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## **Managing risk in insurance companies**





# Managing risk in insurance companies

How to identify and control the hidden risks

By Charles Golding

## Background

The UK insurance industry has gone through a significant period of turmoil over recent years.

In the life insurance sector, there have been the industry-wide endowment and pensions misselling “scandals”, and the notable guaranteed annuity option judgement against Equitable Life. There have also been concerns about the lack of clarity of with-profits contracts.

The general insurance sector has also had its fair share of problems, including the liquidation of Independent Insurance and the well-publicised problems in the Lloyds Market.

On top of all this the long bear market in recent years has strained the finances of many insurance companies.

For an industry that in the past took pride in its skills and its ability to measure and control risk, and that was considered by many to be the world leader, these problems are perhaps all the more surprising.

Government concerns about the UK insurance industry have led to the Tiner Project<sup>(1)</sup> and a plethora of reports and papers from the Financial Services Authority (FSA).

So, what can be done to avoid such problems in the future and ensure that there are no more skeletons in the cupboard? What is the FSA proposing and what additional controls should the directors of an insurance company put in place? This Briefing looks at these issues in more detail.

## Risk categories

Insurance companies face a wide range of risks. Whilst some risks are unique to the insurance industry, most are not. However, the long term nature of some insurance contracts tends to increase the financial impact of these risks.

The FSA divide risks into six main categories<sup>(2)</sup>. These categories are:

- Credit risk and risk concentration (the default risk attaching to counterparties);
- Market risk (risk relating to the fluctuation in the value of assets and the income therefrom and the related effect on the value of a firm’s liabilities);
- Liquidity risk (risk that a company, whilst technically solvent, does not have sufficient liquid assets to meet liabilities as they fall due);
- Insurance risk (risk relating to the amount, timing and occurrence of insurance liabilities);
- Group risk (risk resulting from the membership of a group of firms); and
- Operational risk (the risk of loss resulting from inadequate or failed internal processes, or from external events, but excluding risk of a credit, insurance, liquidity or market nature).

Insurance companies are potentially subject to all these risks, so how do they manage them?



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## The FSA proposals

The FSA has made some wide-ranging proposals on managing risk. The proposals are consistent with a move to a risk-based approach to supervision.

The proposals are contained in a variety of reports and papers. Some of these documents look at the broad framework, whereas others look at specific areas of concern.

The stage of development of the proposals varies. The proposals relating to individual capital adequacy and the new regulatory reporting environment are only at an early stage.

The full development of the FSA proposals will take time but for insurance companies the plan is to introduce all the main proposals by mid 2004<sup>(3)</sup>. For other financial firms, full implementation is unlikely until 2006.

In the meantime, the FSA has put forward some interim prudential guidance on operational risk systems and controls for insurance companies<sup>(4)</sup>. This interim guidance is planned to come into force from 1 February 2003.

Other early changes are proposed for insurance companies in relation to financial engineering, the appointed actuary role, and with-profits business.

## Timetable

The table below shows the various phases and likely implementation dates for the proposals being put forward by the FSA.

TIMING	ISSUE
February 2003	Interim prudential guidance on operational risk systems and controls
March 2003	Guidance on insurance firms use of financial engineering (reporting of financial engineering comes in December 2002 for life and December 2003 for non-life)
Mid 2003	Narrowing of the Appointed Actuary role to with-profits discretion and creation of actuarial function. Creation of With-Profits Fund Committee
Mid 2004	Integrated Prudential Sourcebook, including rules and guidance on managing the six main categories of risk (new-style reporting from 2005)
During 2004	Individual capital adequacy standards

In addition, the FSA supports the IASB fair value accounting proposals and a risk-based approach to solvency capital for the EC Solvency II review. These changes should increase transparency and, hopefully, reduce the likelihood of insurance failures.

IASB agreed proposals are unlikely before 2006. Solvency II is unlikely before 2005, which is why the FSA is pressing ahead with its own proposals on individual capital adequacy.

