NED Note

Volume I

Dear Non-Executive Director,

We would like to welcome you to our first edition of the Non-Executive Directors' Note, which focuses on the life insurance sector, and includes some generic information about the regulation and supervision of the insurance industry.

Who is this note for?

As the title suggests, this is aimed at Non-Executive Directors ("NEDs"). More specifically, we had in our minds those NEDs who do not have an actuarial / financial background.

One issue that crops up regularly is technical jargon particular to insurance business acting almost as a language barrier between NEDs, their actuaries and other financial professionals. The barrier can be an obstacle to NEDs fulfilling their key responsibilities. The Institute of Directors' **The role of the non-executive director: Factsheet** summarises four areas of responsibility: Strategic Direction; Monitoring Performance; Communication, and Risk. The note explains that "Risk" means NEDs should satisfy themselves on the integrity of financial information and that financial controls and systems of risk management are robust and defensible.

This note is aimed at demystifying some of the key "insurance speak" to assist NEDs to fulfil their role of providing robust challenge to their Boards and management.

Contained in this note

We have designed this edition of the glossary to cover some of the most common terms that NEDs are likely to come across in life insurance actuarial reports, as well as some more common financial and regulatory reporting terms. This glossary not only provides definitions of the terms but also the high-level impact on business results. It also contains a useful Solvency II calendar.

Feedback / Suggestions

Whilst we have used our best efforts, we know there is always room for improvement. We welcome your feedback / suggestions. If you have any comments about this note or have any questions about how we can help you and your business, do get in touch with our team. If you would like more details please contact Kirpal Kalsi (Kirpal.kalsi@mazars.co.uk) or find a list of contacts in section 2.

1. Glossary

1.1 Assumptions

These are often collectively called the "basis". Assumptions are essentially expectations of the future course of events. For instance, the mortality assumption is what an insurer expects future rates of death will be for its existing/prospective customers.

Assumptions are broadly divided into demographic and financial. Demographic assumptions include mortality, morbidity and lapse/surrender. Financial assumptions include price/wage inflation, investment returns and discount rates. We explain these different assumptions in more detail below.

Depending on the purpose to which assumptions will be put, they will vary (see pricing basis vs reserving basis below).

1.1.1 Mortality assumption

Mortality or mortality rates are generally a measure of the number of deaths in a population. This is most often presented in a table format and is based on historical data expressed as a percentage of a standard table for a given population. The two most well known publishers of UK mortality are the Office of National Statistics and the Continuous Mortality Investigation Bureau (CMI).

A mortality table typically shows the probability of a person's death by age and by sex. Other characteristics can also be included to distinguish different risks, such as smoking status, occupation, socio-economic class and post code.

It is a well established fact that people are living longer (i.e. mortality rates have been falling), to allow for this, actuaries may make mortality improvement adjustments.

For long-term products such as annuities, the mortality assumptions and future improvements can have a significant impact on the insurer's financial position.

1.1.2 Morbidity assumption

Morbidity rates are used by insurers to predict the likelihood that its existing or prospective customers will fall ill. The likelihood is then used to determine the level of premiums for healthcare insurance, life insurance (e.g. income protection) and long-term care insurance products. It will also be used to determine the likely future cashflows under the same products for existing policyholders.

1.1.3 Lapse / Surrender / Paid-up / Transfer assumption

Both lapse and surrender involve cessation of insurance cover. If a policyholder fails to make the premium payment on certain policies then the policy may lapse. On other policies, if the policyholder notifies the insurer that the contract is to be cancelled then it may have an intrinsic value and these policies may be surrendered for a cash payment (the surrender value).

When a policyholder decides not to pay any further premiums, the policy in question does not necessarily end. If sufficient premiums have been paid, the policy may continue without further premiums; benefits are often reduced as a result. The policy then becomes "paid-up".

Transfer of a policy (say personal pension plan) involves moving the policy from one provider to another. For the provider, the main impact is that their existing customer mix will change.

1.1.4 Investment returns assumption

For most products, insurers invest their customers' premiums to generate returns in order to provide the benefits under the policies sold such as annuities, with-profits bonds and endowments. Therefore insurers make assumptions about investment returns in order to calculate whether their asset portfolio will generate enough returns to meet the benefit payments when due (e.g. annuities). Life insurance policies, such as term

assurance products, are designed such that benefits are paid mainly from premiums received rather than returns earned on those premiums. The investment returns assumption is not significant in this case.

Unit-linked policyholders generally bear all of the investment risks under their policies therefore they receive all the returns less charges. Insurers still need to estimate how much return the assets are likely to generate in order to estimate the amount of charges they will receive from their customers.
Investment returns assumptions depend on the type of investments. The types usually include cash, government bonds, corporate bonds, equities and property.

