New Guidance Notes for the Integrated Prudential Sourcebook

Mike Kipling, Chairman, Life Supervision Committee
Changes on commencement of PRU

- Appointed Actuary role abolished
- Firms have responsibility for liability valuation
- Liability valuation to be audited
  - with actuarial input
- Twin peak approach for large with-profits funds
- ICAs for all
- With-profits actuary role created
- Enhanced ‘systems and control’ requirements
- Peer review - WPA [and AFH?]
Earlier Changes

- Some firms’ realistic balance sheets in FSA returns
- PPFM published
- Independent input into with-profits governance
- Firms to report on exercise of discretion for balance of current financial year
  - in preparing this report, firm should take advice from an actuary (COB 6.11.14G)
  - starting from ????
Existing guidance

- Replaced
  - GN1, GN2 and GN8
- Updated
  - GN7 and GN37
New guidance

▪ Generic guidance to life actuaries with formal roles under PRU/SUP
  ▪ GNL1

▪ Guidance on fulfilling specific roles
  ▪ GNL2 (Actuarial Function Head)
  ▪ GNL3 (With-profits Actuary)
  ▪ GNL4 (Reviewing Actuary and WPA Peer Reviewer)
  ▪ GNL5 (Appropriate Actuary)
  ▪ GNL6 (Lloyd’s Life Actuary)
New Guidance

Guidance on technical issues

- TS1 (Mathematical Reserves and Resilience Capital Requirement)
- TS2 (With-profits Insurance Capital Component)
- TS3 (Individual Capital Assessment)
- TS4 (Stochastic Modelling)
  - to be discussed in break-out sessions

‘TSs’ are not addressed specifically to actuaries

- will count as ‘generally accepted actuarial best practice’ for the purposes of PRU, so apply to firms.
- will apply to all actuaries formally involved
GN L1 - Generic

- Applies to all with ‘FSA’ roles except Lloyd’s actuaries

Section 1
- Possession of relevant knowledge and experience and of an appropriate practicing certificate.
- Audience to be aware of when advice given ‘in role’.

Section 2
- Reminds of regulatory obligations, including ‘whistleblowing’.
- Requires disclosure of practices which differ from guidance.

Section 3 - Conflicts of Interest
- Same individual can be AFH and WPA
  - If so, FSA prevents from being director
GN L1 - Generic

Section 3 cont.- Conflicts of Interest
- WPA can report to AFH
- If either WPA = AFH or WPA < AFH, WPA must seek peer reviewer ‘sign-off’ in advance on any advice likely to be perceived as against with-profits policyholder interests.
- Reviewing Actuary and WPA peer reviewer can be the same individual
  - Must be independent of insurer
  - May not be AFH or WPA

Section 4 - AFH and WPA
- If same person, board to be aware which hat is being worn
- If different, must maintain regular, direct contact.
GN L1 - Generic

- **Section 4 cont. - AFH and WPA**
  - AFH responsible for verifying that recommended valuation basis takes account of PPFM
  - WPA to be aware of capital implications of advice on exercise of discretion
  - WPA to be happy with asset share calculations if carried out by AFH
    - including compliance with PPFM

- **Section 5 & 6 - Reviewers**
  - Inappropriate for AFH or WPA to place reliance on any work carried out by reviewing actuary or WPA peer reviewer respectively.

- **Further suggestions welcome.**
GN L2 - Actuarial Function Holder

Section 1.
- GN written as if only one AFH for firm
  - if more than one, clear apportionment of responsibilities must be obtained and each should seek to find a common view if possible.
- Assumes no requirement for peer review in addition to audit
  - but still under consideration
- Refers to TS1 - 4

Section 2 - Regulatory requirements
- PS167 reinstated SUP requirements for AFH to advise on risk and to monitor ability to meet ‘liabilities to policyholders’
  - as ‘liabilities to policyholders’ includes fair discretionary benefits there is overlap with WPA
  - possibility that FSA may simplify, so old GN1 guidance left unchanged for now (Sections 3 & 4).
GN L2 - Actuarial Function Holder

▪ Section 2 cont.- Regulatory requirements
  ▪ AFH to obtain written instructions as to which extra-statutory responsibilities have been apportioned to him/her, especially of those listed in SUP 4.3.15G.
  ▪ AFH not to accept appointment unless has right of access to board.