## Key points

The central theme is that for each area of risk:

- There should be a well-documented policy;
- Adequate systems and controls; and
- Regular internal and external review.

At board level, insurance companies should comply with good corporate governance principles (e.g. the Combined Code<sup>(5)</sup> for UK listed companies).

The FSA is looking for greater transparency. As well as a move to fair value accounting, it is proposing greater openness in

areas such as with-profits business and financial engineering.

As would be expected, the FSA wants to move to a regime where past mistakes are not repeated. Prompt action should be taken where problems are identified. Past experience has shown that delays in taking action and general complacency heighten the potential cost of rectification.

## Our analysis

This Briefing looks at the key FSA proposals in the following areas:

- Risk management rules and guidance in the Integrated Prudential Sourcebook;
- Operational risk;
- Financial engineering; and
- The future role of actuaries and with-profit fund reforms.

The FSA has not yet made firm proposals on individual capital adequacy standards (ICAS) and so we will not look at this area in any detail.

The ICAS consultation paper<sup>(6)</sup> proposes two elements to the ICAS framework: an internal capital assessment (ICA) determined by the company and a Supplementary Capital Assessment (SCA) determined by the regulators.

The ICA will be based around an enhanced Pillar 1 (minimum capital) requirement, with stress and scenario tests to determine whether a company's own risk profile requires it to put aside additional capital.

The SCA will be a tool used by the regulators to require a firm to hold additional capital in response to specific systems and controls' issues or other concerns not addressed by the ICA.

## How can we help?

Golding Smith & Partners can steer you through the maze of new rules and guidance which the FSA are proposing. We can help you identify the hidden risks in your business and put in place appropriate systems and controls.



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If you require:

- Help in drawing up your risk policy;
- An external review of your systems and controls;
- An experienced non-executive director to sit on your board and take an active part in its audit, risk and with-profits fund committees;
- Training of your senior team on risk management issues; or
- Help on any other matter in relation to the FSA proposals;

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# Risk management rules and guidance

Key FSA objectives:

- Move to a risk-based approach with an increased emphasis on risk identification and management;
- Greater consistency between different types of financial firm;
- Firms should have well-documented risk policies and strong risk management systems;
- The rules and guidance build on existing EC directives, and implement EC Solvency I;
- Rules and guidance will develop in line with proposed European and international developments e.g. EC Solvency II, EC Financial Conglomerates Directive and IASB (fair value) accounting standards; and
- Early implementation for insurance companies of full rules and guidance due to regulatory concerns.

## Introduction

The FSA is moving to a risk-based approach to regulation where the potential impact of prudential failure is the key issue, rather than the risk of failure itself.

One of the key stated objectives for insurance companies is to place greater emphasis on risk identification and management, rather than technical provisions and solvency.

The Integrated Prudential Sourcebook aims to ensure greater consistency of requirements between different types of financial firm. It specifies the prudential requirements for the six main risks which could cause firms a major loss or insolvency: credit, market, liquidity, insurance, group and operational.

For each of the main risks firms should have:

- A well-documented policy; and
- Strong risk management systems in place to identify, measure, monitor and control that risk.

The rules and guidance build on the existing EC directives and implement EC Solvency I. In due course, they will be developed in line with proposed European and international developments e.g. EC Solvency II, EC financial Conglomerates Directive and IASB (fair value) accounting standards. For insurance firms, early implementation of the full rules and guidance is proposed

because of regulatory concerns.

The current proposal is to implement the rules by mid-2004 for insurance companies, whereas for other firms the FSA may wait until 2006.

## Credit risk

Credit risk is the risk of default attaching to counterparties. These risks can arise directly from investments or, indirectly, as a consequence of another objective e.g. exposure to a reinsurer or derivative counterparty.

The proposed prudential rules build on the EC Insurance Directives.