1.1.5 Price / wage inflation assumption
All things being equal, insurers' operational costs will rise over time. This is because the bulk of the costs are related to their employees' wages and these tend to rise with price or wage inflation. When calculating future cashflows, the inflation assumption is therefore one of the key inputs.

Inflation-linked annuities provide customers with income that is linked to an inflation index such as Retail Price Index (RPI) so that their benefits will increase with inflation. Insurers estimate those payments by using a price inflation assumption.

In the UK, the price inflation assumption is often derived from the prices of index-linked UK government securities thus incorporating market expectation of future price inflation. The wage inflation assumption is often based on price inflation assumption plus an adjustment.

1.1.6 Discount rate assumption
Discounting is the means by which time value of money is allowed for when calculating the value of future cash flows in order to arrive at the present value. The discount rate can be regarded as a rate of interest available on an investment.

For annuity business, the time horizon of cashflows usually runs into tens of years and the present value of the cashflows is sensitive and inversely linked to the discount rate i.e. the lower the rate, the higher the present value. On the other hand, short-term business is not as sensitive to the discount rate.

1.1.7 Margins in assumptions
Margins in assumptions represent the degree of bias built into a set of assumptions. The benchmark assumptions, without any bias, are referred to as best estimate. However, the word "best estimate" does not mean that it is the most likely or representative of future experience. Best estimate assumptions are those that are equally likely to either over- or under-predict future experience.

Prudent assumptions are those that contain adjustments to best estimate assumptions such that they contain a margin of safety against adverse future experience. For example, in relation to term assurances, it would be prudent to assume that future mortality will be higher than what best estimate assumptions predict. This has the effect of insurers allowing for more claims and high claims payments, thus boosting their ability to recover from unexpected adverse experience. Policyholders' benefit security is improved by a prudent margin; however, this means shareholders have to wait longer for their profit to be released and policyholders pay higher premiums.

1.1.8 Pricing basis versus reserving basis
The pricing basis consists of best-estimate assumptions plus a profit margin and a margin for adverse experience and is used to determine the level of premium to be charged. Insurers have discretion on how to set their pricing basis and may revise these in response to competitors' premium changes and experience. Insurers do not enjoy the same degree of freedom when it comes to reserving. The reserving basis is used to determine how much money insurers need to hold (or "reserve") to meet their policy obligations and expenses, which is subject to accounting standards and prudential regulations. (See below for accounting standards and regulatory body.) Allowance to meet such requirements often, but not always, requires the inclusion of margins of safety into the assumptions.

1.2 Technical Actuarial Standards

The Financial Reporting Council (FRC) is the UK's independent regulator responsible for promoting high quality corporate governance and financial reporting to foster investment. It sets the framework of codes and standards for the accounting, auditing, actuarial and investment communities and oversees the conduct of the professionals involved. The FRC is responsible for setting technical actuarial standards (TASs). The Institute and Faculty of Actuaries (IFoA) is responsible for setting and maintaining ethical standards.

There are three generic TASs now in force: TAS M (Modelling), TAS D (Data), TAS R (Reporting). There are four Specific TASs in force: Pensions TAS, Insurance TAS, Transformations TAS, and Funeral Plans TAS.

In short, actuaries must ensure that the work they perform meets the relevant TASs.

1.3. Accounting standards: UK Generally Accepted Accounting Practice (UK GAAP)

UK GAAP is the set of standards that establish how company accounts must be prepared in the UK. These include accounting standards called Financial Reporting Standards (FRSs) established by the FRC as well as the principle legislation governing reporting in the UK. The Companies Act 2006 lays down the legislation on financial reporting in the UK. The Act incorporates the requirements of European law. Limited companies are required to file their accounts with the Registrar of Companies. These accounts are made available to general public.

In the UK, listed companies are required to report under International Financial Reporting Standards (IFRSs) (See 1.5 for more detail). Unlisted companies such as mutuals have the option to report either under IFRSs or under UK GAAP although the differences between the two sets of standards have narrowed following recently issued UK FRSs.

1.4 PRA/FSA returns

The UK Prudential Regulation Authority (PRA) is responsible for the prudential regulation of:

- Banks, building societies and investment firms
- Credit unions
- Friendly societies
- Insurance companies

The PRA collects data from the above regulated entities. These are referred to as PRA returns (formerly known as FSA returns). Friendly Societies are categorised as either 'directive' or 'non-directive', depending on whether they are subject to the EU Life/Non-Life Directives. A Friendly Society is classified as non-directive if it falls into one of six categories defined by the Prudential Regulation Authority Handbook; otherwise it is classified as a directive Friendly Society. Directive Friendly Societies are generally larger than non-directive Friendly Societies. The PRA website provides Friendly Societies with forms and guidance for completing the forms.

