Society of Actuaries in Ireland

ACTUARIAL STANDARD OF PRACTICE LA-3

ADDITIONAL GUIDANCE FOR APPOINTED ACTUARIES ON VALUATION OF LIFE ASSURANCE BUSINESS

Classification

Mandatory

MEMBERS ARE REMINDED THAT THEY MUST ALWAYS COMPLY WITH THE CODE OF PROFESSIONAL CONDUCT AND THAT ACTUARIAL STANDARDS OF PRACTICE IMPOSE ADDITIONAL REQUIREMENTS UNDER SPECIFIC CIRCUMSTANCES.

Legislation or Authority

European Communities (Life Assurance) Framework Regulations 1994

Application

Appointed Actuaries appointed pursuant to Section 34 of the Insurance Act 1989

Version	Effective from	Version	Effective from
1.0	25.04.1995	3.1	01.11.2010
2.0	03.09.1997	3.2	30.12.2010
2.1	30.12.2006	3.3	30.12.2011
3.0	01.07.2008		

Definitions

"ASP" means Actuarial Standard of Practice

"the Act" means the Insurance Act 1989

"the Board" means the Board of the Company

"the Company" means the life assurance company in respect of which the Appointed Actuary is appointed

"the Regulations" means the European Communities (Life Assurance) Framework Regulations 1994

"*should normally*" indicates that members of the Society of Actuaries in Ireland to who this ASP applies must comply with a particular requirement or prohibition, unless the circumstances are such that the requirement or prohibition is inappropriate and non-compliance is consistent with the standards of behaviour, integrity, competence and professional judgement which other members or the public might reasonably expect of a member.

1 Introduction

1.1 This ASP is the document referred to in the Regulations as *"the Guidance Note "Additional Guidance for Appointed Actuaries (GN8)" issued by the Society of Actuaries in Ireland"*.

1.2 The primary references in this ASP are to Paragraphs 1 to 12 of Annex IV of the Regulations. Annex IV of the Regulations comprises Paragraphs governing the valuation of liabilities of life assurance companies for various statutory purposes under the Insurance Acts, 1909 to 1990. In particular, these Paragraphs govern the valuations of life assurance liabilities for the purposes of an investigation to which Article 15 of the Regulations or Section 16 or 17 of the Act applies. Such an investigation would normally be for determining:

(a) whether the statutory certificate in respect of life assurance business required by Article 32(b) of the Regulations could be given;

(b) the extent to which assets could be transferred out of the fund in accordance with Section 15(2) of the Act; or

(c) whether a dividend may be declared by the Company or a parent, having regard to Section 15(7) of the Act**.**

These Paragraphs are also relevant to the determination of the margins of solvency required by Article 12(1)(b) of the Regulations.

1.3 The Regulations require such valuations to be carried out by the Appointed Actuary. This ASP, which is supplementary to ASP LA-1, sets out the responsibilities of Appointed Actuaries relating to these valuations.

1.4 Annex II of the Regulations comprises regulations prescribing margins of solvency for life assurance companies. The amounts of mathematical reserves and of capital at risk to be used in the calculations required under Annex II are required to be assessed by the Appointed Actuary. In addition, the Central Bank of Ireland has issued guidance notes stating that it requires a certificate (in a prescribed form) from the Appointed Actuary to accompany any application by a Company to the Central Bank of Ireland under Paragraph 2(g) of Part A of Annex II of the Regulations to enable implicit items as set out in Annex VI to count towards the margin of solvency.

1.5 If, for some exceptional reason, the Appointed Actuary is unable to comply fully with this guidance, the Appointed Actuary must make timely, written and reasoned disclosure, both to the Board and to the Central Bank of Ireland. In this event, the statutory certificate must be qualified accordingly.

2 Paragraph 2 of Annex IV – The actuarial valuation

2.1 Paragraph 2 of Annex IV is paramount. The Appointed Actuary must use prudent bases determined according to actuarial principles, and the professional considerations set out in ASP LA-1, particularly section 4 thereof. Paragraph 2 of Annex IV refers explicitly to the inclusion of appropriate margins for adverse deviations of the relevant factors. This means that the valuation basis used must include appropriate margins for adverse deviations of each of the relevant factors having regard to materiality. In deriving the valuation basis it is permissible to group policies by category of contract. The term “category of contract” is used to mean contracts with similar types of benefit, including options and guarantees, that are considered to be sufficiently homogeneous by the Appointed Actuary. A valuation method which is not in general use in the profession (whether to value a normal type of contract or in other circumstances) is not precluded, but an Appointed Actuary who uses such a method needs to be prepared to justify it by reference to actuarial principles. The Appointed Actuary must also bear in mind that any excess of assets over liabilities disclosed by the valuation can legally be transferred out of the life assurance fund.

