GN2(ROI): FINANCIAL CONDITION REPORTS

Classification

Recommended Practice.

Legislation or Authority

Insurance Act 1989.

European Communities (Life Assurance) Framework Regulations 1994.

Application

Appointed Actuaries. Actuaries responsible for long-term insurance business written by bodies other than those supervised under the Insurance Act 1989 are expected to follow the same principles. The Guidance Note is also written to help actuaries advising Republic of Ireland supervised long-term insurers on their world-wide business.

Version	**Effective from**
1.0	03.09.97

1. INTRODUCTION

1.1 Article 15 of the European Communities (Life Assurance) Framework Regulations 1994 requires Appointed Actuaries to carry out, and report on, the results of an annual investigation in accordance with associated regulations. As well as meeting this obligation, it is advisable for Appointed Actuaries to provide their Board with a more extensive written report into the current solvency position of the company and its possible future development - a Financial Condition Report.

1.2 The purpose of this Guidance Note is to suggest a possible format and contents for a Financial Condition Report. It also outlines how Dynamic Solvency Testing would normally be used to derive the background information underlying the Financial Condition Report.

1.3 The Financial Condition Report should normally be addressed to the Board of the life company concerned. This general intention should be interpreted in the circumstances of the particular organisation. In large and complicated groups the life company Board may not be the most appropriate authority to receive the report. The criterion should be to report to the Board within the group that is responsible for policy formation for the company concerned.

1.4 Within a group of companies it may be appropriate to produce a single report covering more than one company in the group, providing any such combined report is acceptable to all the Appointed Actuaries involved. It is essential that the report is expressed in a form which is accessible to its readers and does not conceal important issues inadvertently by, for example, undue length or complexity. An executive summary or overview drawing attention to important issues would be helpful.

1.5 In the normal course of events this report should be produced annually. It is possible that in a period of financial stability, both externally and within the office, the report could be truncated to avoid undue repetition of information provided in previous years. However, if there are changes either in the company itself or externally the relevant parts of the report may need to be updated as necessary.

1.6 Dynamic Solvency Testing is the principal technique which enables Appointed Actuaries to assess the ability of an office to withstand changes in both the external economic environment and the particular experience of the office. It involves projecting the office's revenue account and balance sheet forward and then changing the important assumptions in turn to establish the sensitivity of the office to changes in that particular assumption or assumptions. The combined effect of a change in two or more related assumption will in many cases be more important than a change in any one of them in isolation.

1.7 Further, the Appointed Actuary should address the issue of what actions are open to the office for dealing with the particular circumstances and, where appropriate, make suitable recommendations. For the appraisal of many risks, these projections can be on a deterministic basis. However, stochastic techniques can be used to identify additional risks and might be considered depending on the circumstances and nature of the office in question. Stochastic techniques can also be valuable in comparing the relative level of probability of adverse circumstances occurring.

1.8 Appointed Actuaries should use whatever techniques they consider appropriate to the business written by their office.

1.9 It is not essential to have a single report covering all the items in this Guidance Note where the Appointed Actuary has already reported to the Board on some aspects previously.

2. GENERAL POINTS

2.1 The Financial Condition Report should normally include:

2.1.1 The purpose of the report.

2.1.2 The extent, if any, to which the report falls short of its stated purpose.

2.1.3 The conclusions that can be drawn about the financial position of the office at the particular time at which the investigation is carried out.

2.1.4 Relevant historical development of the company and any conclusions that can be drawn from that development which may have implications for the future of the company.

2.1.5 Comments on particular aspects of the historical development of the company, such as any policy conditions, prospectuses, methods of selling etc., which have led to Policyholders' Reasonable Expectations being formed with financial consequences for the company.

2.1.6 A commentary on the business of the company and the environment in which it is expected to operate.

2.1.7 A commentary and opinion on the implications of the Dynamic Solvency Testing or other financial investigations with special reference to any future external factors which present a threat to the company's financial security and the options open to the company to deal with those factors.

2.2 It would be usual for the Appointed Actuary to comment in more detail on:

2.2.1 The methods and assumptions that have been used. The report should distinguish between those assumptions which are important and those which are less so, and also those which are within the company's control and those which are dictated by external circumstances.

2.2.2 Any changes made to the methods or assumptions used in the last similar report.

2.2.3 Any significant restrictions to the scope or detail of the analysis for reasons such as the lack of availability of data, shortcomings in computer systems, or availability of resources to carry out the analysis. The Appointed Actuary should draw attention to any such inadequacies and give an opinion as to their importance and relevance to the company. Thus, for example, attention should be drawn to any blocks of existing or proposed new business that have not been evaluated.

2.2.4 The differing nature of some assumptions as compared with others:

(i) Some assumptions such as mortality (except possibly mortality arising from AIDS) can be relied on as fairly predictable.