1.5 International Financial Reporting Standards (IFRSs)

The goal of these standards was to harmonise accounting across the globe. The standards are sometimes still called by their original name: International Accounting Standards (IAS). The International Accounting Standards Board (IASB) is responsible for setting the standards.

The key benefit of reporting harmonisation is having a common global language for business affairs so that company accounts are understandable and comparable across international boundaries.

IFRS 4 covers insurance contracts and the treatment of liabilities in such contracts. Phase 2 of IFRS 4 aims to achieve consistency of valuation of insurance and reinsurance contracts across companies, and to improve investors' understanding of insurance companies' profitability and financial position. This standard has not yet been finalised.

1.6 Solvency II (S2)

S2 is an EU Directive that harmonises EU insurance regulation. Primarily this concerns the amount of solvency capital that EU insurance companies must hold to reduce the risk of insolvency. The regulation becomes effective from 1

January 2016 and replaces its predecessor, Solvency I. The PRA will be the local supervisory authority for the implementation of this regulation in the UK.
The S2 framework consists of three pillars:

- Pillar 1 focuses on quantitative requirements;
- Pillar 2 sets out requirements for the governance and risk management;
- Pillar 3 centres on disclosure requirements.

1.6.1 Pillar 1

This sets out the amount of capital (or assets) that an insurance company must hold. There are four key components to Pillar 1.

1. Best estimate liabilities (BEL) – amount of money an insurer would need to hold to meet all its commitments to policyholders if its best estimate assumptions were realised in future experience;
2. Risk margin (RM) – if an insurer was to transfer its business to another insurer then RM is the sum the insurer would have to pay in addition to BEL, to meet the cost of capital required;
3. Solvency Capital Requirement (SCR) – on top of BEL and RM, an insurer will be required to hold additional capital to ensure that the insurer will be able to meet its obligations over the next 12 months with a probability of at least 99.5%. SCR represents a "soft" threshold whereby if a firm's capital level was to fall below it, intervention from the local supervisor will commence;
4. Minimum Capital Requirement (MCR) – this is bounded between 25% and 45% of SCR. After breaching the SCR, if a firm's capital was to continue to fall towards the MCR, the strength of intervention from supervisors would increase. If the capital level was to fall below MCR, S2 directives provide regional supervisors with a number of discretions to address this breach, including the withdrawal of authorisation from selling new business and the winding up of the company. This can be seen as the "hard" threshold for intervention.

1.6.2 Pillar 2

The second pillar of S2 complements the quantitative capital requirements with quality requirements and a global and appropriate risk management system. The centrepiece to Pillar 2 is the Own Risk and Solvency Assessment (ORSA). The ORSA consists of the ORSA policy, the ORSA process and the ORSA report.

The ORSA Policy covers:

1. Governance: corporate governance, risk management and internal controls;
2. Role of stress testing;
3. Data quality;
4. Risk and capital management;
5. Continuous compliance;
6. Suitability of SCR relative to risk profile;
7. Uses of ORSA outputs.

The ORSA process represents a continuous loop which:

1. Starts with the business strategy;
2. Captures and quantifies all material risks in business plans ultimately dictating the firms risk appetite;
3. Subjects business plans to stress and scenario tests;
4. Determines the economic capital required to support business plans;
5. Compares economic capital with regulatory capital requirements and available capital;
6. Integrates the projection of overall solvency needs into the planning process and projected profits;
7. Produces a clear plan for continuous compliance with capital requirements; and
8. Demonstrates the ability to maintain/ generate the economic capital required to support business plans.

The ORSA report includes:

1. Risk appetite;
2. Risk profile;
3. Capital requirement;
4. Current solvency position;
5. Future capital assessment;
6. Key changes from the previous version;
7. Highlights from scenario and stress testing;
8. Uses of the output from the economic capital model and the report;
9. Key actions arising from the ORSA process.

1.6.3 Pillar 3

Pillar 3 is the convergence of all three pillars and sets out the reporting requirements under S2. There are two types of regulatory returns under Pillar 3: regulator-focused (hence private) and public-focused.

Insurance firms need to submit to the regulator:

- Regular Supervisory Report (RSR);
- Own Risk Solvency Assessment; and,
- Quantitative reporting templates (QRTs) at both quarterly and annual intervals.

