Faculty of Actuaries Students' Society.

Current Topics 2008. Life Insurance

March 2008

Author

Peter Murphy

With contributions from

Caroline Gardner

David Finnes

Diana Cascardo

Marylene Lanari-Boisclair

Jonathan Bundy

Karen Nicol

Contents

1. Introduction

The view for the financial services industry changed substantially over the course of 2007. By the end of the year the "credit crunch" was in full flow and confidence that characterised the start of 2007 had been replaced by a more subdued atmosphere.

Whilst the credit crunch is extensively discussed in the other current topics papers it appears that the life insurance industry does not have significant amounts of direct exposure to structured finance instruments, although wider market consequences could cause problems for the industry. Falling asset values will always present challenges to the industry leading to reduced new business, increased guarantee costs on legacy business and higher costs for funding from capital markets.

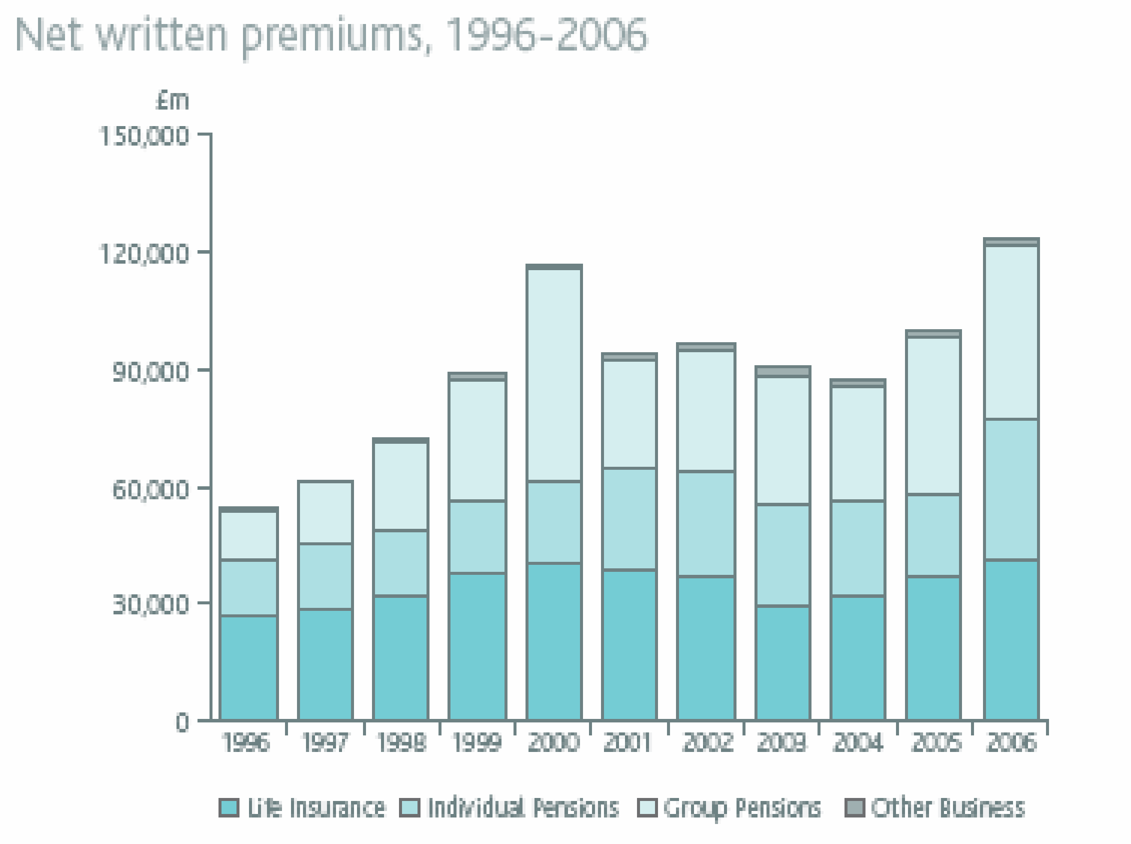
This paper aims to provide the reader with an overview of the current issues in the life insurance industry and an overview of events concerning the industry for 2008. The paper is split into 4 sections:

- The "Industry Update" covers the state of the business, looking at sales, product development and the continuing changes to the distribution of policies.
- "Corporate Activity" looks at M&A and other transfers of business occurring throughout 2007 and the early part of 2008.
- The "Regulatory Developments" section looks at the FSA's Treating Customers Fairly initiative and the progress during 2007 towards the implementation of Solvency II in 2012.
- The final section, "Financial Reporting" looks at Phase 2 of the IFRS for Insurance contracts and briefly looks forward to the changes expected in Embedded Value reporting in 2008.