2.2 Paragraph 2 of Annex IV also requires that the valuation liability must not, in aggregate, be less than that calculated in accordance with Paragraphs 3 to 12 of Annex IV. These Paragraphs require professional interpretation in their application, and guidance on them is therefore given in section 3 of this ASP. However, Paragraphs 3 to 12 of Annex IV must not be regarded as necessarily satisfying the more general actuarial principle set out in Paragraph 2(a) of Annex IV. Rather, they are the basis of a minimum statutory valuation, and the Appointed Actuary must carry out such investigations as considered necessary to be satisfied (and, where required, to satisfy the Central Bank of Ireland) that the valuation satisfies the criteria. The criteria apply for each separate category of contract.

2.3 Paragraph 2 of Annex IV refers to the valuation, in the case of participating contracts, taking into account, either implicitly or explicitly, future bonuses of all kinds. When carrying out the valuation in compliance with Paragraphs 3 to 12 of Annex IV, this must be interpreted as requiring the valuation basis to be sufficiently strong to enable an appropriate level of reversionary bonus to emerge (and similar bonuses which are added periodically over the term of the contract). The Appointed Actuary must be satisfied that the implicit allowance for future bonuses is adequate and consistent on the valuation basis with policyholders’ reasonable expectations.

2.4 The Appointed Actuary is not required to make implicit or explicit provision for any element of terminal bonus or any final payment of additional bonus. The Appointed Actuary must, however, make other investigations in order to be satisfied that the life assurance fund is able to support a proper level of future terminal bonus having regard to policyholders' reasonable expectations and the bonus smoothing policy followed by the Company in the event that the experience were to follow the valuation basis. In particular, where current payouts are in excess of asset shares, the Appointed Actuary must establish a reserve for the excess amounts that would be payable until such time that payouts can be brought in line with asset shares, having regard to policyholders' reasonable expectations. The Appointed Actuary must establish a reserve having regard to policyholders' reasonable expectations with respect to surrender values and, in any event, must set a reserve not less than the surrender value (excluding terminal bonus).

2.5 Any terminal bonus may be used as a first charge on any fall in asset values in the resilience scenario under Paragraph 3 of Annex IV and paragraph 3.2 of this ASP.

2.6 Paragraph 2 of Annex IV refers to the need to provide appropriate margins for adverse deviations of the relevant factors. The Appointed Actuary must consider the resilience of the valuation to changes in circumstances, with special reference to more extreme changes to which the office may be vulnerable, and provide appropriate margins in the valuation basis. In particular, the Appointed Actuary must consider the effect of changing circumstances on the value to the policyholder of all guarantees and options included in the contract.

2.7 Paragraph 2 of Annex IV also refers to the method of calculation and assumptions used in the valuation not being subject to discontinuities from year to year arising from arbitrary changes. This requirement must not be interpreted to preclude changes to valuation interest rates which arise from changes in market yields, or changes to valuation expense mortality or other assumptions, which arise from changes in the Company's actual or anticipated experience.

2.8 For permanent health insurance, the Appointed Actuary, where practicable, should normally use a valuation methodology that makes explicit allowance for claim inceptions and recoveries or other multi-state methodology as appropriate. Alternative methodologies may be acceptable where the resulting calculation is likely to be at least as great as that produced using a multi-state approach. The Appointed Actuary must consider how the observed experience is likely to change as the business matures, and the extent to which such experience is relevant to likely future circumstances. For immature business, and in some other circumstances, significant margins over the observed experience may be appropriate.

2.9 Where policy conditions allow for discretionary charges and deductions, the Appointed Actuary may allow for these in the valuation in so far as they do not conflict with the requirements of unfair contracts terms legislation, or other

regulatory requirements, and do not exceed policyholders' reasonable expectations in the context of the valuation assumptions and the Company's intended practice.

2.10 The Actuary must consider the significance of altered policies and whether, having regard to their materiality, his or her approach to the valuation of these policies is appropriate.

