The Actuarial Profession
making financial sense of the future

consultation response

# Financial Services Authority Consultation Paper CP09/20 - Quarterly Consultation

August 2009

**The Actuarial Profession**
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Dear Trevor

## FSA Consultation Paper CP09/20 Quarterly consultation

Thank you for providing the Actuarial Profession with the opportunity to comment on this consultation. Our substantive comments are attached to this letter.

If you have any questions or would like to discuss any of these matters further, please do not hesitate to contact us as per details below.

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Yours sincerely

Andrew Chamberlain
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## Introduction to The Actuarial Profession

Actuaries provide commercial, financial and prudential advice on the management of a business's assets and liabilities, especially where long term management and planning are critical to the success of any business venture. They also advise individuals, and advise on social and public interest issues.

Members of the Profession have a statutory role in the supervision of pension funds and life insurance companies. They also have a statutory role to provide actuarial opinions for managing agents at Lloyd's.

The Profession is governed jointly by the Faculty of Actuaries in Edinburgh and the Institute of Actuaries in London. A rigorous examination system is supported by a programme of continuing professional development and a professional code of conduct supports high standards reflecting the significant role of the Profession in society.

**Response to CP09/20 – Quarterly consultation (No.21)**

The UK Actuarial Profession is pleased to be able to comment on your Consultation Paper 09/20 Quarterly Consultation. We have concerns at the proposed amendments to INSPRU 3.1.45 R and INSPRU 3.1.46 R. The proposal for realistic basis life firms with respect of their with-profits insurance contracts is likely to be welcomed, but that for other business is likely to have material difficulties in implementation.

Firstly, for with-profits insurance contracts of regulatory basis only life firms, the net premium method of valuation still applies under INSPRU 1.2.38 R. The process for setting a net premium under the Glossary definition is impractical to follow where future investment rates depend upon the time of each premium payment. Aside from the need to settle appropriate terms for those premiums paid in the past (where clearly the only available rate is on the matching assets) there will then be a series of potential investments in the future, but the amount of these is a function of the increase in reserves required at each future point. This increase is itself a function of the rates of interest to be assumed, and a highly complex calculation follows. The net premium method does largely rely upon using a simple approach to the interest rate to give a stable net premium. It is normal practice for such net premiums to be calculated with regard to the lower of current hypothecated asset yields and the current rate obtained by applying INSPRU 3.1.45 R (1), unless future investment is clearly no longer an issue (on demonstrably declining Funds). We do not believe that there is a ready solution to this problem utilising a curve for future rates, and would suggest that the intention behind the structure of the current rule was to provide a reasonable basis to arrive at a single rate, and the retention of the formula coupled with the obligation not to exceed the current yield on hypothecated assets removes any need to apply a curve.

We suggest that the FSA should allow regulatory basis firms the option of continuing to comply with the existing rules for their with-profits business. The alternative is for the FSA to accept that it will be necessary to abandon the net premium method in order to make this change. However, this will necessitate some other mechanism to protect the bonus loadings from misappropriation.

We do not see the change as entirely helpful for other classes of business either, as it materially complicates the calculation for little benefit while the margins are retained. There is a duplication of margins when the yield curve is upwards sloping and necessarily modest benefits when the curve is downward sloping, and then only when that slope is very long lasting. The calculation changes may have significant costs, especially for those not already using such a method for with-profits business, which includes smaller offices and those which write no with-profits business. Where cash flow techniques are employed the problems are not prohibitive to overcome, though they are significant, but for those utilising traditional formula based methods the overhead will be very significant.

If all regulatory basis firms are required to abandon the net premium method then the costs of rewriting valuation systems will be very significant, and the benefits minimal. Many smaller firms will be required to incur significant costs with no discernable benefits. It is also unnecessarily onerous to require such firms to rewrite their systems now and then to change them again to bring them into line with the requirements of Solvency II We note that the FSA indicated that there would be no substantive changes to its rules before the implementation of the Solvency II Directive. Although it might not appear to be so, this is a very substantial change for a significant number of firms, and we suggest that such a change should not be made, or at least firms should be given the option of complying with the existing rule up to the time when Solvency II comes into force.

We would urge FSA to think again on this change and to consult informally on alternatives, and we would be happy to assist in any way we can. If FSA declines to change this proposal, then we must urge that firms be given a significant time to comply. We consider that it could not be considered reasonable to be compelled to apply this rule change with less than six months notice, given the need for design, programming and rigorous testing that such fundamental changes would require. We do not consider the mandatory introduction of this change in 2009 is feasible, therefore.