The Actuarial Profession
making financial sense of the future

Life conference and exhibition 2010
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Close Calls

When to say yes and when to say no

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What is a close call?

Can arise for a number of reasons:

- tension between policyholders and shareholders;
- two or more parties in a transaction;
- situations which are not covered by rules/guidance;
- situations where there is no precedent.

- **In all these circumstances, it often falls to the Actuary to either make or recommend a decision.**

What could be the consequences of making the wrong call?

- Could get sued
  - onerous to defend even if groundless
- Could have a professional complaint raised against you
  - again onerous to defend even if groundless
- Could get disqualified as an FSA approved person for AFH/WPA
- Reputation tarnished generally

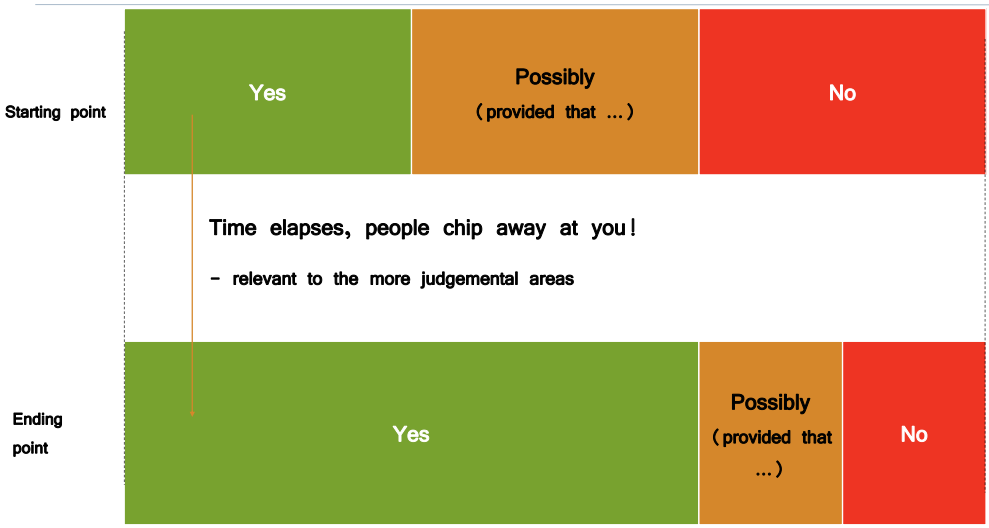
Applies to both consulting actuaries and life company actuaries.

Capacities in which close calls can arise

- As AFH, or as peer reviewer of an AFH
- As WPA, or as peer reviewer of a WPA
- As “independent person” under FSA COBS rules
- As independent expert in a Part VII transfer
- As Reviewing Actuary advising an auditor
- As senior actuary in an embedded value review/audit
- As senior actuary advising on a transaction

But also as a a life company actuary giving advice up the line, eg to the internal AFH or to an external AFH.

Be wary of getting pushed gradually …



Case studies

- Group A:
  - Specific cases – all actual cases
  - Yes or no answers
  - Sometimes yes with provisos
- Group B:
  - General areas
  - More judgemental
  - Virtually all life actuaries will have come across these

Case study A1 – borrowing cash from within unit-linked funds

- Background
  - Unit-linked offshore company
  - Short of liquid assets/cash in shareholder fund to pay expenses/commission
  - Parent did not want to inject new capital or provide funding
  - Significant policyholder unit funds actually invested in cash deposits
- Question
  - Can we borrow some cash from the policyholders' linked funds in order to meet shareholder cash needs, and pay an equivalent rate of interest on the loan?
  - Note: could work technically as surrender penalties would cover the amount in the short term
- Context/Role
  - Peer reviewer of the appointed actuary

Case study A1 – borrowing cash from within unit-linked funds

- Answer
  - No
- Reasons
  - No mention in policyholder contract or literature of ability of shareholder to borrow from policyholder
  - Concerns as to how/whether shareholder would find the cash to repay the loan by time of policy maturity
- Why close?
  - Because technically it could work if loan agreement had repayment date equal to maturity date
  - Because nothing explicit to say you cannot do this

Case study A2 – non-profit VIF in Form 19

- Background
  - Company had declining book of unit-linked life business in its with-profits fund
  - Company gave credit within unit prices for unrealised capital losses, but did not monitor this throughout market fall in 2008
  - At 31 December 2008, was carrying too much deferred tax asset in unit prices – could not be recovered on sensible assumptions
  - Needed to reduce unit prices as a result
  - Issue only identified in January 2009, ie 31 December 2008
- Question
  - Can we increase the 31 December VIF in Form 19 to allow for our planned reduction unit prices to correct the overstatement of the CGT asset?
- Context/role
  - Reviewing Actuary advising the auditor