The key points are:

- There is now a stated requirement on firms to restrict to prudent levels and adequately diversify their counterparty exposure and make prudent provision for credit loss;
- The counterparty limits have been simplified whilst still complying with the EC Insurance Directives. There is now an overriding requirement that the exposure to connected counterparties must not exceed the firm's capital. The usual exemptions apply for linked assets, government securities and UCITS.
- There are new requirements for exposures to reinsurers:
  - (i) a firm must notify the FSA if its exposure to connected

reinsurers exceeds its capital and explain whether or not prudent provision is required for the excess; and

- (ii) the FSA would not normally expect the premiums to connected reinsurers in a single financial year to exceed 20% of gross premiums or £4m, if higher.

These requirements can be overridden, if a reinsurance exposure is guaranteed by a credit institution or a credit derivative. In such circumstances, the reinsurance exposure may be reclassified as an asset exposure to the guarantor or derivative counterparty;

- Where a firm takes security over a counterparty's assets, or uses another method of loss mitigation, credit can only be taken if the method is likely to be effective in the event of default. Professional advice should be taken if preferential access to a counterparty's assets is assumed.

## Market risk

Market risks are risks arising from fluctuations in the value of assets and their income.

The rules and guidance build on current practice and EC Directives. The matters covered include:

- matching of assets and liabilities;
- resilience reserving;

- valuation rates of interest;
- currency matching;
- close matching for linked liabilities;
- asset exposure limits; and
- specific rules for the use of derivatives, quasi-derivatives and stock lending transactions.



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The following points are of interest:

- The basic concepts of the resilience provision have been extended to non-life business;
- For life business, the resilience provision will in future be a capital adjustment rather than being part of the mathematical reserves;
- The asset exposure rules have been simplified whilst still complying with the EC Insurance Directives. The usual exemptions apply for linked assets, government securities and UCITS;
- The FSA is proposing to consult separately on the assets which are suitable for linked long term business. They wish to achieve greater harmonisation between linked life funds and non-insurance investment products.

### Liquidity risk

Liquidity risk relates to the risk that a company, whilst technically solvent, does not have sufficient liquid assets to meet liabilities as they fall due.

Much of the FSA's thinking on liquidity risk has yet to be

published and when it is published will relate to banks and investment firms, rather than insurance companies. However, it is clear that insurance companies could incur liquidity problems in some circumstances.

The proposed guidance on systems and controls<sup>(14)</sup> is the only part of the FSA's thinking currently at the consultation stage. It stresses the need to look at both assets and liabilities when drawing up a liquidity risk policy and the related systems and controls.

### Insurance risk

Insurance risks are risks that relate to the amount, timing and occurrence of insurance liabilities.

The proposed rules and guidance cover:

- insurance systems and controls;
- financial resources; and
- internal contagion risk.

### Insurance systems and controls

The FSA has the view that few insurance companies have a fully documented insurance risk policy. The new rules require a fairly detailed insurance risk policy which should provide the framework for the firm's systems and controls.

The insurance risk policy should cover underwriting, claims management, claims provisioning (which for life companies should include unit pricing and bonus policy) and record keeping.

### Financial resources

The financial resource requirements cover much that is already common practice and embedded in the EC Insurance Directives including:

- minimum standards for new business;
- the adequacy of technical provisions, including the mathematical reserves;
- calculation of equalisation provisions; and
- calculation of the solvency margin requirements.

The key changes are as follows:

- The minimum standards on the adequacy of premiums for new business have been extended to non-life;
- The solvency margin requirements have been extended to cover Solvency I<sup>(11)</sup>. The changes include a 50% increase in the solvency margin requirements for non-life liability business and a solvency margin requirement on previously zero-rated unit-linked business of 25% of annual expenditure;
- There is a new requirement to value with-profits business on a realistic basis including allowance for terminal bonus (see the section on the future role of actuaries and with-profits fund reforms for further details). This realistic valuation will be used to determine whether a capital adjustment called the with-profits capital component is required. The with-profits capital component is the excess, if any, of the realistic reserve over the with-profits mathematical reserves and solvency margin requirements;
- The guidance on margins for adverse deviations has been strengthened considerably compared to the existing actuarial guidance. The new guidance includes a requirement to allow for discretionary benefits and to market test the margins.

