters

Where Schemes of Arrangement, policy, or other documents, delegate particular duties to the Appointed Actuary, it will be for the firms concerned to put in place alternative arrangements. The FSA suggest that in many cases the with-profits actuary or the actuarial function could carry out these duties.

Timing

Implementation of the changes to the role of actuaries will coincide with the introduction of the Integrated Prudential Sourcebook which 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 report of compliance with the PPFM. This annual report will be accompanied by the with-profits actuary's report;
- 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 will be required to set up an appropriate governance arrangement to monitor the firm's use of discretion in its with-profits business, including an element of independent judgement;
- The governance arrangement could take the form of a WPC, the commissioning of reports from an independent person, or, mainly for smaller firms, reports from an independent non-executive director; and
- The PPFM should be drafted by the end of March 2004, with the WPC, or other governance arrangement, coming into effect by the same date.

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 also apply to UK branches of non-EEA life insurers and, in modified form, to UK branches of EEA firms.

As mentioned earlier, the FSA will be issuing a Miscellaneous Consultation Paper later in Summer 2003 to extend with-profit governance arrangements to UK branches of EEA firms. However, the FSA's proposals in this area will be limited by EC directives.

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 available on request. The FSA also recommends that firms post the PPFM on their website. The life insurer may make a reasonable charge for issuing the PPFM to a person who is not a with-profits policyholder.

Existing with-profits policyholders will be informed of the availability of the PPFM in annual reports. The signposting of the PPFM for new policyholders is to be discussed in

the Policy Statement giving feedback on CP170 “Informing consumers: product information at the point of sale” which is due out in Autumn 2003.

The FSA is also looking at consumer friendly delivery of the PPFM. This work will probably be carried out alongside proposed changes to with-profits guides for 2004. However, no formal timetable has yet been published on consumer friendly delivery. The FSA is likely to specify some of the format for consumer friendly delivery of the PPFM to ensure a minimum level of clear content.

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 the members of the firm’s governance arrangement 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* (unless it obtains a S148 waiver from the FSA). 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 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 proposed 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 proposed 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 apportions 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.

Ongoing compliance with the PPFM and annual statements 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 firm’s annual report will also be accompanied by its with-profits actuary’s report to policyholders.

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 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.

The annual report does not need to be sent policyholders. However, its availability must be signposted in annual (bonus) statements to with-profits policyholders and it is suggested that, as well as providing copies on request, the annual report should be posted on the firm's website.

Independent review

As part of with-profits governance, firms must put in place a governance arrangement to monitor and advise on their use of discretion for their with-profits business. This arrangement must include an element of independent judgement.

The structure of the governance arrangement will depend on the scale and complexity of the firm's with-profits business. The aim will be to ensure that the firm complies with, maintains and records, the PPFM. In assessing compliance with the PPFM, the governance arrangement must consider how the

firm addresses any competing or conflicting rights and interests of policyholders and, where applicable, shareholders.

The governance options include but are not confined to:

- A WPC/committee of the governing body, including non-executive members (and/or non-directors with appropriate skills and experience);
- Asking an independent person with appropriate skills and experience to report to the governing body on these matters; or
- Mainly for smaller firms, asking a non-executive member, or members, to report to the governing body on these matters.

A non-director member of a WPC will be treated as non-executive director for supervisory purposes and fall within the CF2 controlled function category.

The FSA have indicated that they consider it would provide reassurance to with-profits policyholders if the WPC, or alternative governance arrangement, produced a report to with-profits policyholders on their work and the firm's compliance with PPFM. However, this stated preference does not form part of the

FSA's formal rules and guidance. Where such a report is produced by the members of the governance arrangement, it must be annexed to the firm's annual report.

The governance arrangement, however constituted, would be expected to have 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 governance arrangement covering all its firms.

Further consultations

The FSA will be issuing the following consultation papers which will have an impact on the way firms treat with-profits policyholders:

- The re-attribution of inherited estates in Autumn 2003;
- Guidance on what the obligation to treat customers fairly means in relation to with-profits business in Autumn 2003; and
- Post point of sale disclosure (on with-profits and other business) in Spring 2004.

Timing

The PPFM and with-profits governance arrangements should be put in place by end March 2004.



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