2. Industry Update

2.1 New Business Sales

New business premiums have now been increasing year on year for the past 4 years. With total premiums on an APE basis* up to £15.1bn, including £95.5bn of single premiums. This is an increase in total premiums of 14% over the previous year. 2007 saw a marked increase in single premium business. However, much of this is transfers of existing pension contracts. Taking this into account the net flow into the industry was negligible. The FSA sees falling levels of real new business as a key risk for the life insurance industry. One example of falling business volumes is Single Premium Bonds where the recent change in CGT rules have reduced the attractiveness of this product. Later in the paper we consider some of the ways that the industry is trying to address this, both by considering the effectiveness of the current distribution model and product innovation. The next figure shows the change in net premiums over the 10 years to 2006.



Source: ABI

* APE - £10 of single premium = £1 of APE

Top 10 Table

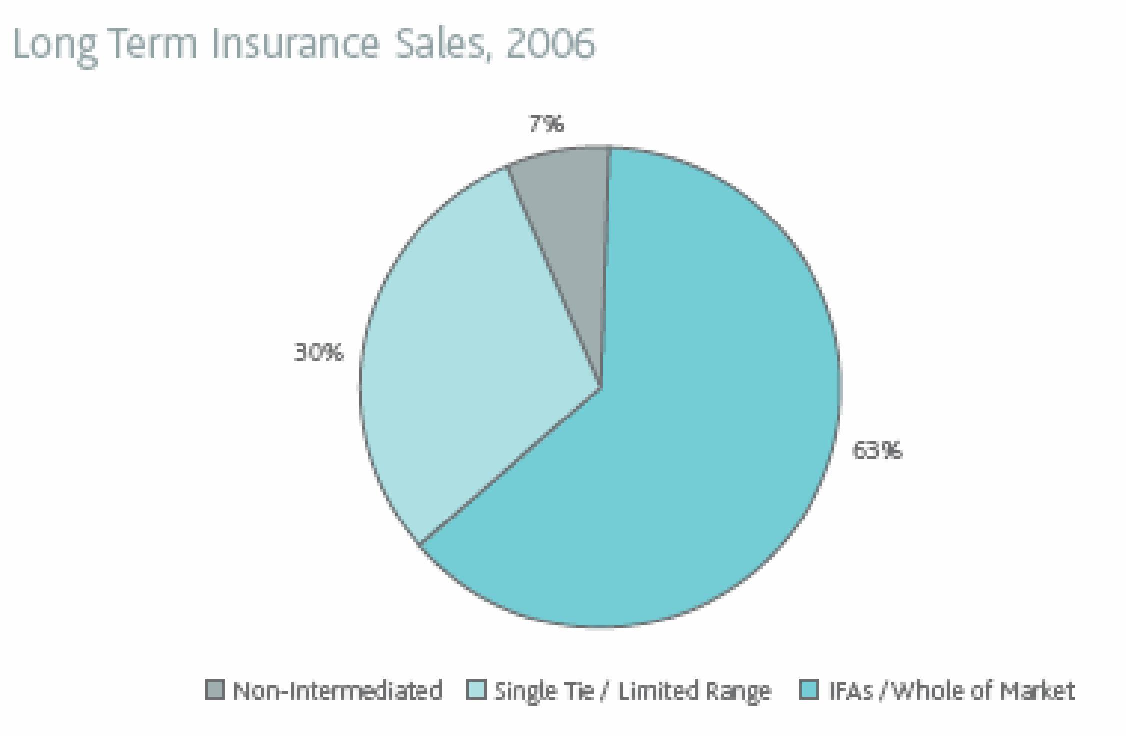
The table below shows the top firms by Long Term business premium income for 2005 and 2006 (the most recent years for which data is available). For 2006 there were noticeable increases for the recently demutualised Standard Life and also for Aegon, but otherwise there are only small changes compared to the figures for 2005. There was only one change in the Top 10 companies in this period

		Total Business	Premium (£m)	
2006	(2005)		2006	2005
1	(4)	Standard Life	11,136	7,633
2	(3)	AVIVA plc	9,767	7,792
3	(6)	Legal & General	7,361	6,273
4	(1)	Prudential	7,305	8,184
5	(2)	Lloyds TSB Group	6,982	7,797
6	(10)	Aegon	6,728	3,056
7	(7)	ALICO	6,562	4,761
8	(5)	HBOS Financial Services	6,374	7,354
9	(8)	AXA	6,237	3,915
10	(12)	Canada Life	5,493	2,490
11	(11)	Friends Provident	3,629	3,023
12	(9)	Zurich Financial Services	3,415	3,295
13	(65)	Resolution plc	2,222	-2,623
14	(15)	St James' Place Capital	1,807	1,153
15	(18)	HSBC	1,256	696
16	(13)	Royal London Mutual Insurance Society	998	1,566
17	(19)	Swiss Reinsurance Company	881	607
18	(26)	Suffolk Life	759	335
19	(25)	Old Mutual Group	737	357
20	(21)	Munich Re	667	542
Total Market			**£96,689m**	**£78,359m**
Share of top 5 companies			**43.93%**	**48.88%**
Share of top 10 companies			**76.35%**	**75.74%**
Share of top 20 companies			**93.25%**	**92.38%**

Source: ABI

Distribution Mix

Due to the complexities of the products the majority of long term life insurance business is sold after a process of advice. The table below shows the split of business between whole of market and limited range advisors. This has been relatively stable over the past 5 years. The marketplace for distributors is likely to change over the next few years and in a few years this graph should look quite different. The next section considers the progress of the FSA's Retail Distribution Review.