### Internal contagion risk

Internal contagion risk is a new definition but covers familiar matters including:

- the requirement on firms to restrict their business to insurance business (and directly related activities);
- separation of long term business assets from other assets;
- maintenance of long-term business assets in excess of liabilities;
- only allowing long-term business assets to be used for

- the purpose of long-term insurance business; and
- localisation of assets for a non-EEA insurer.

There are some new proposals:

- a firm must limit, manage and control its non-insurance activities so that there is no significant risk arising from those activities;
- restrictions on the use of with-profits assets and on the way with-profits funds are managed (subject to further consultation);
- requirements on the selection, allocation and management of assets for unit-linked funds (to avoid excessive market or credit risk).

The with-profits proposals, which are subject to review and further consultation, included ring-fencing of with-profits funds and a 90:10 presumption in proprietary companies.

## Group risk

Group risks are risks that derive from belonging to of a group of firms. These risks include financial and reputational risks.

The proposed rules and guidance focus on systems and controls, and capital requirements.

The systems and controls requirements apply on a worldwide basis. Their aim is to monitor the relationships between the various members of the group. They should cover issues including group risk capital requirements and group risk reporting.

The capital requirements are based on current and planned EC Directives. There are two tests on the adequacy of group capital:

- an insurance test; and
- a cross-sector test.

In the tests, group capital is assessed on a basis that avoids any double gearing or leveraging. There is an overriding requirement that double counting must be avoided in calculating group capital.

## The insurance test

The insurance test relates to the adequacy of the group's capital to meet the aggregate solvency margin requirements of all the insurance and reinsurance companies within the group. It follows the Insurance Groups Directive.

The test is carried out on:

- (i) an EEA basis with the group being defined as all the subsidiaries of the firm's EEA parent insurance undertaking; and
- (ii) on a supplementary, worldwide, basis with the group being defined as all the subsidiaries of the firm's ultimate parent insurance undertaking.

A group needs to ensure that at all times its group capital (group capital resources) is greater than or equal to its aggregate solvency margin requirements (group capital resources requirement).

There are various points that should be noted about the calculations:

- The aggregate solvency margin requirement is calculated by adding together all the solo solvency capital requirements of all the insurance companies in the group;
- Where the group has a subsidiary which is a financial firm then the net assets of that subsidiary included within the group capital calculation are reduced by that subsidiary's margin requirement under the financial firms' rules;
- Where a subsidiary is not wholly owned then only a proportionate share of that subsidiary's capital and solo solvency margin requirement is included in the calculations, provided the subsidiary has surplus assets (otherwise a full share must be included).

## The cross-sector test

The cross-sector test looks at the adequacy of the group's capital to meet the aggregate requirements of all the insurance companies,

banks and investment firms within the group. It is based on the planned Financial Conglomerates Directive.

The test is only carried out on an EEA basis, with the group being defined as all the subsidiaries of the firm's highest EEA parent company whose main business is insurance, banking or investments (whether or not the parent is itself an insurance undertaking or financial firm).

The group needs to ensure that at all times its group capital (cross-sector capital resources) is greater than or equal to its cross-sector capital resources requirement.

There are various points that should be noted about the calculation:

- The cross-sector capital resources requirement adds together the solo capital requirements of all the insurance companies, banks and investment firms in the group;
- In the calculation of group capital:
  - (i) a holding company is valued under the asset valuation rules applicable to a financial firm or an insurance company, dependent upon which side predominates;
  - (ii) any surplus insurance assets (i.e. any assets over the solvency capital requirements) which would not be admissible under the financial firms' valuation rules must be disallowed;
  - (iii) similarly, any surplus banking and investment firm assets which would not be admissible under the insurance valuation rules must be disallowed; and
  - (iv) No cross-sector large exposure adjustments are applied because of differences between the insurance and financial sector valuation rules.