3 Paragraphs 3 to 12 of Annex IV – The minimum criteria

3.1 General

3.1.1 As explained in paragraph 2.2 of this ASP, Paragraphs 3 to 12 of Annex IV set out minimum criteria against which the valuation basis of Company must be determined for each separate category of contract. However, there are several respects in which these criteria are not precise, and the Appointed Actuary must interpret them in a prudent way, in regard to both the individual criteria and the criteria as a whole. If the Appointed Actuary considers that one of the required provisions or margins for any element of the basis is excessive, then it is not permissible for this purpose to offset part of it against another provision or margin required by the Regulations except as set out in paragraph 3.5.1 below.

3.1.2 The Paragraphs apply equally to both linked and non-linked business, except for Paragraphs 5 and 6 of Annex IV which do not apply to linked business.

3.2 Paragraph 3 of Annex IV

3.2.1 Professional judgement is particularly necessary in applying the requirement in Paragraph 3 of Annex IV, which applies to the aggregate liability, that the determination of the amount of life assurance liabilities shall include prudent provision against the effects of possible future changes in the value of the assets on their adequacy to meet the liabilities. Paragraph 2.6 of this ASP and paragraph 4.10 of ASP LA-1 set out considerations to be taken into account.

3.2.2 Paragraph 3 of Annex IV gives no indication of the range of possible future changes in the value of the assets which is to be allowed for. In determining an appropriate range, the Appointed Actuary must use his or her professional judgement. The essential point is that if changes in market conditions would result in a change in the aggregate liability that is not matched by a change in the market value of the corresponding assets, then Paragraph 3 of Annex IV requires the Appointed Actuary to consider what provision is required as a contingency margin, having regard to the consequences should the provision prove to be insufficient. In particular, the Appointed Actuary must exercise special care with regard to any investments presenting novel or unorthodox features, derivatives (whether assets or liabilities) and any contracts containing substantial options.

3.2.3 Appointed Actuaries must consider mismatching provisions from the viewpoint of cash flows from assets and liabilities over a wide range of investment conditions. Where the incidence of asset and liability cash flows is not identical, the Appointed Actuary must make a prudent assumption of the extent to which investment markets could move against the Company. Even if assets and liabilities are exactly matched on a cash-flow basis, additional reserves may have to be set up to cover a mismatch created by the valuation requirements of Annex IV. In performing these calculations, the Appointed Actuary must:

(a) comply with the valuation principles set out in Paragraphs 2 to 12 of Annex IV on assumptions which are prudent in the context of the changed investment conditions;

(b) have regard to the reinvestment restrictions set out in Paragraph 7(8) of Annex IV; and

(c) have regard to any other relevant regulatory requirements.

3.2.4 The Company's reserves (including any additional reserves required under Paragraph 3 of Annex IV) must be sufficient to absorb the effect of changes in interest rates, credit spreads, volatilities, asset values, or other relevant factors on a suitably prudent basis. This is without prejudice to the Company's ability to hold reserves which satisfy Paragraphs 2 and 4 to 12 of Annex IV in the changed conditions. Where the life assurance fund has liabilities under derivative contracts, these must be revalued on an estimated market value basis in the changed conditions when assessing any additional reserves required under Paragraph 3 of Annex IV.

3.2.5 As referred to in paragraph 3.3.7 below, Paragraph 7(10) of Annex IV allows a notional apportionment of assets for the purposes of determining the rates of interest to be used when valuing a particular category of contract. Paragraph 3 of Annex IV can, if desired, be applied separately to each differentiated category having regard to the assets notionally apportioned to it. Any assets which are entirely free after such an apportionment do not have to be brought into account in determining the matching position.

3.2.6 Furthermore, when applying the Regulations to the changed investment conditions postulated, it is appropriate to allow for the revised yields on the relevant assets at their new value and to review any margins in the valuation basis that are not strictly required by the Regulations.

3.2.7 For with-profits business, however, actuaries must ensure that the liability in the changed investment conditions adequately covers policyholders' reasonable expectations appropriate to the changed conditions and (more generally) that the valuation basis satisfies Paragraph 2 of Annex IV (excluding the reference to Paragraph 3 of Annex IV).

3.2.8 For unit-linked business, the Appointed Actuary must allow for the impact of the changed asset values on all elements of the future cash flows. The Appointed Actuary must also make allowance for the effect of the revised investment conditions on the valuation rate of interest, most particularly when calculating the non-unit reserve.

