Institute and Faculty of Actuaries

The impact of different currency options on the Scottish Life Insurance sector

by IFoA Scottish Independence Working Party

June 2014

The impact of different currency options on the Scottish Life Insurance sector

The life insurance industry in Scotland is a major part of the Scottish financial sector, itself a major component of the wider economy, contributing significantly to Scottish GDP and employment. Actuaries have been at the forefront of the development of both the UK and Scottish insurance industries for over 150 years.

This note is set in the context of recent information provided by a number of authoritative sources including the Fiscal Commission Working Group, the Scotland Analysis Programme and the Bank of England. Our intention is to provide further context to the currency debate by presenting an analysis of the different options considered thus far from the perspective of actuarial professionals working in the life insurance sector.

As an independent, not-for-profit, professional body with a Royal Charter, the Institute and Faculty of Actuaries (IFoA) has a public interest duty to uphold. We believe the public interest is best served by having an electorate that is fully informed and it is for this reason that we seek to enlighten the debate on Scottish independence ahead of September’s referendum. We hope to do this by highlighting key issues, relevant to the debate, in the areas that actuaries work.

We do not side with any political group on this or any other political question. This paper does not, therefore, make any recommendation as to which currency option is best suited to Scotland, should it become an independent country. Instead here we present a balanced analysis of each of the main options which have been assessed by the above bodies, highlighting the advantages and disadvantages of each in turn.

We do not disregard recent declarations by Her Majesty’s Treasury, and the three largest Westminster political parties, ruling out a formal Sterling currency union between Scotland and the UK in the event of a 'Yes' vote in the referendum on Scottish independence. At the same time, however, we cannot ignore the fact that this option is the stated preference of the Scottish Government. In the spirit of political neutrality, and noting that the Bank of England continues to hold technical discussions with the Scottish Government, we present here our considerations of the likely impact that adoption of each of the main currency options would have on the life insurance industry. These are as follows:

1) The creation of a formal Sterling currency union;
2) Informal retention of Sterling;
3) Creation of a new Scottish currency; and
4) Formal adoption of the Euro.

We have looked at each of these options in turn bearing in mind the following points:

- For most Scottish life insurers the majority of their UK customers live outside of Scotland and would presumably continue to pay premiums and receive claim payments in Sterling after independence. Additionally, many insurance companies based in the rest of the UK (rUK) have a sizeable customer-base within Scotland that would likely wish to transact in whichever currency an independent Scotland adopted.

- Legal agreements underpinning existing insurance policies in Scotland are likely to specify that payment of premiums and claims are always made in Sterling. It is unclear at this time what would define a ‘Scottish’ insurance policy, or whether any such policies would automatically be switched to a new currency. We assume that the necessary legislation to ensure continuity of contract through a change in payment currency would be passed by a Scottish Parliament (if not, insurers may need to cancel existing contracts and ask customers to sign new ones). However, we note that establishing a fair conversion rate that accurately reflects the 'Sterling' value of the contract in a new currency is not necessarily a straightforward process, and recall similar problems that arose in the Eurozone following adoption of the Euro.

- A key investment approach regularly employed for reducing risks to both the insurer and the customer is the practice of 'matching liabilities' - whereby an insurer invests premiums received into assets that make cash payments of similar size and frequency to those the insurer expects to make to customers. In order to minimise exchange rate risk, it is common for insurers to seek to invest in assets denominated in the same currency as the payouts they will make to their customers.

- Insurers may face shareholder or other pressures to move their head office to the currency region where they transact the majority of their business. Other commercial options may be considered in light of their specific circumstances.

Whatever currency option is the outcome, there would need to be separate Scottish and UK books of business if the sector became subject to two different tax and regulatory regimes. For the consumer this would mean Scottish and UK insurance policies would be subject to supervision by the relevant authorities in the two separate countries. For insurers this is likely to mean having Branch or Subsidiary operations in different jurisdictions to support the different books of business in the same way as between the UK and Republic of Ireland at present.

Under a Sterling currency union arrangement, insurers would be faced with compliance to three regulators instead of the present two – the Prudential Regulation Authority (PRA) and Financial Conduct Authority (FCA) in the UK, with the addition of a new Scottish regulator which will assume the key responsibilities of the UK FCA in Scotland (as set out in the Scottish Government's White Paper from November 2013 *Scotland's Future*).

If an independent Scotland moved to a new currency, then it is likely that a Scottish regulator would need to be established to cover prudential regulation, meaning that Scottish insurers conducting business across Scotland and the UK could in fact be required to comply with four different regulators.

1) The creation of a formal Sterling currency union

Under this scenario, we would envisage Scottish life insurers continuing to receive premiums from, and pay claims to, all policyholders in Sterling. Insurers would not be exposed to currency risk and additional trading costs.

The main advantages of this scenario are:

- Stability: there may not be an immediate need to change the terms and conditions of existing policies based on currency and no need to rebalance portfolios to maintain any matching that was in place;
- Administrative simplicity for industry and individuals; and
- No trading costs and no additional difficulties in matching assets and liabilities.

The main disadvantages of this option are that:

- Depending on the joint agreements and conditions laid out in the political negotiations to establish a currency union, both countries may need to harmonise aspects of regulation, for example the reserving requirements or policyholder protection levels, however there is no guarantee that a harmonised approach would be in the best interests of the insurance markets in both countries;

- Given the recent experience of the Eurozone it is hard to be certain of the long-term continuation of a currency union.