# Operational risk

Key FSA objectives:

- Full involvement of non-executive directors, including within an audit committee;
- Separate risk assessment function and risk committee;
- Risk committee should determine the firm's risk policies, including its appetite for risk;
- Internal audit should use risk based methodologies;
- Timely and comprehensive management information; and
- To highlight the importance of legal, outsourcing and group risks.

## Introduction

Operational risk is one of the areas highlighted by the FSA and where early action is proposed. It is defined as the risk of loss resulting from inadequate or failed internal processes, or from external events.

The FSA do not include credit, insurance, liquidity or market risks within operational risk, as these risks are specifically covered elsewhere in their rules and guidance.

So what types of risk are covered within the FSA definition and why do the FSA consider this area so important?

The operational risk category is wide-ranging. It covers issues such as:

- accounting errors;
- disasters, whether natural or man-made;
- fraud;
- legal rulings;
- outsourcing risks;
- misleading sales and marketing;
- processing and systems failures; and
- professional mistakes and/or misjudgements.

This list is by no means exhaustive but shows why the FSA considers this area so important.

The FSA proposals on operational risk are contained in CP140<sup>(4)</sup>, which covers changes to the Interim Prudential Sourcebooks, and CP142<sup>(7)</sup>, which looks at changes to the Integrated

Prudential Sourcebook (PSB) and Senior Management Arrangements, Systems and Controls (SYSC).

The FSA have made it clear that they consider the interim guidance in CP140 is compatible with the proposals in CP142.

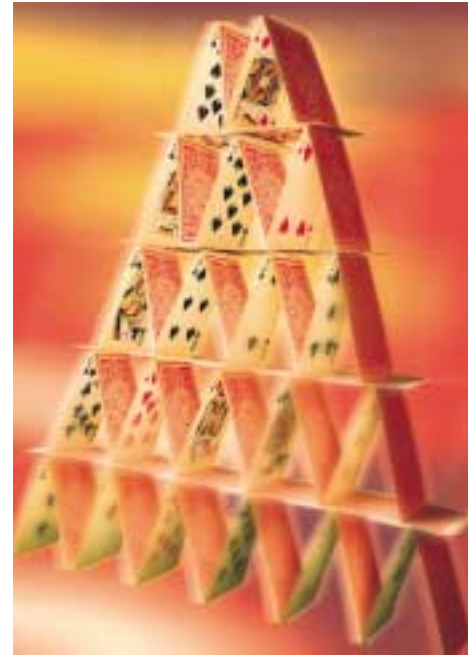
The proposed interim guidance for insurance companies in CP140 is divided into seven sections:

- high-level controls;
- risk assessment;
- internal audit;
- management information;
- legal risk;
- outsourcing; and
- group risk.

The sections variously cover organisational structures, reporting requirements and specific areas of risk.

The proposed guidance in CP142 is framed differently and is more detailed. It looks at sources of risk (people, processes, external events etc.) and how a firm should identify, assess, monitor, and control these risks within the framework of its operational risk policy.

The way in which the guidance is implemented will depend upon the nature of the insurance company including its size, the complexity of its business, where it is incorporated and whether it is a subsidiary or branch operation.



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## Key points

The key points which apply to most insurance companies are as follows.

### High level controls

- The board must be suitably skilled and experienced and include non-executive directors with sufficient knowledge and expertise to act as a challenge to the executive directors;
- The firm should comply with good corporate governance principles (e.g. the Combined Code<sup>(5)</sup> for UK listed companies);
- The firm's management structure should be clearly defined and documented;
- There should normally be an audit committee whose members should be non-executive directors;

- The audit committee should have free access to information and be able to take external advice;
- The audit committee should meet at least once a year with external auditors without executive management being present.

### **Risk assessment**

- There should normally be a separate risk assessment function, reporting to a risk committee;
- The risk committee should determine the firm's appetite for risk and its risk management policies;
- The head of the risk assessment function should be appropriately experienced and influential;
- The risk assessment function should have an appropriate mix of skills, including underwriting, claims, accounting, actuarial and legal;
- The appointed actuary will no longer have any formal responsibility for risk assessment.