In addition, firms need to publish publicly the following:

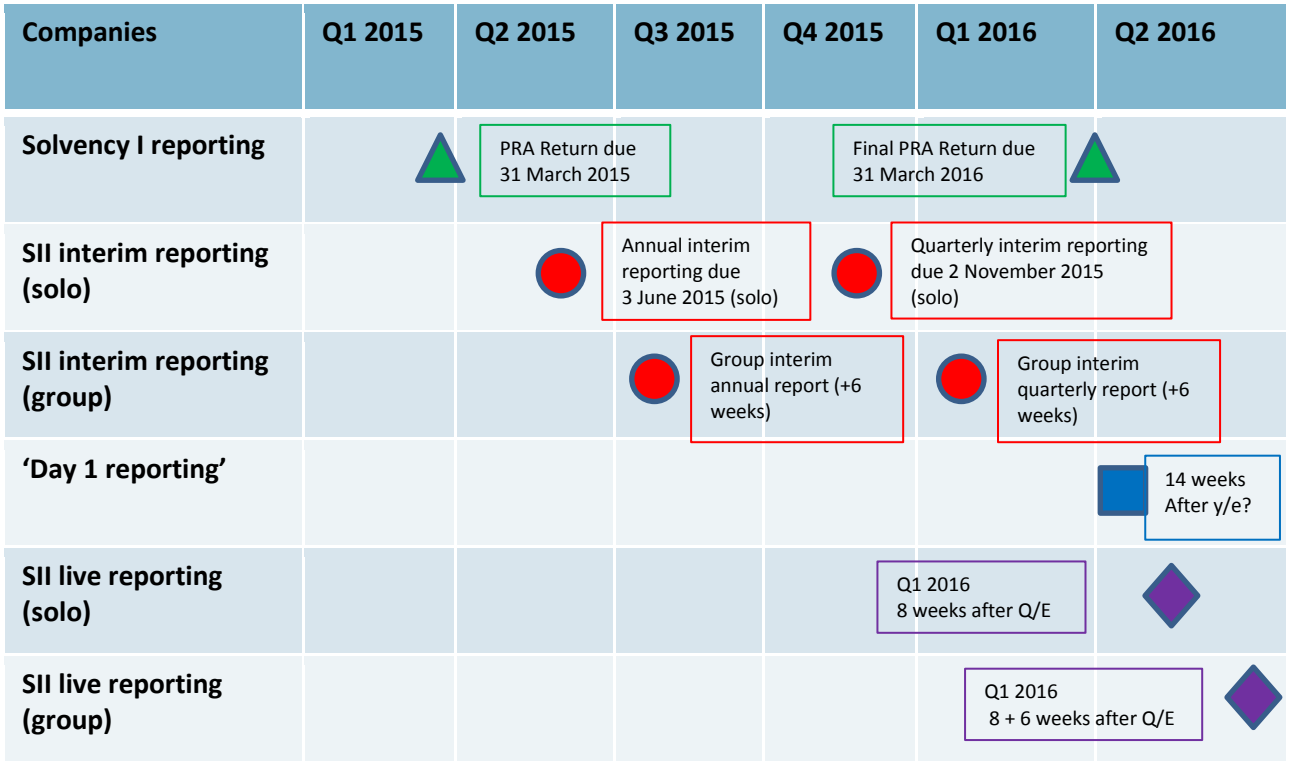
- Quantitative reporting templates (QRTs) at annual interval; and,
- Solvency & Financial Condition Report (SFCR).

Appendix A shows the expected timetable for regulatory returns under Solvency I and Solvency II in the changeover period. 2015 will be a busy year for many insurance companies in the run-up to Solvency II commencement. Appendix B shows some key deadlines in 2015 and 2016.

Appendices

A. Reporting Timeline

N.B. Group reporting timelines are only relevant for those entities that are part of an insurance group.



B. Solvency II Calendar

Timetable of activity Dec 2014 – 2015 Q2 (Source: Directors' update PRA 19 Dec 2014)

1 Dec 2014 – 6 Jan 2015	Submit matching adjustment pre-application approval process submissions
December	Reporting information for firms without a 31 December year end
December	Letter to CEOs of firms in scope for regulatory reporting preparatory guidelines – principle user and readiness survey
9 January 2015	Deadline for responses to CP23/14: Solvency II approvals
16 January	Provide information on principle users and complete regulatory reporting readiness survey
30 January	Deadline for responses CP24/14: solvency II further measures for implementation
January	Consultation paper on transitional arrangements
January	Consultation paper on volatility adjustment (depending on HMT decision)
February 2015	Consultation paper on EIOPA guidelines
March 2015	Individual firm feedback following MA submissions
March 2015	Policy Statement on Solvency II
31 March 2015	Transposition of Solvency II into the PRA Rulebook
2015 Q2	Feedback for firms on the Preparatory Guidelines
2015 Q2	Feedback on the MA pre-application process
2015 Q2	Feedback on the internal model pre-application process
2015 Q2	PRA to provide information on GI stress testing questionnaire

Other Key Dates

01/01/2016	Solvency II goes live
April 2016	First reporting to supervisors under Solvency II regulations

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Our expertise covers life, general insurance, healthcare, investment, risk & capital and pensions.