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CURRENT ISSUES IN LIFE ASSURANCE SEMINAR

THE BARBICAN CENTRE, LONDON
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Issues relating to the implementation of PS06/14 – a perspective from a firm

This part will cover how FP and others addressed issues relating to:

- Allowance for a prudent lapse rates for policies without a guaranteed surrender value or a guaranteed surrender basis
- Allowing liabilities to be negative at individual policy level
- Reserving separately for non-attributable expenses

Prudent lapse rates and negative reserves

The main issues were

- Scope of application
- Margins in lapse rates
- Interest rates to apply for negative liabilities
- How to apply direction of prudence in lapse rates and interest rates
- Matching rectangles with negative liabilities

Scope of application

- Protection business only
- At least one company has applied lapse changes to linked business
- Further work to follow in 2007

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Lapse margins and application of prudence

- Margins against best estimates looked to ICA work
- Best estimates may be understated for negative liabilities. We have applied direction of prudence at individual policy level.
- Prudence at individual policy level is converted into larger margins at product type level
- We did not vary the direction of prudence over the term of policies. At least one other company does by varying the direction of lapse margins by duration.

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Interest rates for negative liabilities

- 0.5%p.a added to 15 year gilt yield to value negative liabilities
- Interest rate not reduced for tax
- INSPRU 3.1.29AG appears to imply that interest rate prudence should be applied at individual policy level. Interest margin applied at product type level for both positive and negative protection liabilities is increased to allow for this.

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Matching Rectangles and Resilience

- At what level should positives and negatives be offset? (e.g within protection, Protection v annuities)
- Insufficient real assets to match positive liabilities may be a constraint.
- If protection is matched against annuities what interest rates should be used?

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Non-attributable expense issues

Which expenses are not attributable?

How do we value the non-attributable expenses?

- Linked business only.
- Sterling reserve using cashflows calculated at homogeneous risk group level
- Size of 'homogeneous risk groups' was not important for us.
- Other companies use approaches involving comparison of future non-attributable expenses with loadings.

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Issues relating to rules and guidance for 2006 – perspectives from reviewing actuaries

- Issues encountered with PS 06/14 implementation
- Analysis of change in working capital

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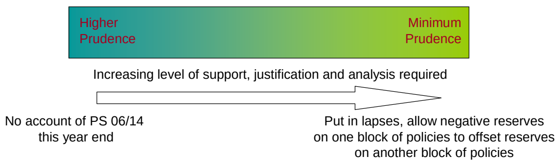
Issues encountered with PS 06/14

- PS 06/14 guidance is very generic. This has meant a very wide spectrum of approaches are being taken by different companies
- Due to many companies waiting to take full account of changes it will only be possible to know the full effect on reserves at 31/12/2007



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Tests Required

Tests Required
Testing the direction of prudence for interest rates
Testing the direction of prudence for lapse rates
Testing for avoidance of future valuation strain

The three tests are being performed on different groupings by some companies. What is acceptable in this area?

Companies also need to consider at what level negative reserves are used to offset positive reserves

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Interest rate impact on negative reserves

High or low interest rates can be prudent depending on whether policy reserves are positive or negative

Very few companies have disclosed the approach taken to setting the valuation interest rate. Where this has been done;

- Two rates specified – high rate for product groups with aggregate negative liability
- Low rate for product groups with aggregate positive liability
- Difference in interest rates 3% plus

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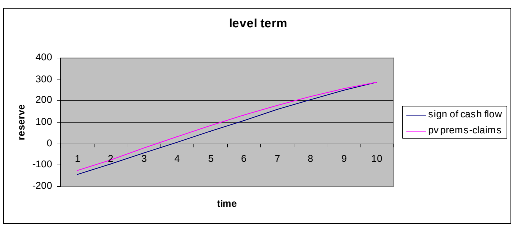
Allowance for lapses

Company	Approach
A	For certain contracts 2 rates are specified. The High rate is applied where a policy is an asset at a particular point in the projection; otherwise the Low rate is applied.
B	For the majority of protection business, a valuation persistency basis has been set by applying a prudential margin over the best estimate assumptions. The margin acts to increase the best estimate lapse rate in the early part of a policy's lifetime (when it is being treated as an asset) but to reduce the best estimate lapse rate later in the policy's lifetime (when it is treated as a liability). The crossover point at which the margin changes direction is assessed for broad product groups but applied at a policy by policy level
C	*Separate High and low rates (high rates typically 85% higher than low rates equivalent to a margin of +/-30%)* "For products where negative reserves are permitted we use the combination of lapse rates shown above and interest rates in 4 (2) that produce the most prudent result. Where negative reserves are not permitted the lapse rates are assumed to be zero."
D	*Typically +/-25% or 35% depending on class.* Low (high) lapse rate used where the reserve is positive (negative)
E	Reserve calculated using base lapse rate and +40% and -40% with the most onerous at the policy level being used