2) Informal retention of Sterling

Under this scenario, we would envisage Scottish life insurers continuing to receive premiums from, and pay claims to, all policyholders in pounds Sterling. Insurers would not be exposed to currency risk or additional trading costs.

The main advantages under this scenario are similar to those of establishing a formal currency union. However, the main disadvantages of this option are that:
- Scotland would find itself without a lender of last resort;
- It is not clear how macro-prudential policy would be formulated and how systemic risks would be mitigated by the Scottish Government, and what appropriate bailout mechanisms would be established; and
- Liability matching and capital requirements may encourage investment in Sterling based activities in rUK rather than in Scotland, depending on how insurers view the relative long-term prospects of each economic area.

3) Creation of a new Scottish currency

Under this scenario, Scottish life insurers would receive premiums from, and pay claims to, policyholders in Scotland in the new Scottish currency and receive premiums from, and pay claims to, rUK policyholders in Sterling.

Unlike option 4 below (formal adoption of the Euro), there would be no Scottish currency assets for insurers' investments at the outset. It would be expected to take many years for a deep and liquid (mature) market of such assets to develop. This has implications for the currency hedging approach, either with an absence of an adequate hedge and/ or placing higher capital holding requirements on insurers.

If the insurer's existing Scottish business had to change from Sterling to a new currency, the insurers could be mismatched and exposed to currency risk and additional trading costs in respect of their existing business. The price of Scottish currency matching assets would reflect market views of the additional risks from this new market to investors, and would also reflect the demand versus the supply of such assets.

The main advantages under this scenario are that:
- Having insurance contracts priced in a currency that moves in line with the Scottish economy, rather than one reflecting a larger economic area (that, overall, may not share the same characteristics), would allow insurers to more finely tune their policies to reflect the needs of Scottish consumers; and
- The Scottish Government would have greater autonomy to take action to mitigate the risks of major insolvency events occurring in Scotland.

The disadvantages of this option will be similar to option 4 (formal adoption of the Euro) but:
- Insurers could be mismatched and exposed to currency risk and additional trading costs in respect of existing business.
- The price of Scottish currency matching assets would also reflect market views of the additional risks from this new market to investors. This is likely to increase the costs of insurance for consumers.
- As with the adoption of the Euro, insurers could face significant rearrangement costs in having to develop separate systems to manage their Sterling business and Scottish currency business separately.

- Scottish insurers may seek to exchange the currency of their future commitments (including existing business) through currency swaps. This could also result in a transfer of value from the shareholders (and for With-Profits funds, the policyholders) of Scottish insurers to investment banks (mostly based in London/ US/ Germany) who charge a margin whenever currency changes denomination.

4) Formal adoption of the Euro

With 18 countries now in the formal Euro system it has become the world's second largest reserve currency. However the Eurozone has faced significant pressure since 2008 and uncertainty remains over the long-term viability of the currency.

It should be noted that no certainty has, to date, been provided as to whether Scotland would automatically become a Member State of the European Union. It remains unknown under what timeframe and legal process membership would be attained, if indeed it could be attained. This could have wider implications for Scottish insurers beyond the question of currency – for example whether the EU requirement for gender-neutral pricing (GNP) would be maintained.

If Scotland is required to join the EU as a new entrant and, unless the Scottish Government can negotiate an opt-out of the Euro, a strict application of the accession treaties would require adoption of the Euro as its national currency. However, this would not take place straight away, thereby creating uncertainty for any interim currency arrangements. Indeed Scotland may be required to join ERM II in the first instance. This would require Scotland to introduce its own currency in the interim, as ERM II requires that the applicant country's currency is stable against the Euro for two years prior to joining the Euro.

If the Euro were adopted at a future date, Scottish and UK life insurers would be expected by Scottish based policyholders to receive premiums from and pay claims in Euros, while receiving premiums from and paying claims to UK policyholders in pounds Sterling.

The main advantages of this option, relative to option 3 (creation of a new Scottish currency), are that:

- There is a wide range of Euro denominated assets in which insurers can invest without risking exposure to movements in exchange rates; and
- The market for Euro denominated assets is mature, providing a reasonably stable source of matching assets for insurers.

The main disadvantages of this option are that:

- To accommodate customers' needs, insurers would need to make IT changes and rearrange internal practices to separately administer Euro business and Sterling business, which could incur significant costs on insurers (which may then pass through onto customers), although there is precedent for this - UK insurers operating in the Republic of Ireland had to make similar changes when it adopted the Euro.
- Insurers may need to sell some Sterling assets used to back Scottish policies and replace them with Euro assets, so incurring trading costs; and
- Legal agreements underpinning insurance policies in Scotland are likely to specify the payment of premiums and claims in Sterling. Whilst there are existing legal procedures for agreeing continuity of contracts during a change in national currency, establishing a conversion rate that is fair to both sides of the contract is not necessarily straightforward.

This paper was written by a working party of the Scottish Board of the Institute and Faculty of Actuaries, whose membership includes:

- John Brogan
- Stephen Cunningham
- Dave Gordon
- Xian Li
- Stuart Mainland
- Keith Miller
- Martin Potter
- Alan Rankine
- Andy Sinclair
- Kenny Tindall
- Alan Watson
- Nick Wright

Contact the Public Affairs team at the IFoA with further enquiries:

Nick O'Hara, Head of Public Affairs
Nick.Ohara@actuaries.org.uk
020 7632 1458

Paul Reynolds, Director of Public Affairs
Paul.Reynolds@actuaries.org.uk
020 7632 1468