▪ Section 5 - Methods and Assumptions
  ▪ AFH must provide enough information about material factors to enable the board to judge
    ▪ the appropriateness of the advice
    ▪ the implications of accepting it
      ▪ including the implications for the policyholders of the firm.
GN L2 - Actuarial Function Holder

- Section 5 cont.- Methods and Assumptions
  - If firm’s required basis falls outside a reasonable range of uncertainty around AFH recommendations
    - AFH must inform the firm of this opinion.
  - If the firm does not alter its instructions
    - the investigations or calculations must then be carried out on the assumptions provided by the firm.
  - AFH must consider whether this would be a matter to communicate to FSA under GN37

- Sections 6 & 7 - Investigation & Reporting
  - Still to be developed
GN L3 - With-profits Actuary

Section 1

GN written as if only one WPA for firm
- if more than one, clear apportionment of responsibilities must be obtained
- professional requirement not to normally accept a split role unless in respect of a clearly defined sub-fund

Requirement for peer review in respect of formal advice given to firm and annual reports to firm and to policyholders

Section 2 - Regulatory requirements

mainly a summary
GN L3 - With-profits Actuary

- **Section 3 - Relationship with Firm**
  - Mainly summarises regulatory position
  - WPA should ensure access to adequate data
  - Should ensure that appointment allows comment on with-profits sales literature and regular communications prior to production.

- **Section 4 - Reporting**
  - Based on GN1 - but new guidance on report size/content
  - WPA should normally exercise right to present to board
  - Possible communication requirement under GN37 if inadequate allowance for future bonus in
    - mathematical reserves for ‘regulatory basis’ firm
    - realistic balance sheet for ‘realistic basis’ firms.
Section 1

The practicing certificate held must be relevant to the type of business of the firm.

Section 2 - Role of Auditor

Explains that auditor must take advice from an actuary
- the ‘reviewing actuary’

May rely to an extent on his or her advice (SAS 520)
- but ultimately must make up own mind on value placed on liabilities and on capital requirements.

Refers to auditing guidelines PN20
- to be updated to include PRU liability audit?

Reviewing actuary does not formally advise on Companies Act accounts
GN L4 - Reviewing Actuary and WPA Peer Reviewer

- Sections 3 & 4 - Roles
  - Summarises FSA Reviewing Actuary certification requirements
  - Requires WPA peer reviewer to report to WPA on whether the duties reviewed have been performed in accordance with FSA rules and actuarial professional guidance.
  - What additional guidance, if any, is needed?
TS1 - Mathematical Reserves and Resilience Capital Component

- Residual guidance from GN8
  - much already in PRU 7.3
  - plus some new guidance
  - order follows PRU 7.3

- Section 1
  - introduction
  - additional reserves plus disclosure if data unreliable

- Section 2
  - now explicit rule not requiring MR for final bonus
    - but provision in realistic b/s and/or ICA
  - CP195 text implies no MR for future annual bonus
    - but draft rules still require
    - draft TS1 follows rules - but may change.
Section 3 - Margins for adverse deviations.

- PRU 7.3 requires margins which are “sufficiently prudent to ensure that there is no significant risk that liabilities will not be met as they fall due”.
  - Surprisingly onerous - and similar to ICA
- For main market risks, OK to assume that PRU 4.2 plus the resilience capital requirement satisfy this
  - but not for, say, volatility risk on embedded options.
- PRU 7.3.18 -19 suggest that the firm’s own or a market risk premium may be an appropriate margin
  - or an external proxy (i.e. a published mortality table)
  - important to square these with above definition, if not changed.
- Need to consider stochastic modelling of mortality now
TS1 - Mathematical Reserves and Resilience Capital Component