Source: ABI

2.2 Distribution – The Retail Distribution Review

In an attempt to combat some of the perceived weaknesses in the current distribution model, the FSA set up the Retail Distribution Review (RDR) of the investment market. This was launched with a flourish by its Chair, Callum McCarthy, in September 2006, and was in progress throughout 2007.

The FSA issued its Discussion Paper DP07/1 in June 2007 in which it called for the retail financial services markets to develop, amongst other areas, remuneration structures that are transparent, understandable and do not conflict with acting in the best interests of consumers.

The Discussion Paper also 'segments' the current market for providing advice, dividing it into four tiers;

- Professional Financial Planners,
- General Financial Advisers,
- Primary Advisers and;
- Generic Financial Advice.

In the first of these advice segments, Professional Financial Planners, the FSA suggests that advisers would only be able to operate on a fee-basis, adding 'for this purpose we might redefine the term 'fee-based' to mean any advisory remuneration derived in discussion with the customer'. One of the options outlined was Customer Agreed Remuneration (CAR).

The CAR model proposed is thought to have the potential to not just reduce the scope for provider bias, but to improve the clarity of the costs of advice for consumers. The fundamentals of CAR are:

- products priced by manufacturers excluding any charge for remunerating advisers ("factory gate pricing");
- fee for the advisers' services agreed between the adviser and the customer, in relation to advice and services to be supplied (like a fee discussion); and
- additional charges then added to the product charges over a time period to reflect agreed remuneration.

In essence, the provider no longer has a role in establishing the adviser's remuneration – this is now agreed between the adviser and the customer.

The concept of CAR is in fact not a new one. Factory Gate Pricing, as CAR was formerly known, has existed in the UK market for a few years, albeit at the periphery. Of late, an increasing number of product providers have distributed products through intermediary channels offering CAR terms.

CAR and the Customer

Certainly, CAR looks well positioned to deliver better consumer outcomes in relation to helping give consumers greater clarity on what the cost of the advice they are receiving might be, as they will be discussing and agreeing a specific fee with their adviser. What is less certain is the impact this might have on consumer appetite for advice. Some claim that current consumers, who believe commission-based advice is 'free' would baulk at the explicitness of a separate, specific fee for advice. Some consumers are possibly more likely to find a charge based on a percentage of the sum to be invested to be psychologically more 'acceptable' than a specified sum.

Will CAR remove bias from the equation? As it is based on a sale occurring, it will not address one form of bias – the bias to 'sell' as opposed to not making a sale. CAR should remove provider bias, although some critics fear that 'soft commissions' may emerge. Careful consideration also needs to be given to the extent to which CAR is applied, and how intermediaries might respond. As currently presented in the Discussion Paper, CAR would only apply in the investment market and for Professional Financial Planners (PFP) advisers.

The way forward?

In a discussion paper forming part of its RDR (DP 07/2), the FSA presented the cost structure used by an IFA (Baigrie Davies) as a case study. In this case study, ongoing charges are explicit for the customer and are composed of distinct elements such as:

- Annual management charges on the underlying funds
- Average fund manager expenses
- Average fund manager rebate
- Average large wrap rebate
- Fund based charge payable to the adviser

The IFA agrees an initial and ongoing fee with the client, with the costs coming out of a cash account held on the wrap. Fees are explained both in percentage and cash terms and are viewable by the client. The overall yearly charge may be higher than a client would pay outside the wrap although this depends on the wrap charges, the level of fund rebates available through the wrap, and other factors. The explicit nature of the charges allows the adviser and client to work out exactly what the yearly charges are over the whole portfolio or for sections of it.

This approach appears to meet the FSA's concept of CAR:

- products priced by manufacturers excluding charges to cover the costs of remuneration to advisers for their services;
- advisers and customers agree the level and pattern of remuneration in the context of a discussion of all services being supplied (and to be supplied) - very much like a fee discussion; and
- additional charges are then added to the product charges to reflect agreed remuneration.

However, attention also needs to be paid to other charges, for example switching and exit charges. Transparency is central to the spirit of the RDR and the FSA is aiming for a structure to develop that will support the best customer outcomes: using appropriate advice, technology and investment vehicles to meet their investment risk profiles.