Case study A2 – non-profit VIF in Form 19

- Answer
  - No
- Reasons
  - No firm plan as to when the change would be made, or what the magnitude of the change would be
  - Change, if/when made, properly falls into the following year
  - Change, if/when made, could have an effect on lapse rates and possibly lead to valid complaints
- Why close?
  - Because the company clearly did intend to put through a correction
  - Not covered by any rules/guidance

Case study A3 – tax charges on overseas reassurance

- Background
  - Part VII transfer involving a partial reassurance to Ireland of a block of unit-linked life business
  - Part of a larger financial re-structuring
  - Lower taxes on income and gains in Ireland than in UK
- Question
  - Can we levy charges for tax on the unit-linked funds as if UK tax rates were payable, even though actual tax rates are lower?
  - Note
    - shareholder benefits from the difference
    - contracts and literature very vague on tax charges and deductions
- Context/role
  - Independent Expert in the UK Part VII transfer

Case study A3 – tax charges on overseas reassurance

- Answer
  - Yes
- Reasons
  - Policyholders expect to be levied UK tax rates
  - Could not accept higher tax charges if reassurance was to a higher tax country
  - No reason not to accept reassurance to a lower tax country
  - Policyholders in exactly the same position
- Why close?
  - Because an alternative view is that the policyholders should benefit from the lower tax rates

Case study A4 – expanding/contracting unit-linked funds

- Background
  - Part VII transfer to merge two unit-linked companies – small company going into the large company
  - Both companies essentially closed to new business
  - Small company still growing as relatively young, with regular premiums coming in, and all funds priced on an **offer** basis
  - Large company declining with claims exceeding premiums, and all funds priced on a **bid** basis
  - Unit-linked funds being merged as investment objectives similar, standard equity fund, managed fund, etc

Case study A4 – expanding/contracting unit-linked funds

- Issue/question
  - Policyholders in small company will see a fall in unit values due to move from offer pricing basis to bid pricing basis
  - Timing issue only for longer term maturities versus, as small company basis bound to revert to bid basis over time; no real loss
  - Real issue for maturities over next five years; difficult to resolve accurately
- Context/role
  - Independent Expert in Part VII transfer

Case study A4 – expanding/contracting unit-linked funds

- Answer
  - OK, but …
  - Need to give an additional unit allocation funded by shareholders to compensate shorter term maturities
- Why close?
  - Needed a practical approach as very difficult to deal with these issues 100% accurately

Case study A5 – management actions in ICA

- Background
  - Carrying out ICA for a large portfolio of unit-linked and charges based UWP business
  - Considering what management actions might be possible in stress conditions
  - Not much which can be done in many stresses, but …
  - Can consider increasing non-guaranteed charges in the expense stress
- Question
  - Is it reasonable to increase charges on unit-linked business in a 1 in 200 expense stress?
  - Need to consider policy conditions, policy literature, TCF rules, unfair contract terms rules
  - Plus, would be it be fair, reasonable and proportionate in the circumstances?
- Context/role
  - AFH

Case study A5 – management actions in ICA

- Answer
  - Yes, not an unreasonable management action to recommend, but …
  - Share pain 50/50 between policyholders and shareholders in order to demonstrate proper consideration of TCF
  - Check out position will legal and compliance teams, and check policy documentation and literature (which was fine)
  - Get Board buy-in (which was obtained)
- Why close:
  - Due to need to ensure TCF considered and a fair balance adopted between policyholders and shareholders

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Case study A6 – expense deal in a mutual with-profits insurer

- Background
  - Took over as AFH/WPA of a mutual with-profits insurer
  - Investigations revealed that expenses being charged to asset shares were increasing each year
  - Unchecked, these expenses would become a large proportion of premiums/asset shares and would clearly breach TCF
  - No indication of this issue from previous AFH
- Question
  - What to advise?
- Context/role
  - AFH and WPA, but with emphasis on WPA

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Case study A6 – expense deal in a mutual with-profits insurer

- Answer
  - Cap expense charges to asset share at a sensible level, similar to recent years
  - This crystallises a maintenance expense overrun
  - Implications for Pillar 1 and Pillar 2 balance sheets – need to reserve for n years of overruns
- Why close:
  - Because overrun could call into question the longer term viability of the mutual

