GN8(ROI): ADDITIONAL GUIDANCE FOR APPOINTED ACTUARIES

Classification (See APC)

This Guidance Note is classified in relation to the code of professional conduct as *mandatory*.

Scope

Republic of Ireland. Worldwide business of Republic of Ireland supervised long term insurers.

Application

Appointed Actuaries in Insurance Companies

Legislation or Authority

This Guidance Note deals with the determination of liabilities and solvency margins under the European Communities (Life Assurance) Framework Regulations 1994.

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1. INTRODUCTION

1.1 The primary references in this Guidance Note are to Paragraphs 1 to 12 of Annex IV of the European Communities (Life Assurance) Framework Regulations 1994. Annex IV of the European Communities (Life Assurance) Framework Regulations 1994 comprises Paragraphs governing the valuation of liabilities of insurance companies for various statutory purposes under the Insurance Acts, 1909 to 1990. In particular these Paragraphs govern the valuations of long-term liabilities for the purposes of an investigation to which Article 15 of the European Communities (Life Assurance) Framework Regulations 1994 or Section 16 or 17 of the Insurance Act 1989 applies. Such an investigation would normally be for determining:

(a) whether the statutory certificate in respect of long-term business required by Article 32(b) of the European Communities (Life Assurance) Framework Regulations 1994 could be given;

(b) the extent to which assets could be transferred out of the fund in accordance with Section 15(2) of the Insurance Act 1989; or

(c) whether a dividend may be declared by the company or a parent, having regard to Section 15(7) of the Insurance Act 1989.

These Paragraphs are also relevant to the determination of the margins of solvency required by Article 12(1)(b) of the European Communities (Life Assurance) Framework Regulations 1994.

1.2 Such valuations are the responsibility of the Appointed Actuary and this guidance, which is supplementary to that set out in Guidance Note GN1(ROI), has been prepared to draw the attention of Appointed Actuaries to certain aspects of their professional responsibilities relevant to these valuations.

1.3 Annex II of the European Communities (Life Assurance) Framework Regulations 1994 comprises regulations prescribing margins of solvency for insurance 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 Department of Enterprise and Employment 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 Minister for Enterprise and Employment under Paragraph 2(g) of Part A of Annex II of the European Communities (Life Assurance) Framework Regulations 1994 to enable implicit items as set out in Annex VI to count towards the margin of solvency.

1.4 It is the Appointed Actuary's professional duty to make timely written and reasoned disclosure, both to the company and to the Department of Enterprise and Employment. If for some exceptional reason the Appointed Actuary is unable to comply fully with this guidance then the statutory certificate must be qualified accordingly.

2. PARAGRAPH 2 - THE ACTUARIAL VALUATION

2.1 Paragraph 2 of Annex IV is paramount. The Appointed Actuary should use prudent bases determined according to actuarial principles, and the professional considerations set out in GN1(ROI), particularly Section 6 thereof. The Paragraph refers explicitly to the inclusion of appropriate margins for adverse deviations of the relevant factors. This means that the valuation basis used should 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 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 actuary who uses such a method needs to be prepared to justify it by reference to actuarial principles. In relation to an insurance company, the Appointed Actuary should also bear in mind that any excess of assets over liabilities disclosed by the valuation can legally be transferred out of the fund.

2.2 This Paragraph 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 paragraph 3 of these notes. However, they should not be regarded as necessarily satisfying the more general actuarial principle set out in Paragraph 2(a). They are the basis of a minimum statutory valuation, and the actuary should carry out such investigations as considered necessary to be satisfied (and, where required, to satisfy the Department of Enterprise and Employment) that the valuation satisfies the criteria. The criteria apply for each separate category of contract.

2.3 Paragraph 2 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, this should 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) but not as requiring implicit or explicit provision for any element of terminal bonus or any final payment of additional bonus. The actuary would, however, be expected to make other investigations in order to be satisfied that the life fund is able to support a proper level of future terminal bonus having regard to the bonus smoothing policy followed by the company.

2.4 Paragraph 2 refers to the need to provide appropriate margins for adverse deviations of the relevant factors. The actuary should 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.

2.5 The actuary should take account of any relationship which the company has with another company which is relevant for the purposes of the valuation. For example, where there are service agreements with other companies (whether or not within a group structure) the actuary should consider whether any additional provision is appropriate for the contingency that such agreements might cease. This would be particularly relevant where a subsidised or beneficial agreement exists.

2.6 Paragraph 2 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 shall 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.

3. PARAGRAPHS 3 TO 12 - THE MINIMUM CRITERIA

3.1 General

3.1.1 As explained in paragraph 2. 2, Paragraphs 3 to 12 set out minimum criteria against which the valuation basis of an insurance company should be determined for each separate category of contract. However, there are several respects in which these criteria are not precise and the actuary has to interpret them in a prudent way, in regard to both the individual criteria and the criteria as a whole. If the 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 which do not apply to linked business.