2.3 Product Development

The key new product for 2007 was Variable Annuities. These have been described as "not really variable and not necessarily annuities". Rather they are unit-linked savings contracts with attaching guarantees. A number of the larger players in the US market have launched products into the UK market (e.g. Aegon, MetLife, Hartford, AIG & Lincoln). Variable Annuities have yet to become a mainstream product, but as a number of the larger UK based companies are currently considering launching products in this area it is expected that they will become much more prevalent in 2008. Variable annuities also create the need for complicated hedging programs to manage the risks resulting from the guarantees contained in the policies.

The other trend in 2007 was the increase in popularity of WRAP platforms. Wraps come in many forms and there is no one consistent definition for them. Generally, wraps are regarded as an administrative platform that allows customers and their intermediaries to group all of their investments and savings inside one wrapper. From a single point of access, "typically a website", the entire portfolio can be viewed, analysed, altered and managed according to asset allocation, value and tax treatment. Wrap platforms will come in many flavours depending on the tax regimes covered, size of allowable assets, suite of financial tools, online availability and the pricing mechanism.

In 2007 the size of the UK wrap market was estimated at around £60bn; it is expected to grow to £150bn by 2011 as a result of growth in retail market and growing share of wrap, mainly targeting the 1.2m consumers with over £250k free assets. However, not all commentators are convinced that wrap will have the penetration forecasted.

3. Corporate Activity

There has been a wide range of corporate activity over the 2007. From the high profile saga over the ownership of Resolution to quieter disposals and transfers of business as companies continue to focus on their core areas of business.

3.1 Resolution

The contest to see who will end up owning Resolution plc raged over most of 2007 and is still not finished. At the time of writing Pearl was still trying to finalise its £5bn takeover of the closed fund consolidator.

After acquiring RSA Life UK, Swiss Life UK, Britannic Group and Abbey's (Banco Santander) UK Life Business in the period since 2004, Resolution became a takeover target itself in 2007. In July Resolution agreed a merger with Friends Provident. This prompted groups headed by Pearl (in conjunction with Royal London) and Standard Life (in conjunction with Swiss Re) to bid for Resolution. A hard fought battle ended in November with victory for Pearl after it had built up a stake of nearly 25% on the open market. The takeover will result in a business with assets under management of £85bn. The failure of the merger with Resolution left Friends Provident vulnerable to takeover itself and there have been consistent market rumours that a bid might appear from JC Flowers.

3.2 Annuity Transfers

Concern over longevity risk has been increasing over the past few years. In 2007 this led to the transfer of a number of blocks of annuity business; continuing the trend for a small number of companies, with a great deal of specialist knowledge to take on more longevity risk. Some of the main transactions are listed below:

- Standard Life reinsured £6.7bn of UK immediate annuity liabilities, more than half of its total £12bn, to Canada Life International Re, a wholly-owned subsidiary of Great-West Lifeco. Standard Life expects this to result in a one-off positive impact on embedded value operating profit of at least £100m.
- Equitable Life completed the transfer of £4.6bn of annuities to Canada Life a wholly-owned subsidiary of Great-West Lifeco following the re-insurance of this block in 2006;
- Equitable Life transferred £1.8bn of with-profits annuities from Equitable Life to Prudential.
- Zurich FS transferred a book of annuities worth £3.9bn to Swiss Re.

3.3 Bulk Buy Out

More and more specialist life insurance companies have started up in 2007 looking to take on defined benefit pension liabilities and bulk annuities. Over the year these companies have started to take on a larger range of liabilities. Some of the highlights are given below:

- Goldman Sachs' subsidiary Rothesay Life's takeover of the Rank Group's £700m pension scheme.
- Paternoster ended the year with assets under management of £1.5bn, up from around £100m at the end of last year (including the pension schemes of P&O, Chrysalis & Emap).
- Pensions Corporation purchased the whole of both Threshers and Telnet in order to take control of their pension schemes.
- Lucida, a recent start-up, completed a deal to reinsure €100m of annuities from the Bank of Ireland and then took out a contract with JP Morgan to hedge the longevity risk based on the "LifeMetrics" Index.

3.4 Reattributions

As sales of With Profits have reduced, companies have had to start to think about the future of the inherited estates that have built up in these With Profits funds and whether they are necessary going forward. During 2007 both Aviva and Prudential have started to consider reattribution of the free assets in their With Profits funds.

Aviva has appointed Clare Spottiswode as Policyholder Advocate to help with the process of determining the correct way to distribute the £5 billion surplus that had accumulated by the end of 2006. So far Aviva has proposed to distribute more than £2bn of this in the form of a special bonus with the remainder to be distributed by the process of reattribution. At the time of writing Aviva is considering the Policyholder Advocate's reply to its third offer, with the intention of finally deciding whether or not to put an offer to policyholders in 2008.