(ii) Others, for example policy persistency, may need to be placed in the context of both historical experience and changes anticipated in the light of different operating methods now used by the company.

(iii) Yet others may be highly uncertain and totally outside the control of the office. This is particularly true to investment conditions, the volatility of which may have profound implications for the financial condition of the office.

Where appropriate, the report should state how the assumptions adopted compare with recent experience, and should give explanations where assumptions differ significantly from that experience.

2.2.5 Any particular financial characteristics of existing or current new business that may require special consideration.

2.2.6 The special characteristics of the office in terms of the way in which they may affect its development and future prospects. It is helpful to draw attention to any such characteristics and be clear about the importance of both the absolute position of any particular aspect and, where possible and relevant, the relative position when compared with other companies.

2.3 The report should indicate, where appropriate, how the following issues have been addressed:

2.3.1 Any unusual features of business either on the books, current new business or proposed product development.

2.3.2 Any financially significant reinsurance arrangements and any possible options contained within them.

2.3.3. The effects of any known or planned changes in the company's method of operation, its corporate structure, etc.

2.3.4 Any use made by the company of derivatives, where potentially financially significant, and their purpose.

2.3.5 Post Balance Sheet events - some comment on experience and events since the end of the financial year to which the report relates will almost always be required.

3. DYNAMIC SOLVENCY TESTING

3.1 A distinction should be drawn between testing the effect of a change in individual assumptions in a relatively mechanistic way and testing groups of assumptions which are assumed to change in a related way. This is sometimes described as "scenario" testing, whereas varying individual assumptions independently is referred to as sensitivity testing. Stochastic modelling will normally incorporate the scenario concept by assuming specific statistical relationships between variables such as inflation and investment returns.

3.2 It may be helpful, as a matter of routine, to test the effect of each assumption separately but in the final report to restrict comment to those which are judged likely to have a material effect. Certain assumptions, in particular those which are a consequence of the economic environment, are best treated as a group. The office's ability to withstand a period of inflation or recession, rising or falling stockmarkets, increasing market sizes or increasing competitiveness, needs to be investigated using coherent sets of assumptions.

3.3 The choice of the term over which to carry out projections is an important one. Generally a period of five years will be sufficient but there may be some areas of risk where full effects become apparent only over a longer period. Such circumstances might include the effects of bonus smoothing following a period of quickly rising or falling stockmarket levels, or the impact of a substantial but gradual fall in new business levels.

3.4 It is not thought helpful for guidance to prescribe particular variations in assumptions or even which assumptions need to be tested and reported. Individual Appointed Actuaries will need to judge what is appropriate for a given company in the particular circumstances in which it finds itself. Nevertheless it may be helpful to draw attention to the following:

3.4.1 There would need to be specific reasons for not testing variations in the following assumptions:

(i) future investment conditions;

(ii) levels of new business, where this is being written;

(iii) expenses;

(iv) persistency.

3.4.2 Other assumptions may be of considerable importance in some companies but not others, for example:

(i) allocation of profits and/or special distributions of carried forward surplus to policyholders and/or shareholders;

(ii) mortality and morbidity;

(iii) taxation;

(iv) exercising of options by policyholders;

(v) exercising of options by the company;

(vi) effects of asset-defaults;

(vii) unit pricing bases;

(viii) risk of reinsurer default.

3.4.3 The Appointed Actuary needs to be alert to various factors that might affect a company. For example;

(i) concentrations of assets in particular risk areas;

(ii) derivatives;

(iii) assets containing unusual provisions which may be susceptible to particular risks;

(iv) sources of new business which have unusual characteristics;

(v) impending major claims or litigation that might affect the company;

(vi) operational exposure to accidents, terrorism, or malicious damage;

(vii) unusual contracts or relationships which may have financial implications;

(viii) risks created by deficient product literature or policy documentation;

(ix) loss of a distribution channel;

(x) the effect in different scenarios of options and guarantees in the insurance liabilities;

3.4.4 In each scenario tested, provision should be made for all elements of the statutory liability including an appropriate level of resilience reserve.

3.5 As well as drawing attention to those potential developments which are of concern, the report should explain the options open to the company and how to deal with those possible developments. Developments which can be dealt with in a straightforward fashion are of relatively little concern. If, however the Appointed Actuary identifies developments, or sets of developments, which lead to financial difficulty for which no satisfactory remedial action can be found, the Appointed Actuary should ensure that such matters have special prominence in the report and include any recommendations as to what might be done to avoid such circumstances. The very least that it is reasonable for a Board to expect of the advice from the Appointed Actuary is that the company does not unknowingly run foreseeable risks which could jeopardise its financial well being.