### **Internal audit**

- Internal audit's terms of reference should normally be approved by the audit committee;
- The head of internal audit should be a senior and experienced individual and the internal audit staff should be suitably qualified and experienced;
- Internal audit should have full access to the books and records of the firm and an open relationship with the firm's external auditors;
- There should normally be an audit plan which should be approved by the audit committee and reviewed at least annually;
- Internal audit should use risk-based methodologies. Issues raised should be prioritised. There should be formal procedures for escalating high risk issues;

- Outsourcing of internal audit should not normally occur but there may be circumstances where specialist technical knowledge is needed and a skilled person brought in to assist.

### **Management information**

- Management information should be produced on a timely basis for the board and senior management;
- The information should be sufficient to identify, measure and control all material risks in the business. It should cover operational risk measures (e.g. processing errors and customer complaints), as well as financial information;
- Stress and scenario testing should be part of the management information.

### **Legal risk**

Recent events in the insurance industry have shown the clear need for firms to understand the effect of legal risks on their business.

- There should be processes for identifying, mitigating and making appropriate provisions for legal risks;
- Legal risks should be reported to the risk assessment function and others, as appropriate.

### **Outsourcing**

Outsourcing is becoming increasingly common, whether to group companies or independent third parties. The FSA is concerned that material outsourcing can give rise to loss of control and business continuity risks.

- Before outsourcing, the firm should carry out due diligence of the service provider and consider the risks involved (including its ability to meet its regulatory obligations);
- The outsourcing contract should cover a wide range of issues relating to the level and continuity of service, including the ability to change or terminate the agreement;

- The firm's internal and external auditors should have a right of access at all times to the service provider which is equivalent to that of an auditor under the Financial Services and Markets Act;
- There should be a service level agreement in place with appropriate performance targets, management information, remedial action and escalation processes;
- Business continuity plans should be in place in the event of a significant loss of services or failure of the service provider.

### **Group risk**

- The firm should not be subject to material control or influence from other group companies through informal or undocumented channels;
- Linkages between group functions and the firm should work effectively and the firm's approved persons' structure should reflect the extent of group influence;
- Potential conflicts of interests should be minimised by the use of Chinese walls and transactions at fair market value;
- The firm should be aware of events in other group companies that may give rise to adverse publicity or impact upon its ability to comply with regulatory or other requirements. It should have plans in place to minimise the effect on its business;
- The firm should have procedures in place to make other group companies aware of its regulatory obligations;
- The firm should have systems in place to monitor its effect on the group and the group's reporting requirements.



# Financial engineering

Key FSA objectives:

- Financial engineering arrangements may only be used for a legitimate business purpose;
- They must not be used to mislead the regulators or the public;
- Credit for arrangements in regulatory returns should be commensurate to the risk transfer;
- Prudent allowance should be made for contingencies which would materially change the value of arrangements; and
- Regulatory reporting should identify the effect of financial engineering arrangements.

## Introduction

The FSA is concerned that financial engineering can be used to mislead the public and regulators, may lead to significant counterparty risks and, in extreme circumstances, could be used as a cover for financial crime.

The FSA definition of financial engineering includes implicit items (the value of future profits allowable against an insurance company's solvency margin), as well as financial reinsurance, contingent loans (these are loans repayable out of future profits) and other forms of financial engineering. It does not include subordinated loans.

Insurance companies use financial engineering to improve or smooth reported profits or to enhance their balance sheet position.

Financial engineering can validly be used by an insurance company to release overly prudent technical provisions and, hence, give access to capital. However, it can be used to obscure the underlying financial position, particularly where there is no genuine transfer of risk but full credit is taken for the reinsurance cover purchased.

The FSA proposed guidance on financial engineering is contained in CP144<sup>(8)</sup>. The proposals cover both life and non-life business, although the review of financial engineering was originally prompted by a recommendation in the Baird Report<sup>(9)</sup> relating to the Equitable Life's use of financial reinsurance.