During this process the policyholder advocate has asked for clarification from the FSA on a number of points in the reattribution process. This is discussed in more detail in the Regulatory Developments Section of this note.

In 2008 Aviva and Prudential are both likely to put detailed plans for re-attributions to their policyholders. The Treasury Select Committee has launched an inquiry into the reattributions which is bound to influence the course of events.

3.5 Others

There were a number of other transactions in 2007 including the following:

- Lloyds TSB sold the closed Abbey Life book to Deutsche Bank for £977m in the latest part of its attempt to repatriate capital from Scottish Widows.
- The business of Scottish Legal Life was transferred to Scottish Friendly adding £200m to assets under management.

4. Regulatory Developments

During 2007 there has been little change in the regulation as regards to valuation and solvency. The FSA has been concentrating on furthering principles based regulation and the moves on treating customers fairly are discussed below. Also progress towards Solvency II continues with the intended implementation now planned for 2012.

4.1 Treating Customers Fairly

Treating Customers Fairly ("TCF") forms a key part of the FSA's flagship move to more principle based regulation. While the shift away from detailed rules provides firms with greater flexibility, it also results in greater uncertainty. To provide further TCF support to firms, the FSA published four papers during July. These covered:

- Responsibilities of providers and distributors;
- Good and poor practice in relation to product design;
- Culture in firms; and
- Management information ("MI").

Embedding TCF Culture

The embedding of TCF into the culture of a firm is arguably the most important of the six TCF outcomes defined by the FSA. The paper states that "Consumers can be confident that they are dealing with firms where the fair treatment of customers is central to the corporate culture". A strong TCF culture is a foundation for the delivery of the other five TCF consumer outcomes.

The FSA has outlined a culture framework based around key cultural drivers which are believed to have a significant influence over the way firms behave. These are:

- leadership – the leaders of the firm have the most impact over a firm's culture by setting direction and monitoring performance;
- strategy – TCF should form an integral part of a firm's strategy, whether it be to grow through acquisition or to develop new products and target markets, and these should be incorporated at both the planning and implementation stages;
- decision making – decisions made throughout the firm are challenged with appropriate balance to include the interest of customers;
- controls – ensuring TCF risks are incorporated into the risk framework with appropriate controls and MI to manage, monitor and take action where issues are identified;
- recruitment, training and competence – staff's behaviour can shape the culture of a firm and this can be influenced through recruitment and training processes and the ongoing monitoring of performance; and
- reward – the structure of reward strategies can play an important role over staff behaviour and the treatment of customers. For example having reward strategies that are not only based on the achievement of sales targets but equally take into consideration the quality of the sales advice.

The FSA plans to incorporate the framework into its ARROW risk assessments and will also make use of it in "culture" visits and as part of its thematic work. The FSA also intends to look at middle management and frontline staff, to ensure messages from the top are filtering through and, in practice; fair outcomes are being delivered to customers.

Controls and MI

TCF MI continues to be a high priority for the FSA. MI needed to be in place for March 2008 and a deadline is in place of December 2008 for MI to demonstrate customer outcomes are being delivered.

Firms should consider:

- risk assessment - has risk assessment incorporated all risks which could impact on the achievement of the six consumer outcomes? Firms should identify potential "hot spots" or priority areas and ensure that their assessment is updated on an ongoing basis.
- controls - what controls are in place to mitigate or reduce the level of risk posed to TCF? For example, having a clear and structured process around product design involving consumer research and all relevant business areas at an early stage to identify the risks to consumers. Monitoring and seeking customer feedback on key interactions (such as calls and advice meetings) can identify the need for improvements.
- management information – has a review been carried out to assess if MI is able to demonstrate the outcomes are being delivered? Qualitative and quantitative data must be of sufficient quality for senior management to make informed decisions. For example, does senior management challenge actual sales figures compared to forecast and is it able to determine from the MI whether the intended target market has been reached? Over performance could be due to an aggressive sales strategy with products being sold to inappropriate customers. This could potentially lead to brand damage and costs to the firm if early action is not taken. There must be clear responsibility for monitoring particular customer risks that were identified and for ensuring the appropriate MI is received by the appropriate people in the business. In addition, clear TCF key performance indicators will also help to set the standards the firm wants to attain and maintain.
- closed loop process - what process is in place and what records are kept to demonstrate that the firm is appropriately monitoring TCF? Controls must cover performance against the consumer outcomes and the actions taken as a consequence of the information received. For example, complaint handling issues are identified and remedied, resulting in improved customer experiences and ultimately customers that are more likely to consider using the firm again in the future.