3.3 Paragraph 7 of Annex IV

3.3.1 The Appointed Actuary must decide the rates of interest to be used in the valuation of the liabilities. These are affected by the Appointed Actuary's estimate of the rate at which future investment will be possible and by relevant regulatory requirements. Paragraph 7(1) of Annex IV requires the Appointed Actuary, in making his or her interest rate assumptions, to have regard to the yields obtained on the existing portfolio and to the anticipated yield on future investments.

3.3.2 Due allowance must be made for the current and future taxation position of the investment return on the policyholder assets. Any such allowance must be consistent with any allowance made for tax relief on expenses. The rates of tax assumed must be such that, for the period in respect of which tax is to be assessed and on the valuation basis, the Company’s total implied liability for tax arising from the allocation of assets to liabilities is not less than the Company's actual expected liability for tax.

3.3.3 The Appointed Actuary will need to be aware of the possible effects of derivative instruments used by the Company when choosing the valuation basis. This must particularly be borne in mind when choosing the basis used in the changed investment conditions envisaged under Paragraph 3 of Annex IV of the Regulations. The appropriate valuation interest rates must allow for the return on the assets held as adjusted to reflect economic exposure under futures contracts and contracts for differences. Consideration must be given to the treatment of, and allowance for, financial options, particularly when close to an option date.

3.3.4 Paragraph 7(7)(a) of Annex IV requires an adjustment (where relevant) to the yield on assets other than equity shares or land to recognise the possibility of default. This is in addition to the 2.5% margin required by Paragraph 7(3) of Annex IV. This Paragraph refers to the need to have regard to the yields available on risk-free investments of a similar term in the same currency when assessing this adjustment. It is appropriate to have regard to any differences in yield which arise from differences in marketability of the asset in question as compared with the risk-free alternative when assessing the deduction for the default risk. Provision for the possibility of default for credit-rated securities, including government and sovereign bonds, must be made on a prudent basis. Making this provision will require the exercise of professional judgement. In all cases, including but not limited to government and sovereign bonds, the Appointed Actuary must consider (a) historical default rates of similar securities with a

similar credit rating, taking into account differences in credit characteristics that may not be reflected in ratings and (b) alternative approaches, such as by reference to current and historical market based measures. Provision for the possibility of default for securities that are not credit-rated must be made on principles at least as prudent as those adopted for credit-rated securities.

3.3.5 Paragraph 7(7)(b) of Annex IV requires an adjustment (where relevant) to the yield on equity shares and land to recognise the possibility of a future reduction in aggregate yield on each category of asset. When assessing this adjustment, it is appropriate to allow for market knowledge, degree of marketability and, for land, the covenant of the tenant.

3.3.6 Paragraph 7(8) of Annex IV specifies an upper limit of 7.5% per annum for the yield on investments in all currencies made more than three years after the valuation date. The Appointed Actuary must consider, in the light of conditions prevailing at the valuation date, whether a limit lower than 7.5% per annum would be appropriate. The Appointed Actuary must also have regard to any other relevant regulatory requirements.

3.3.7 Paragraph 7(10) of Annex IV allows assets to be notionally apportioned, where appropriate, between different categories of contracts for the purpose of determining the rates of interest to be used in valuing a particular category of contract. Any such apportionment must have regard to the prudence concept.

3.3.8 Where derivative contracts are held in connection with particular assets or liabilities in the life assurance fund, then it will generally be appropriate to apportion these derivatives together with the corresponding assets and liabilities.

3.4 Paragraph 8 of Annex IV

3.4.1 Paragraph 8 of Annex IV requires prudent rates of mortality and disability. Account must be taken of relevant trends in experience within the Company or the industry, including appropriate allowance for future improvements in mortality for contracts where the assumption of lighter mortality increases the required reserve. For assurance and sickness business, allowance must be made for the incidence of mortality and morbidity arising from known diseases whose impact may not yet be reflected fully in current mortality or morbidity experience.

3.5 Paragraph 9 of Annex IV

3.5.1 Paragraph 9 of Annex IV must be interpreted as requiring the Appointed Actuary to make provision for the future increases considered likely in expenses for existing business, based, inter alia, on prudent assumptions as to the future rates of increase in prices and earnings. In considering such provision, it would be reasonable for the Appointed Actuary to take into account margins arising from, and restrictions on, interest rate assumptions.

3.5.2 The Appointed Actuary must make provision for expenses having regard to how the life assurance contracts will be fulfilled in the future, and must make clear what he or she has assumed in this regard. In determining the minimum provision, the Appointed Actuary must allow for any contractual obligations imposed on the Company including those arising from third party administration agreements, where a third party administrator is being used to fulfil the existing contracts.