## Key points

The key proposed guidance which will be added to the Interim Prudential Sourcebooks is as follows:

### Legitimate business purposes

- Financial engineering should only be used for a legitimate commercial purpose e.g. to provide financing through risk transfer or to enable access to economic reserves within the technical provisions;
- It is acceptable to use financial engineering to create cash to enable an insurance company to support its business but it is unacceptable to distribute that cash if it leaves inappropriately thin prudential margins.

### Arrangements must not mislead

- Arrangements should not mislead policyholders or the FSA as to the financial strength, or solvency, of an insurance company;
- For life business, there is a specific requirement that arrangements should be consistent with the principle of treating customers fairly.

### Procedures and documentation

- Insurance companies should have written procedures regarding financial engineering arrangements to ensure that their purpose is fully understood, the risks are properly identified, and proper sign off is given;
- Where financial reinsurance is involved, the documentation

should clearly demonstrate that a contract of insurance<sup>(10)</sup> has been effected.

### Reserving and related matters

- In the regulatory returns, any credit taken for an arrangement should be commensurate to the risk transferred and the value added by the arrangement in its entirety;
- In reserving, prudent allowance should be made for contingencies which could render arrangements ineffective or materially change their value. Credit risk should be taken into account.

### Implicit items

The proposed guidance also covers implicit items. However, the use of implicit items already requires a waiver from the FSA and implicit items are due to be phased out under Solvency I<sup>(11)</sup> by 2009.

### Proposed reporting

The FSA is also proposing changes to regulatory reporting from end 2002 for life and end 2003 for non-life.

For life business, the reporting will identify and strip out the effect of financial engineering and add back the value of implicit items, financial reinsurance and contingent loans.

For non-life, there will be additional disclosure for reinsurance contracts.



# The future role of actuaries and with-profits fund reforms

Key FSA objectives:

- The board of directors must take full responsibility for their firm's financial position and bonus policy;
- The appointed actuary's role will be narrowed to with-profits discretion;
- The creation of a actuarial function with the holder responsible for actuarial advice to the board;
- Actuarial liabilities will be audited;
- Greater disclosure for with-profits business including a statement of Principles and Practices of Financial Management ("PPFM");
- Establishment of a With-Profits Fund Committee to give an independent oversight;
- The creation of the role of Policyholder Advocate for inherited estate reattribution proposals; and
- More realistic reserving for with-profits business.

## Introduction

For some time, the FSA have been concerned about the role of the appointed actuary. They have felt that life insurance companies have relied too heavily on the views of their appointed actuaries and have not made their own judgements.

The reliance on the appointed actuary has been reinforced by a regulatory regime where the appointed actuary's periodic actuarial investigation has not been subject to audit or, for that matter, any form of independent review.

In addition, for many with-profits companies, decisions about bonus rates have often been left largely left to the appointed actuary.

Various proposals have been put forward but the FSA has come to the sensible view that the role of the appointed actuary is largely anachronistic. They have, therefore, put forward proposals in two feedback statements<sup>(12)(13)</sup> to put full responsibility on the board subject to independent oversight.

## Key proposals

### Board responsibilities

- The board of directors should take full responsibility for the assessment of the financial position of their life insurance

company and, for with-profits business, the level of bonuses;

- The requirement to produce a financial condition report, which currently falls on the appointed actuary, will now be placed on the insurance company. As at present, the report will not be in the public domain because of commercial sensitivity.

### The role of actuaries

- The role of the appointed actuary will, in future, be reduced to advising the board on the use of discretion for with-profits business (so, in future, only with-profits companies will have an appointed actuary);
- A new required function, the actuarial function, will be introduced for all life insurance companies. The individual holding this position will be responsible for providing actuarial advice to the board, in particular, on the calculation of the actuarial liabilities;
- There will be no prohibition on the appointed actuary and the actuarial function roles being combined;
- The appointed actuary or the holder of the actuarial function should not be the chairman or CEO or hold other posts with significant conflicts of interest;

- Actuarial liabilities will in future be subject to audit.