Provider and Distributor Relationships

The FSA suggests that providers should consider evaluating, through the use of MI, the actual versus planned experience of distribution channels. Commercial realities mean that many providers are paying greater attention to the conduct and quality of their distribution. This is being driven by, for example:

- provider investment in distribution firms and the responsibilities of ownership means providers take a keener interest in TCF practice within the intermediary,
- increasing provider understanding of intermediaries and more focus on the appropriate intermediaries that introduce high value, high persistency business, and
- the Retail Distribution Review: a clear statement of intent from the industry and the FSA that standards will have to be raised and that TCF can mean regulatory and commercial benefits.

4.2 Solvency II

2007 has seen further progress on Solvency II. On 10 July 2007, the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) published a proposal for a framework directive on its Solvency II project. The framework allows for more sophisticated solvency requirements and proposes the following three pillars for insurance regulation:

- Pillar 1: deals with quantitative requirements;
- Pillar 2: deals with requirements for the governance and risk management of insurers and effective supervision of insurers; and
- Pillar 3: deals with supervisory reporting and transparency requirements.

There are various proposals to streamline the supervision of insurance groups. A dedicated "group supervisor" will be responsible for all aspects of an insurance group's supervision with coordination and decision power to be exercised in consultation and cooperation with local supervisors.

The proposal now goes to the European Parliament and Council for consideration and CEIOPS is aiming for a new solvency regime to be in place in 2012. Thomas Steffen, chair of CEIOPS, delivered a speech at the official presentation of the Solvency II framework directive and some of his key messages were:

- supervisors will better understand insurance firms, their risks and internal control processes;
- CEIOPS aims to achieve a very high degree of consensus and convergence and limit the room for national discretion and options.

Also during 2007 the results from the third quantitative impact study (QIS3) into the effect that the EU Solvency II regime will have on European insurers have been published and the specification for the fourth study (QIS 4) has been released.

QIS3 was organised across Europe by CEIOPS between April and June 2007 as part of its continuing effort to assess the impact of the standard formula for capital requirements for the Solvency II regime. The objectives of QIS3 were broader than those in the previous QIS2 study and group risk issues were also included. The feedback provided by the industry as part of QIS2 was a key input to the design of QIS3. The results of the UK Industry Feedback, published by the Financial Services Authority show that UK insurers are taking an increasing interest in preparing for the new system.

UK participation in QIS3 was considerably higher than for QIS2 with 39 life firms representing 65% of the market share by premiums. Nine of the participants were small companies, an increase on the number taking part in QIS2, when there was a very low involvement by small firms. This improved data has enabled the FSA to draw appropriate conclusions about the impact of Solvency II on smaller companies.

Although solvency rates were lower than in Solvency I, the industry as a whole shows a substantial buffer over the Standard Capital Requirement (SCR). Additional work remains to be done however on adapting the model for larger insurance groups.

Findings from QIS3:

1: The UK Industry is measuring up well - The FSA's results were given by sector. This shows that QIS3 solvency ratios of actual capital held relative to the SCR are more consistent in each sector compared to those in Solvency I. So the industry's attempts to hold suitable capital against risks are going reasonably well;

2. More work is needed on calibrating the Minimum Capital Requirement - There is a substantial variation in the ratio between the Minimum Capital Requirement (MCR) and the SCR for different companies. This suggests that the approach tested in QIS3 was not sufficiently risk sensitive. In some cases, for example, this ratio was actually negative. In view of this, three alternatives are being considered for QIS4: a re-calibrated version of the modular approach used in QIS3, a compact approach that derives the MCR as a percentage of the SCR and a linear approach that determines the MCR as a percentage of technical provisions and other risk drivers, similarly to how it is done in Solvency I;

3. The Lapse Catastrophe Risk Calibration needs to be reconsidered – The calibration of the lapse catastrophe risk which requires holding 75% of the surrender strain was an area of concern for linked life providers. This calibration overstated capital requirements and had a significant impact on the companies' solvency position. More work is needed here as many believe that the current calibration is not at a reasonable level.

4: Actions of Life companies' management need to be better taken into account – The KC factors suggested in QIS3 to measure the difference in a firm's solvency before and after actions by its management, remain an area of conflict. The results show that the methodology to allow for profit sharing suggested in QIS3 could understate the SCR. Insurers have requested that the methodology is reviewed and that the basic capital requirement is derived net of management actions rather than using the KC factors approach.

Other significant issues that may be cause for concern include the omission of some of the asset classes in respect of calculating the capital charge for credit risk. More work is also need on the simple factor- based calculation specified for operational risk which will not be risk sensitive to underlying operational exposure. Operational risk modelling remains a big issue for the SCR formula with many UK firms commenting that the standard approach does not recognise the investment made by firms in risk management. The lack of diversification benefits between business written in different countries was also raised by some participants.

Calculation of the risk margin under the cost of capital approach - Many participants in QIS3 suggested that the 6% risk premium used in the calculation is too high to achieve market consistency. Feedback also included comments regarding the inclusion of market risk in the first year of the calculation and the absence of diversification benefits between product lines.