- **Section 4 - Avoidance of future valuation strain**
  - clarifies that reasonable, experience-based, paying-up assumptions may be used
    - i.e. no need to assume all made paid-up at worst time
    - consistency of expense inflation and investment return assumptions (but must be overall prudent)

- **Section 5 - Interest Rates**
  - need to ensure that overall tax liability is allowed for in netting down
    - if asset allocations differ from those for tax purposes
  - allocation of assets to liability classes need not, for realistic basis firms, be the same as under PRU 7.4. 23
TS1 - Mathematical Reserves and Resilience Capital Component

Section 5 cont. - Interest Rates

- guidance given on earnings to be used in equity yield calculations
  - remove one-off profits
  - adjust for published half-year results and stock-exchange announcements
  - no need to adjust for analyst forecasts, whether in-house or not.
- PRU 4.2.36R requires adjustment to yields for credit risk
  - know how to do for bonds
  - what guidance is needed for equities and property?
  - To what extent does market price this risk anyway?
- Is guidance needed on how to apply forward yield curve?
  - As realistic basis firms are required to do
  - E.g. acceptable approximations?
TS1 - Mathematical Reserves and Resilience Capital Component

▪ Section 6 - Future premiums
  ▪ net premium method may still be used by realistic basis offices
    ▪ provided premium valued does not exceed gross
    ▪ and adequate allowance for expenses (and future bonus?)

▪ Section 7 - Expenses
  ▪ generally little changed from GN8
  ▪ is any more guidance required?

▪ Section 8 - Mortality & Morbidity
  ▪ requirement to assume that current rates of annuitant longevity improvement continue
    ▪ unless good reason
    ▪ may apply by birth-year cohort
    ▪ margin must assume increase in improvement rate
**TS1** - Mathematical Reserves and Resilience Capital Component

- **Section 8 cont.- Mortality & Morbidity**
  - may net off margin against decreasing trend in assurance mortality
  - but allow for critical illness claim trends
    - e.g. angioplasty
    - especially for guaranteed rate products

- **Section 9 - Options**
  - GAOs
    - rules require 95% take-up after 20 years
    - GN requires uniform progression from a prudent current rate to that
  - TS4 on stochastic modelling may be relevant
  - May only assume lower than current MVR on mass surrender if PPFM explicitly allow this.
TS1 - Mathematical Reserves and Resilience Capital Component

**Section 9 cont.- Options**
- PRU 7.3.70(1) requires adequate reserves for each policy
  - PRU 7.3.70(4) lifts this to apply only at the level of ‘groups of similar contracts’
  - What are these groups? Should FSA or profession define?
  - Similar issue with non-option reserves in PRU 7.3.28

**Section 10 - Persistency**
- Needed for realistic basis offices
  - must assess whether increase or reduction is prudent
  - may be different directions for different classes or on particular events
  - rules require increasing prudence further into the future

**Section 11 - Reinsurance**
- What guidance is needed?
Section 12 - Resilience Capital Component

- PRU 4.2.15 (1) to be interpreted as not allowing an increase in running yield after equity/property fall
  - i.e. consistent with realistic balance sheet requirements
  - potentially quite harsh, given property covenants and earnings yield restrictions
  - possibility of change in PS195?

- Revised hypothecation of assets can take place in stress scenario
  - but only using assets originally hypothecated to liabilities or to the 4.2.9 (3) ‘shortfall’

- Assets allocated to 4.2.9 (3) shortfall may come from outside the long-term fund.