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### With-profits governance

- With-profits companies will need to publish a statement of the Principles and Practices of Financial Management ("PPFM") showing how their with-profits funds work and the nature of the board's discretion. This will be backed up with a statement of compliance with the PPFM in annual statements to policyholders, as well as in regulatory returns;

- It is proposed that some form of independent assessment of PPFM and bonus policy is available to policyholders. The proposal is that a With-Profits Fund Committee should carry out the role. This committee would be comprised of non-executive directors, including external non-executive directors;
- Where there is a proposal to re-attribute the inherited estate of a with-profits company, then a 'policyholder advocate' will be appointed to secure the best deal possible for policyholders.

### Improved financial information

- There should be disclosure in the regulatory returns of with-profits liabilities on a realistic basis. Firms will have a choice of either:
  - (i) a retrospective asset share method with allowance for smoothed bonuses where these are expected to be in excess of asset share; or

(ii) a prospective bonus reserve valuation on a realistic basis with allowance for terminal bonus;

- Information should also be given at a fund level on key information such as investment returns, allocations to asset shares, who meets the cost of guarantees, expense levels and how shareholder tax is met. There should also be full disclosure of the effects of financial engineering, reinsurance and other factors on the solvency of the with-profits fund;
- Regulatory returns will at some stage in the future be made available on the FSA website to make financial information on insurance companies more accessible.

Interestingly, the FSA recently asked firms to give them information on a realistic basis, so that they could assess the true solvency position of firms following market falls. The results were favourable and are summarised in the progress report on the Tiner Project <sup>(1)</sup>.



Jason Reed/Getty Images

### Improved disclosure to consumers and advisers

- The FSA is proposing a tiered approach to information with core information being given to consumers and supplementary information being available on request;
- This information will be available both at the point of sale and in annual statements. It will include information on the PPFM.

## References

- <sup>(1)</sup> The future regulation of insurance report submitted by the Board of the FSA to the Economic Secretary to the Treasury and published by the FSA in November 2001, and the progress report published by the FSA in October 2002
- <sup>(2)</sup> CP97, Integrated Prudential Sourcebook, published by the FSA in June 2001
- <sup>(3)</sup> CP143, Feedback on CP97 applicable to insurance firms, published by the FSA in July 2002
- <sup>(4)</sup> CP140, the Interim Prudential Sourcebook for Insurers and Friendly Societies and the Lloyd's Sourcebook: Guidance on Systems and Controls, published by the FSA in July 2002
- <sup>(5)</sup> The Combined Code, Principles of Good Governance and Best Practice, first published by the London Stock Exchange in June 1998 and now available from the FSA
- <sup>(6)</sup> CP136, Individual Capital Adequacy Standards, published by the FSA in May 2002
- <sup>(7)</sup> CP142, Operational risk systems and controls, published by the FSA in July 2002
- <sup>(8)</sup> CP144, a new regulatory approach to insurance firms' use of financial engineering, published by the FSA in July 2002
- <sup>(9)</sup> Report of the FSA on the review of the Regulation of the Equitable Life Assurance Society from 1 January 1999 to 8 December 2000, published by the Stationery Office in October 2001
- <sup>(10)</sup> CP150, the authorisation manual: consultation on the identification of contracts of insurance, published by the FSA in August 2002
- <sup>(11)</sup> Directives 2002/12/EC and 2002/13/EC, respectively amending the life and non-life solvency margin requirements, published in March 2002
- <sup>(12)</sup> Feedback statement. Future role of actuaries in the governance of life insurers, published by the FSA in May 2002
- <sup>(13)</sup> Feedback statement on with-profits review, published by the FSA in May 2002
- <sup>(14)</sup> CP128, Liquidity risk in the Integrated Prudential Sourcebook: systems and controls chapter, published by the FSA in March 2002



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