The implications for large insurance groups

Groups,as well as stand alone companies, exhibited a decrease in their solvency ratios when compared with those derived under the Insurance Groups Directive. The difference in the solvency ratios was mainly driven by the differences in the calculation of the QIS3 and Solvency I technical provisions and solo solvency requirements. Some groups with large operations outside the EEA might need to raise capital if local requirements did not meet the principle of equivalence. The biggest area of concern for groups was in respect of diversification benefits both within the EEA and with other non-EEA entities. Most if the participants agreed that the capture of group specific risks within the standard formulae was not possible due to the difficulty in defining and quantifying these risks.

Moving forward

The draft specification for QIS4 was released in December 2007 and finalised in March 2008. The study will run from April to June with the results of QIS4 available towards the end of the year. This may be the last chance for UK insurers to help calibrate the formula appropriately and to allow for the concerns about the calibration for the standard formula model for capital requirements indentified as part of QIS3 (e.g. the calculation of the MCR and the allowance for group diversification benefits). Industry participation is key to determine whether the unresolved issues are on track.

Then over 2009 CEIOPS anticipates issuing advice on the final shape of the regulation enabling the EU to adopt the implementing measures during 2010. This will lead to a target of 2012 for the new regime coming into force.

4.3 FSA clarification on reattributions

After questions from Clare Spottiswode the policyholder advocate in the Aviva reattributions the FSA issued clarifications on a number of issues around the reattribution process. This letter made clear that the FSA's rules require firms to ensure that use of the inherited estate does not impact unfairly upon the interests of current with profit policyholders.

In addition the FSA also stated that the following uses of the inherited estate would be acceptable:

- Supporting the writing of new business
- Making strategic investments

The letter also comments that further consideration is necessary to determine whether it is reasonable to continue the practice (which the FSA had previously allowed) of paying misselling compensation costs from the inherited estate.

4.4 Briefing on ICAS

In October the FSA published a document "ICAS – Lessons learned at looking ahead to Solvency 2" The main points of this included:

- the average FSA add-on is 14% with most firms receiving an add on in the range 0-10%;
- the degree of justification or supporting evidence from key assumptions in the model is given as one of the most common reasons for requesting additional capital;
- though progress has been made in important areas such as oversight and governance of the ICA process, models are still not fully embedded in firms' risk management frameworks;
- for ICA results to be used with confidence for business management purposes senior management need to understand and be able to challenge the most material actuarial judgements underlying the results;

There are key challenges that need to be addressed for successful group capital adequacy regime ahead of Solvency II.

4.5 Permitted links for long term insurance business

In September 2007 the FSA issued PS07/17 entitled 'Permitted Links for Long Term Insurance Business'. The policy statement confirmed that the changes in CP07/7 would be introduced. PS07/17 outlined the changes to the permitted links regime in IPRU(INS), IPRU(FSOC) and COB, governing which assets the unit-linked insurance sector can invest in. The changes came into force on 6 October 2007.

The previous Permitted Links rules had been in place for 13 years. The CP proposed a set of high level principles and rules for unit-linked insurance funds underpinned by more detailed rules on specific assets.

The main changes are:

- Allow investment in property through investment vehicles rather than only directly;
- Allow investment in property in properly functioning markets rather than only specified territories;
- Replace the current detailed "readily realisable" requirement for certain asset types by a high-level rule, based on what is necessary for the firm to meet its policy obligations;
- Allow unlimited use of authorized or recognised collective investment schemes (CIS) but restrict the use of certain other CIS to institutional policyholders which are defined as trustees of defined benefit occupational pension schemes; and
- Allow some tolerances to avoid the need for waivers in the case of minor breaches.
- Many of the current investment restrictions are being relaxed although retail funds restrictions remain.

Eight principles, in line with TCF and other regulations, were set out in the PS each of which was backed up by high level rules in COB (new section 6.14 in COB).

4.6 New COB

On 1st November 2007, the FSA's new simplified regime for the conduct of investment business – the Conduct of business sourcebook came into force. The new rulebook incorporates the implementation of the relevant conduct of business provisions of the Markets in Financial Instruments Directive (MiFID), but also covers firms and businesses outside of the MiFID scope.

Although insurance products are formally outside of the scope of MiFID, the FSA is planning to consider insurers on a "case-by-case" basis regarding its implementation. This is of particular importance to the life insurance industry as, with the large volumes of stakeholder pensions, investment trusts and other "investment vehicles" there remains a fair possibility of applying MiFID on a non-scope basis. Implementing MiFID to the investment portions of an insurer will in particular affect systems and processes of control and the management of conflicts of interest.