3.2 Paragraph 3

3.2.1 Professional judgement is particularly necessary in applying the requirement in Paragraph 3, which applies to the aggregate liability, that the determination of the amount of long-term 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. Paragraphs 6.7 to 6.10 of GN1(ROI) set out considerations to be taken into account, as does paragraph 2.4 above. Paragraph 3 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 actuary must use professional judgement as an experienced financial practitioner. The essential point is that if changes, for example in market yield or currency values, 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 requires the 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 actuary needs to exercise special care with regard to any investments presenting novel or unorthodox features, derivatives (whether assets or liabilities) and any contracts containing substantial options

3.2.2 Actuaries should look at mismatching provisions from the viewpoint of cash flow over a wide range of investment conditions. Even if assets and liabilities are exactly matched on a cash-flow basis, however, additional reserves may nevertheless have to be set up to cover a mismatch created by the valuation requirements of Annex IV.

3.2.3 The company's reserves (including any additional reserves required under Paragraph 3) should be sufficient to absorb the effect of changes in interest rates and asset values, on a suitably prudent basis, without prejudicing the company's ability to hold reserves which satisfy Paragraphs 2 and 4 to 12 in the changed conditions. Where the life fund has liabilities under derivative contracts, these should be revalued on an estimated market value basis in the changed conditions when assessing any additional reserves required under Paragraph 3.

3.2.4 As referred to in 3.3.4 below, Paragraph 7(10) 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 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. Furthermore, when applying the valuation 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.

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

3.3 Paragraph 7

3.3.1 Paragraph 7(7)(a) 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). 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.

3.3.2 Paragraph 7(7)(b) 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.

3.3.3 Paragraph 7(8) 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 should consider, in the light of conditions prevailing at the valuation date, whether a limit lower than 7.5% per annum might be appropriate. Furthermore, the limit of 7.5% per annum has been set in the context of Republic of Ireland interest rates and lower limits may be appropriate where the liabilities and assets are in currencies other than Irish pounds.

3.3.4 Paragraph 7(10) 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 shall have regard to the prudence concept. It would not, for example, be prudent to allocate overseas branch assets to cover Republic of Ireland policyholders' liabilities where, in practice, local regulations in the territory concerned made such an allocation impractical to achieve. Where derivative contracts are held in connection with particular assets or liabilities in the long-term fund, then it will generally be appropriate to apportion these derivatives together with the corresponding assets and liabilities.

3.4 Paragraph 8

Paragraph 8 requires prudent rates of mortality and disability. The calculation of a specific reserve for AIDS is not sufficient, of itself, to demonstrate prudence.

3.5 Paragraph 9

3.5.1 Paragraph 9 should be interpreted as requiring the 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 actuary to take into account margins arising from, and restrictions on, interest rate assumptions e.g. increases in income from existing holdings of index-linked stocks or the restriction on income created by the limitations of Paragraphs 7(8) and 7(9).

3.5.2 In requiring provision to be made for meeting 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. Explicit allowance for future expenses will be 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.

3.5.3 Whether or not the actuary performs the valuation under Paragraph 2 on the assumption that the office will continue to transact new business, Paragraph 9 requires an assessment of the provision for future expenses against the total (net of tax) cost that would be likely to be incurred in fulfilling existing contracts if the company were to cease to transact new business. 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. In addition, the future tax position of the fund may be affected.

4. SOLVENCY MARGINS, ETC.

4.1 Although it is not a requirement of the European Communities (Life Assurance) Framework Regulations 1994, the actuary will need to advise the company as to the action required

(i) to maintain the margins of solvency as prescribed by Annex II to the European Communities (Life Assurance) Framework Regulations 1994 as the existing business becomes more mature, or

(ii) in view of the requirement under Article 32(b) of the European Communities (Life Assurance) Framework Regulations 1994 for the actuary to continue to give statutory certificates, to protect its position in certain circumstances such as those referred to in paragraphs 5.5 to 6.12 of GN1(ROI), if in the actuary's opinion there are reasonably foreseeable circumstances in which the office would be unable to meet its obligations.

4.2.1 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 actuary would consider it prudent to make provision for the more extreme stochastic variations in valuing particular categories of contract (for example, in relation to mortality and morbidity fluctuations, and variations in benefits resulting from the inclusion in a unit-linked contract of a maturity guarantee) the 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 only be done if the actuary is satisfied that:

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

(b) the balance of the solvency margin required in respect of the company's long-term 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 European Communities (Life Assurance) Framework Regulations 1994.

4.2.2 In exercising professional judgement in the circumstances envisaged under paragraph 4.2.1 the actuary will need to assess the security for the required margin of solvency for the long-term business as a whole, particular caution being required where it is in part covered by assets held outside the long-term fund. Furthermore, the actuary will have to certify that the resulting reserves, standing on their own, constitute a proper provision for the long-term liability on actuarial principles and reliance on the margin of solvency must not result in the margins in the valuation basis falling below the level where the actuary can give this certificate.