- Still allowed to relax any ‘hidden’ margins and any asset PAD
TS2 - With-Profits Insurance Capital Component

- Covers all elements of the realistic balance sheet
- Sections 1 - 3
  - General introduction
  - Need to develop guidance on fair allocation of assets
  - Note need to keep each asset share parameter until last policy using it has expired
- Section 4 - Value of Assets
  - Guidance so far only on value of non-profit business
    - Must not take credit beyond a ‘market consistent’ value
    - May be negative if statutory basis asset allocation ‘artificial’
- Section 5.2 - With-profits benefit reserve
  - Main ‘message’ is consistency with practice
    - PPFMs and terminal bonus calculations
Section 5.2 cont. - With-profits benefit reserve

- 5.2.1.7 suggests that proprietary firms may take credit in certain circumstances for future shareholder transfers which it has agreed not to dividend
  - FSA have yet to accept this - we await PS195 and/or FSA response to due process
- Prospective approach
  - what guidance needed?
  - what discount rate to use?

Section 5.3 - Future Policy-related liabilities

- 5.3.1 highlights lack of guidance in PRU as drafted on order of calculating guarantee costs vs asset share enhancements/reductions
  - unlike current informal reporting process
  - PS195 may elucidate
TS2 - With-Profits Insurance Capital Component

- **Section 5.3 cont. - Future Policy-related liabilities**
  - Planned distribution of estate must be recognised as liability
    - but not distribution of RCM
  - How to value future charges for guarantees?
    - What discount rate?
    - Maybe stochastic/dynamic approach better?
  - Market-consistent approach preferable for all items
  - Smoothing
    - drafted pre-CP207….
    - …..but must reflect real-life practices and PPFMs
    - Will an annual stochastic model pick up full cost?
- **Misselling Costs**
  - necessary to make best estimate of future compensation, administration and FOS costs
    - for all time, unless office is applying valid ‘limitation’
    - only for ‘mass’ exercises (endowments, pensions, etc)
TS2 - With-Profits Insurance Capital Component

Section 6 - RCM

- 6.1.2 makes clear that the realistic liabilities plus RCM do not necessarily constitute adequate reserves and capital
  - neither does the mathematical reserves (+ RCC +RMM)
  - but the ICA must.

- 6.2.1 guides on determining falls for overseas equities equivalent to the 25% prescribed for the UK.

- 6.2.3 allows, for regular realistic solvency monitoring, the assumption that the gilt yield fall/rise most onerous at the last half-year applies.

- Credit risk - feedback awaited from FSA on treatment of approved securities and derivatives/bank deposits

- Persistency - GN clarifies that ‘retirement’ means at a guarantee date only
  - otherwise it is an early termination
TS2 - With-Profits Insurance Capital Component

Section 6 cont.- RCM

6.5.2 requires any ‘management actions’ to be realistically achievable in the circumstances in which they would apply

- allow for time to transact
- allow for size relative to market capacity
- allow for likely similar intentions of competitors
- must be consistent with PPFMs
- if changes assumed to be made to practices, must allow time for governance processes to take place

Cannot assume ‘mass’ surrender MVRs in scenarios where persistency is assumed to increase

- or at least stays unchanged - depends on eventual persistency test

Must assume increased GAR take-up rates in lower interest rate scenario

- may not offset possible reduction due to increased concern over insurer solvency in stress scenario.
TS2 - With-Profits Insurance Capital Component

Section 7 - Options
- Stochastic model ‘best practice’
- Alternative using market prices which can be shown to be equivalent may be used
- Ideally allow persistency/mortality to vary dynamically (and even stochastically)
  - deterministic alternative to allow for correlation (or absence thereof)
- TS4 gives guidance
- What guidance needed on deterministic alternatives?

Section 8 - Reporting
- ‘Claims’ defined for purposes of required claims ratio
- Allocation of investment return where a ‘differential’ approach used
- Disclosure re stochastic model
  - needs review for TS4 consistency
- Analysis of working capital
  - comments needed on practicality (c.f. 31.12.03 FSA submissions)
TS3 - Individual Capital Assessment

- Will probably only have ‘recommended practice’ status
  - ICAs are a new development
    - although drawing on FCRs
  - No formal requirement for an actuary to be involved
    - and one may not be in some parts (e.g. operational risk).