Policy by policy lapses



When considering whether higher or lower lapses are more prudent companies need to consider either:
•policy cash flows in a particular year
•future reserves for a policy

Non-attributable expenses

Issue	Approach
Definition of Homogeneous Risk Groups (HRGs)	▪ Focus (as expected) on unitised business ▪ A number of companies group all unitised business as a single HRG ▪ A number of companies split unitised business further but with 3 groups typically being the maximum ▪ Some companies appear to have generated a small amount of benefit from non-unitised business ▪ At least one company has grouped some unitised and non-unitised business in a single HRG
Non-attributable expenses	For classes of business where non-attributable expenses have been identified these represent; 4% - 38% of all valuation expense loadings 5% - 64% of loadings excluding investment expenses

Changes to reserving requirements - PS06/14

	Business/funds affected	Impact on solvency capital	Impact on value of in force	Valuation workload	Impact of IFRS accounts
Attributable/ non-attributable expenses	**Unit-Linked**	**Significant**	**Reduction**	**Increased – Expenses need to be allocated more carefully**	**Significant**
Lapse rates	**All**	**Significant**	**Reduction**	**Increased – Lapse investigation**	**Significant**
Policies held as assets	**Mainly Non-profit**	**Significant**	**Reduction**	**Increased – Policies will need to be valued differently if assets**	**Significant**
W-P internal transfers	**With-profit**	**Significant**	**None**	**Increased**	**None**
RCR removal	**W-P Realistic reporters**	**Peak 2 offices – None** **Peak 1 offices – Some impact**	**None**	**Reduced**	**None**

Analysis of change in working capital
IPRU(INS) Appendix 9.4A - section 13

(a) the investment return on the opening working capital;

(b) mismatched profits and losses on assets backing the future policy related liabilities (may include associated assumption changes);

(c) assumption changes split by economic, non-economic and *policyholder* actions assumptions;

(d) other variances split at least as to economic and non-economic variances;

(e) the impact of new business;

(f) changes in other liabilities of lines 47 and 51 of Form 19;

(g) modelling changes and opening adjustments.

Attributing expenses

- What does INSPRU 1.2.54A say?
- What might it mean?
- What might be the best practice?

What it says

- Paragraph 1 relates to “attributable expenses”
- This includes volume related expenses
- It does **not** relate to per policy expenses alone – it includes for example commission and investment management expenses

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What it says - continued

- Paragraph 2 relates to “non-attributable”
- It says a firm **may** determine reserves for non-attributable expenses at the level of a homogeneous risk group
- It goes on to say when a homogeneous risk group exists or may exist

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What does it mean?

- The use of **may** makes determination at other levels possible in principle
- Nothing says contracts in a homogeneous risk group cannot support higher level expenses as well – e.g. cost of CEO
- The guidance on when a group exists hints at, but does not mandate, some allocation at those levels
- A final sentence claims the approach (which approach?) ensures prudent reserves

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What might be best practice?

- Expense reserving is a combination of assets set aside and of margins from contracts earmarked for the purpose
- Contributions to overhead type expenses (“fully” non-attributable) can still come from almost anywhere, subject to prudence and allowing for voluntary discontinuance (no new prohibitions)

What might be best practice? - continued

- All expenses directly related to individual contracts should be attributed (paragraph 1)
- All expenses which can be attributed to a group of policies in a “homogeneous risk group” and **to no others** probably should be

What might be best practice? - continued

- All higher level expenses which are unrelated to any particular policies can be met by contributions from anywhere, or from assets, but:
  - Proper account needs to be taken of “run-off” – do they outlive the sources of revenue?
  - Undue reliance on particular classes should be avoided where discontinuance may create exposure
  - **But** consideration of the impact of a prudent level of lapses may remove the issues

Survey

- **33** forms completed
- About **13%**

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The Survey

- Have you read/used the revised Guidance Notes 44-47 as issued by BAS and effective from 31 December 2006?
  88%
- Have you had to refer back to the previous versions since the new ones were issued for any purpose?
  24%

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The Survey

- How useful (in practical terms) do you find these Notes compared to previous versions? If your answers are different for each GN, please indicate this.
  - a lot better………………………… 0%
  - a little better……………………… 38%
  - the same………………………….. 31%
  - a little worse……………………… 24%
  - much worse. ……………………… 7%

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The Survey

- Would you welcome Information and Assistance notes issued by the Profession which:
  - included some material which attempted to explain FSA rules? 59%
  - gave examples of methods an actuary can adopt which would be acceptable, but which acknowledge there are others? 79%
  - acted as a guide drawing together or referencing in one place other sources, including FSA material, ABI material and BAS material? 75%

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