3.5.3 Where there are service agreements with other companies (whether or not within a group structure) the Appointed Actuary must consider whether any additional provision is appropriate for the contingency that such agreements might cease. This is particularly relevant where a subsidised or preferential agreement exists.

3.5.4 In providing for the expenses likely to be incurred in future in fulfilling the existing contracts, it is permissible to take credit to the extent appropriate for the difference between the gross premium and the valuation net premium. The Appointed Actuary must be satisfied in this instance that the provision on such an implied basis is prudent. Explicit allowance for future expenses is required for all contracts under which no future premiums are receivable where these are not provided by disclosed margins in the valuation rate of interest.

3.5.5 Whether or not the Appointed Actuary performs the valuation under Paragraph 2 of Annex IV on the assumption that the Company will continue to transact new business, Paragraph 9 of Annex IV requires an assessment of the provision for future expenses against the total (net of tax) cost that would be incurred in fulfilling existing contracts if the Company were to cease to transact new business. In assessing the required provision, the Appointed Actuary may take account, on a prudent basis, of outstanding margins on the existing business projected to emerge on the valuation assumptions over the period that the additional expenses are incurred.

3.5.6 Experience has shown that the transition to a closed fund is likely to be costly and that more than twelve months may elapse from such closure before the lower level of expense appropriate to a closed fund is achieved. The Appointed Actuary must provide for any expense overruns, particularly in relation to business assumed to be written in the period from the valuation date to the assumed date of closure to new business. In addition, the Appointed Actuary must allow, on a prudent basis, for the costs of staff retention, redundancy and the costs of future known projects and other fixed, accelerated or other additional costs arising from closure to new business. In addition, the future tax position of the fund may be affected.

3.5.7 In the case of expenses that are not directly attributable to an individual long-term insurance contract, the Appointed Actuary may make aggregate provision for these 'non-attributable expenses' at the level of contract groups that share the same or similar expense risk characteristics. Such 'homogeneous risk groups' must be composed of individual contracts that the Appointed Actuary has

identified as having similar exposures to the risks that affect the level of expenses borne by contracts including: persistency risk, in particular, bulk lapse risk; regulatory risk; and expense inflation risk. If the Appointed Actuary chooses to make aggregate provision for non-attributable expenses at homogeneous risk group level, then the Appointed Actuary must confirm that the mathematical reserve established in relation to such expenses has a minimum value of zero for each homogeneous group of contracts.

3.5.8 The Appointed Actuary must attribute to an individual contract at least those expenses that vary directly with the volume of business for that type of contract. Commission payments, charges to a fund on a 'per policy' basis and investment management fees are generally directly attributable to individual contracts. Non-attributable expenses will typically include overheads that are relatively insensitive to the volume of business for the type of contract in question. Examples of expenses that may be considered non-attributable include (but are not limited to) salaries of head office staff involved in monitoring products and drafting standard communications to policyholders and allocated overheads for centralised functions such as human resources, finance and IT.

3.6 Paragraph 10 of Annex IV

3.6.1 Paragraph 10 of Annex IV requires provision to be made on prudent assumptions to cover any increase in liabilities caused by policyholders exercising options under their contracts. The Appointed Actuary must consider all options in both new and existing contracts to determine whether the reserves established satisfy the requirement to avoid future valuation strain and make allowance for all known liabilities. Consideration must also be given to the terms on which new business and increments are sold having regard to policyholders' reasonable expectations.

3.6.2 Where an optional benefit is of greater value than the basic benefit under the valuation assumptions, the Appointed Actuary must make prudent allowance in the valuation for the proportion of policyholders likely to exercise the option, having regard to the circumstances in which options are likely to be attractive to policyholders. In this regard, past experience may only be taken into account to the extent that it is relevant under the valuation assumptions and is likely to give a reasonable estimate of future experience. In addition, any assumption made must be prudent in the context of possible future changes in circumstances.

3.6.3 Many options are long-term and need careful consideration in that context. The Appointed Actuary must have regard to the fact that policyholder behaviour may change over time as policyholders and their advisers become more aware of the value of their options. The impact on policyholder behaviour of possible changes in taxation must also be considered.