Section 1
- An open firm should carry out ICA as if it was to close a.s.a.p.
  - and to run off the business in accordance with its PPFM
- And also as if it was to continue under its current new business plans
- Capital must at least cover the former.....
- .....and if the latter requires more capital, it must be clear when and from where this is to be obtained if not already possessed.
- Usual requirements re data quality and deviation from GN.
TS3 - Individual Capital Assessment

Section 2 - Role of Actuaries
- SUP 4.3.15 requires firms to take professional advice on financial and risk analysis
- TS3 recommends that advice is sought from an actuary, especially on market and insurance risks
- If not from the AFH, TS3 recommends that the AFH is asked to comment on the advice received.
- Similarly, the WPA should be asked to comment on external advice received relevant to exercise of discretion
- There is no formal peer review requirement on any actuarial involvement in ICAs.

Section 3 - Identification of Risk
- FSA’s risk categories are suggested as a starting point
- No specific guidance given in TS3 on operational risk
  - but statistical approach recommended if usable data available
  - and likely to require all costs during run-off to be covered.
**TS3 - Individual Capital Assessment**

**Section 4 - Stress and Scenario Testing**

- Thoroughness and depth of tests depends on capital strength
  - as demonstrated by a previous ICA
  - or if a high level ICA shows a newly weak position
- Normal to use stochastic modelling in ICA if used in realistic balance sheet
  - using consistent assumptions, particularly with regard to management and policyholder actions
- If deterministic scenarios are used, broad aim should be to be as extreme as a scenario that an acceptable stochastic model under TS4 would generate to the selected quantile.
- Need to combine different risks scientifically
  - allowing for correlation
  - and possibly for increased correlation in more extreme circumstances
- FSA have implied that ECR is intended to be BBB capital
  - but only covers some risks, doesn’t allow for less than 100% correlation and may over or understate those risks it includes.
Section 4 cont. - Stress and Scenario Testing

- So no need for ICA tests to be same as RCR/RCM
  - even if BBB is target
- But likely that more onerous tests needed if stronger rating required
- Time horizon long enough to ensure that all material risk costs included
- Is FSA requirement just to be able to meet liabilities when due?
  - or is it to meet ECR at all times (or at least at all year ends)?
  - or to have assets in excess of liabilities at ‘all’ times?
- For firm to discuss with FSA what is possible
  - ‘all’ times approaches may involve ‘nested’ stochastic modelling
  - only possible, at least in theory, using closed-form approaches within the ‘loop’
- But directors likely to want stochastic projections of realistic solvency positions?
TS3 - Individual Capital Assessment

- Sections 5 & 6 - Market & Credit Risk
  - Still under development - input sought!
  - Stochastic credit models may require some combination of these headings in practice.
  - Outline guidance on credit risk for non-investment counterparties

- Section 7 - Insurance Risk
  - Expenses - Need to allow for a return to inflationary environment of 70s/80s
    - important for closed funds, especially non-linked non-profits
    - appropriately calibrated stochastic modelling may be necessary
  - Guidance on assumptions re expenses of outsourced functions and of shared functions within a group
TS3 - Individual Capital Assessment

- Section 7 cont.- Insurance Risk
  - Assurance mortality - need to consider ‘large scale’ events
    - e.g. epidemics, terrorist attacks
  - but only to a ‘reasonably foreseeable’ level
    - i.e. not a repeat of the black death - or a large meteorite impact!
  - particularly important if material group life business written
  - Annuitant mortality - adverse scenario will be an increase in the rate of improvement
    - ‘large scale’ event (e.g. a major medical breakthrough on ageing prevention, cancer treatment, etc)
  - Persistency - consider both general deterioration and specific causitive factors (e.g. correlation to interest rates, impact of closure to new business).

- Section 8 - Liquidity Risk
  - to be written - what would be useful?
What Next?

- Your comments welcome
  - To Maria Singleton - or any Supervision Committee member
- Revise after PS 195/202/207 and final SUP
- Due Process summer/autumn
  - Probably accelerated due to limited time
  - Open meetings in London & Edinburgh
- To apply from coming into force of PRU
- Expect some revisions as experience gained
- Longer term : Morris Review

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