ALSO: SEVERAL OTHER CASES/CONTEXTS AS WELL WHICH ARE ESSENTIALLY THE SAME AS THIS ONE

Case study B1 – credit spreads

- Background
  - Credit spreads started to widen in 2008
  - Given low recent default experience many insurers had low long term default assumptions
  - FSA rules for Pillar 1 require a prudent assumption but no real indication of what that means
  - Capital requirements vary greatly with different levels of default assumption
- Questions
  - What is really a short term effect and what is a step change in long term reality?
  - Need to consider actual asset portfolio and yield currently being earned?
  - Plus, what are the implications for EV, IFRS and Pillar 2?
- Context/role
  - AFHs, senior company actuaries, Reviewing Actuaries

Case study B1 – credit spreads (continued)

- Answer
  - No simple answer, varies by company and asset portfolio
  - Historical analysis may not be relevant to current economic situation, consider scaling to current situation in some way
  - Consider financial market indicators
  - Develop a working rule to cope with ongoing volatility
  - KPMG working rule for year end 2008
  - Get buy in of Board
  - Clear rationale for approach to demonstrate have considered all regulatory and other requirements

Case study B1 – credit spreads (continued)

- Answer (continued)
  - Keep under review as economic conditions change over time
  - Consider consistency with IFRS approach, EV and treatment of any short term provisions, Pillar 2
  - For MCEV consider applicability of liquidity premium with CFO Forum principles
  - Consider application of “hold to maturity” principles to other blocks of business eg particularly overseas business with annuity type features
  - Consider overall yield achievable on pools of assets backing a portfolio of liabilities and the degree to which a liquidity premium can be justified
  - Consider when any “additional” capital held may be released

Case study B1 – credit spreads (continued)

- Why close:
  - Significant FSA and investor scrutiny, significant judgement required, significant capital injections required in some situations and shareholder pressure to release capital quickly
  - At least one large listed company had to change its approach publicly due to market pressure and analyst comment
  - Illustrates dangers of making the wrong call

Case study B2 – transactions

- Background
  - Adversarial situation, both sides looking to get the best deal
  - Essentially room for significant disagreement over interpretation and application of judgement, remember Professional Conduct!
  - Significant financial implications depending on where land on key assumptions
  - Often very complex and many non-actuaries rely on actuaries for advice
- Question
  - How far should you push assumptions – on both sell and buy side?
  - How do you quantify potential synergies – potentially on very little data?
  - What are the implications for the business going forward once a deal is done?
- Context/role
  - AFH, senior company actuaries, consulting actuaries involved in deals

Case study B2 – transactions (continued)

- Answer
  - See slide 4!
  - Justify why would move away from assumptions commonly used for EV reporting – based on experience / benchmarking and provide evidence to back up
  - Look at in the round – are you suggesting anything that is “new” in the market or significantly out of line with other practices
  - Is there a logical explanation to synergy calculations that justifies the approach
  - Would you be happy running the business yourself going forwards based on the financials you are suggesting and have you set out any caveats

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Case study B2 – transactions (continued)

- Why close:
  - Significant FSA and investor scrutiny, significant judgement required, increasingly litigious environment
  - Much more likely to affect life office actuaries involved in due diligence discussions with the “other” side

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Case study B3 – capital release / risk transfer schemes

- Background
  - Increasing focus on releasing capital / reducing risk – particularly using capital market type solutions
  - Usually very complex, usually requires application of significant judgement to “grey” areas of the regulations
  - Banks increasingly bringing innovative solutions to this area
  - Regulatory scrutiny high
- Questions
  - Does the scheme reduce security for policyholders / genuinely transfer risk?
  - How do you quantify the impact on security / amount of risk transferred?
  - Have you considered all possible reporting bases including Solvency II to ensure there are no risks to the company / policyholders?
- Context/role
  - AFH, senior company actuaries, reviewing actuaries and consulting actuaries involved in deals

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Case study B3 – capital release / risk transfer schemes

- Answer
  - Set out the risk that is being transferred and in what circumstances the company / policyholders are still at risk
  - Set out the rules and regulations that you are following and demonstrate clearly why it is in compliance
  - Do this on a number of bases
  - Would you be happy with this if you had a policy that was affected?
- Why close:
  - Significant FSA scrutiny, often based on interpretation of the rules rather than being clear cut, usually an “innovative” feature not seen before

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Questions or comments?

Expressions of individual views by members of The Actuarial Profession and its staff are encouraged.

The views expressed in this presentation are those of the presenters.

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