3.6.4 The likelihood that options will be exercised, and the liabilities increased as a result, may be linked to the interest rate prevailing from time to time. The assumption of a single fixed interest rate for the purposes of determining whether such liabilities are likely to arise may in some circumstances produce an unreasonably low or nil reserve, whereas the recognition of a potential range of interest rates may give rise to a significantly higher reserve. The difference could be particularly large if a single fixed interest rate is assumed which is relatively close to the interest rate at which options would be likely to be exercised. The Appointed Actuary must therefore take account of the possibility that the selection of a single fixed interest rate may understate the potential liability, and if appropriate make additional allowance in the valuation of the relevant liability.

3.6.5 Where the option offers a choice between two non-discretionary financial benefits (in particular, between a guaranteed cash sum and a guaranteed annuity value, or between a unit value and a maturity guarantee) and where there is a wide range of possible outcomes, then, to estimate the required reserves and the adequacy of reserves determined using other actuarial methodologies, the Appointed Actuary should normally assess the increase in liabilities under Paragraph 10 of Annex IV by modelling such liabilities stochastically together with matching assets, where those liabilities are material in the context of the overall position of the Company. In particular, the Appointed Actuary may take account of the extent to which the increase in liabilities is hedged by a matching asset. In carrying out such modelling, the Appointed Actuary must take into account, on a prudent basis, the choices likely to be made by policyholders in each scenario. Prices from the asset model used in the stochastic approach should normally be benchmarked to relevant market asset prices before determining the value of the option.

3.6.6 For with profit business, the Appointed Actuary may, if he or she considers it appropriate and prudent to do so, give credit to the extent to which future bonuses, and attaching policyholder liabilities, might reduce in the modelled scenarios for the company as a whole as well as the policies to which the options attach, having regard to the reasonable expectations of policyholders.

3.6.7 In determining the increase in liabilities under Paragraph 10 of Annex IV, the Appointed Actuary may, if he or she considers it appropriate and prudent, reduce the amount of these liabilities to the extent that provision is already made under Paragraph 3 of Annex IV and paragraph 3.2 of this ASP.

3.6.8 Where regular automated withdrawals are expected to be made under a contract, the Appointed Actuary must take this into account, if to do so would increase the reserves held. The Appointed Actuary must make allowance for all contracts where withdrawals are currently taking place and for contracts where withdrawals may reasonably be seen to arise in the future.

3.6.9 Paragraph 10(1) of Annex IV requires that allowance be made for contracts being converted to paid-up policy status. The Appointed Actuary must make a prudent assumption as to the proportion of policies expected to become paid-up. In calculating the reserves, the Appointed Actuary may, as he or she considers appropriate:

(a) carry out calculations at every future duration in order to determine the reserve required;

(b) assess any additional reserve based on sample calculations, provided he or she is satisfied that the overall reserve is prudent and in accordance with the requirements of the Regulations; or

(c) consider an immediate change to paid-up status if he or she considers the reserve is unlikely to be higher in the future.

It may be reasonable to assume lower renewal expenses (though still on a prudent basis) than if premiums were still being paid, but no credit may be taken for possible commission recoveries.

3.7 Paragraph 12 of Annex IV

3.7.1 Provision for lapses must be made on a prudent basis. In addition, Paragraph 12 of Annex IV requires that the liability for a contract must not be less than the amount determined on the assumption of no lapses. It follows that the liability must be determined as the greater of the amount determined on the assumption of prudent lapse rates and the amount determined on the assumption of no lapses. In many circumstances, the assumption of no lapses after the valuation date will give the greater liability, but this may not always be the case, particularly when the Company closes to new business. A decline in the number of policies in force may not necessarily result in a commensurate decline in expenses due to the persistence of fixed costs.

4 Reinsurance

4.1 The Appointed Actuary must be satisfied that reserves held in respect of contracts where benefits have been ceded to a reinsurer represent prudent provision for benefits payable under those contracts net of anticipated reinsurance recoveries.

4.2 The Appointed Actuary must also be satisfied that reserves established after the deduction of reinsurance cessions include a prudent allowance for the risk of reinsurance impairment or default affecting those contracts.

4.3 The potential costs associated with the impairment of or default by a reinsurer include (this list is not necessarily exhaustive): unrecoverable outstanding claims under existing reinsurance arrangements; fees payable to recapture ceded

business; and the incremental cost of replacing reinsurance cover or raising capital from alternative sources. In determining a prudent allowance for reinsurance impairment or default, the Appointed Actuary must assess the probability and potential severity of such events. This assessment should normally have regard to the Company's evaluation of the security of reinsurance cover in line with the 'Guidelines on the Reinsurance Cover of Primary Insurers and the Security of their Reinsurers' issued by the Central Bank of Ireland and relevant financial strength ratings maintained by credit rating agencies.