5 Financial Reporting

5.1 Phase II of IFRS for insurance contracts

On 3 May 2007, the International Accounting Standards Board ("the Board") released for comment a Discussion Paper on accounting for insurance and reinsurance contracts entitled 'Preliminary Views on Insurance Contracts' ("the DP"). This is the second phase of the insurance contracts project which in 2005 introduced IFRS 4 – the International Financial Reporting Standard for Insurance Contracts. The proposals set out in the DP would introduce fundamental changes to insurance accounting and focus on market consistent measurement of insurance liabilities. This will impact the way investors, regulators and other stakeholders assess the insurance industry.

The IASB insurance project aims to establish a common standard for financial reporting of insurance contracts, based on a form of "fair value". Phase I of the project (IFRS 4) provides a specific definition of an insurance contract, temporary dispensations from certain standards, and guidance on implementing current standards not covered by the dispensations. IFRS 4 was designed to enable insurance companies to report under IFRS by 2005. Phase II of the project is the introduction of a comprehensive IFRS dealing with the recognition and measurement of insurance contracts. Under Phase I there is currently no globally accepted insurance accounting practice and insurance contracts are not dealt with elsewhere in the body of International Financial Reporting Standards (IFRS). Differences in insurance accounting between some countries are material, making it difficult for users of financial statements to compare and understand results of insurance businesses worldwide. This, together with the complexity of insurance and the current attention focused on corporate accounting integrity, brings a need for a common financial reporting basis for insurance business. Another incentive for change has been the concern raised over the lack of transparency in existing bases of accounting for insurance. Stakeholders are demanding more information as to how insurance business and its inherent risks are managed and mitigated.

Overview of the Discussion Paper

The DP outlined the Board's preliminary views on the main components of the Phase II accounting model for all insurance contracts, including life, non-life, direct insurance and reinsurance. It sets out twenty specific questions and highlights a variety of issues, some controversial; following a six months consultation period which closed on 16 November 2007, an Exposure Draft (ED) is expected to be issued late in 2009. This ED will expose the comprehensive standard on the recognition and measurement for insurance contracts based on a "current exit value" basis, assuming the measurement model proposed in the Discussion Paper is agreed on. The final standard, now expected to be issued in 2012, should replace the temporary dispensations and interim accounting standard developed in IFRS 4.

The DP focuses on the measurement of insurance liabilities and the need for an approach that will provide more relevant information on the amount, timing and uncertainty of future cashflows, a consistent approach to changes in estimates, consistency of approach to all types of insurance and reinsurance for both life and non-life contracts, and consistency with other IFRS. It does not address the definition of insurance as set out in IFRS 4 but adds that the proposed ED will expose the current definition to further comment.

The DP also briefly touches on the recognition and derecognising criteria for insurance liabilities i.e. recognition of the rights and obligations when the insurer becomes a party to the contract and de-recognition when any specified obligation is discharged, cancelled or expired.

Measurement of liabilities

The main proposition in the DP is that all insurance liabilities (including life, non-life, direct insurance and reinsurance) should be measured at current exit value ("CEV") using the following three building blocks:

I. Current estimates: explicit, unbiased, market-consistent, probability weighted and current estimates of the contractual cash flows;

II. Time value of money: current market discount rates that adjust the estimated future cash flows for the time value of money; and

III. Margins: an explicit and unbiased estimate of the margin that market participants require for bearing risk (risk margin) and for providing other services, if any (service margin).

CEV is defined as the amount an insurer would expect to pay at the reporting date to transfer its remaining contractual rights and obligations immediately to another entity.

Typically, the CEV of an insurance liability is not observable so it must be estimated using the three building blocks described above. The purpose of this measurement attribute is to provide useful information that will help users make economic decisions.

Before concluding on a preliminary view of using the CEV as the measurement model, the Board considered other possibilities for a suitable insurance liability measurement attribute including the Embedded Value (EV) as described in the EEV principles published by the CFO forum. The Board noted that Market Consistent EV ("MCEV") techniques have a number of similarities with CEV. Both take into account the best estimate of all cash flows and do not use risk adjusted discount rates. However, there are differences, for example in their approaches to risk margins, and MCEV does not include a service margin. Notwithstanding the advantages of EV, the Board's view is that CEV is a more relevant measurement attribute.

5.2 Embedded Value Reporting

European Embedded Value has become the industry standard for embedded value reporting. 2007 saw most large European proprietary life insurers publish their results in line with the CFO Forum's European Embedded Value Principles. The introduction of the guidelines has seen more companies moved from the "top-down" approach to market risk to the more robust "bottom-up" market consistent technique. Allianz changed to the "bottom up" approach for their 2006 year end results. The release of margins possible as a result of this change generated €0.9bn of value. More firms are moving to this approach and it is very likely that this approach will be required when the CFO Forum issue its Market Consistent Embedded Value guidelines later in 2008.

The EEV principles also aimed to increase transparency through improved disclosures. While the level of disclosure was high, there is still scope for improvements in consistency and transparency. Currently there is no fixed format for movement analysis and the users of the statements would benefit from more detail on operating assumptions and operating experience.