4.4 In coming to a decision on the probability and potential severity of reinsurance impairment or default, the Appointed Actuary may take into account the nature and extent of credit support arrangements provided by the Company's reinsurers as security for future benefits payable to the ceding Company.

4.5 In determining the extent to which the Appointed Actuary would consider it prudent to make provision for the more extreme reinsurance impairment or default contingencies in valuing particular categories of contract, the Appointed Actuary may reasonably take into account support provided by assets held to cover the required solvency margin arising from restrictions on credit for reinsurance cover in the calculation of the required solvency margin relating to those contracts.

4.6 The constraints set out in paragraphs 5.2 and 5.3 - on the extent to which the Appointed Actuary may reasonably take into account the basis of the solvency margin that the Company is required to hold on account of liabilities under particular contracts when making provision for extreme contingencies related to those contracts - also apply in the circumstances relating to extreme reinsurance contingencies that are addressed in paragraph 4.5.

5 Solvency margins, etc.

5.1 Although it is not a requirement of the Regulations, the Appointed Actuary must advise the Company as to the action required:

(i) to maintain the margins of solvency as prescribed by Annex II to the Regulations as the existing business matures, or

(ii) in view of the requirement under Article 32(b) of the Regulations for the Appointed Actuary to continue to give statutory certificates, to protect its position in certain circumstances, if in the Appointed Actuary's opinion there are reasonably foreseeable circumstances in which the Company would be unable to meet its obligations.

5.2 The prudent assumptions on which the reserve under Annex IV must be calculated will naturally allow for stochastic variations as well as other contingencies. In determining the extent to which the Appointed Actuary would consider it prudent to make provision for the more extreme stochastic variations

in valuing particular categories of contract the Appointed Actuary may reasonably take into account the basis of the solvency margin that the Company is required to hold on account of the liabilities under those contracts (net of the permitted deduction for reinsurance cessions). However, this should normally only be done if the Appointed Actuary is satisfied that:

(a) the Company's available assets can provide explicit cover for the amount of required solvency margin that the Appointed Actuary is taking into account, and

(b) the balance of the solvency margin required in respect of the Company's life assurance business can be covered by the balance of the available assets and by any allowable implicit items, and that the former are sufficient to satisfy Paragraph 4 of Part B of Annex II of the Regulations.

5.3 In exercising professional judgement in the circumstances envisaged under paragraph 5.2 of this ASP, the Appointed Actuary must assess the security for the required margin of solvency for the life assurance business as a whole, particular caution being required where it is in part covered by assets held outside the life assurance fund. Furthermore, the Appointed Actuary must certify that the resulting reserves, standing on their own, constitute a proper provision for the life assurance liabilities on actuarial principles. Reliance on the margin of solvency must not result in the margins in the valuation basis falling below the level where the Appointed Actuary can give this certificate.

5.4 Paragraph 10(c) of Annex II of the Regulations requires that the solvency margin for certain policies be calculated as an amount equivalent to 25 per cent of the prior year’s net administrative expenses relating to that business. The figure shown in line 15 of Form 2 of the annual return to the Central Bank of Ireland should normally be used for the purpose of this calculation subject to the following:

(a) In determining the allocation of total net administrative expenses to different groups of policies, the Appointed Actuary should normally take account of any internal expense allocation reports. The approach used should normally be consistent with the allocation of expenses that has been used to derive the valuation assumptions; and

(b) If the figure shown in line of Form 2 is not fully representative of the Company’s actual administrative expenses (in particular where certain administrative expenses are shown as commission), the Appointed Actuary must make an appropriate adjustment.

EXPLANATORY NOTE

ACTUARIAL STANDARD OF PRACTICE LA-3

This explanatory note does not form part of the ASP.

Version 3.3 incorporates changes to Section 3.3.4.
The changes include a specific reference to sovereign bonds and require the consideration of alternative approaches, such as market based measures, in all cases (including, but not limited to, government and sovereign bonds) when calculating the provision for the possibility of default.

ASP LA-3 continues to be relevant for Companies and Appointed Actuaries operating under the Solvency I regime. It is retained for this purpose only and will be discontinued after a period.