November 2021

Subject F202 — Life Insurance

Specialist Applications

EXAMINER'S REPORT

QUESTION 1

A South African life company started five years ago. The company writes a full range of lump sum risk products on a level premium basis. The company provides these products on an individual and group basis. It has grown steadily since starting.

The company is performing the annual Analysis of Surplus (AOS) as part of the reporting for the year-end period. The surpluses that arose from the regular sources are being compared to the prior year-end surpluses and there are significant differences for some of the regular sources. The AOS is being performed on an IFRS basis with the projection approach.

Additional information:

- **The mortality experience was materially worse than prior years.**
- **Other risk experience was similar to prior years.**
- **The company reduced their sales force and number of underwriting staff during the year in a move to try and sell more policies through direct channels.**
- **The company wrote the same amount of new business during the year compared to the prior year.**
- **The company has been experiencing poorer persistency than expected since starting and has decided to adjust the lapse assumption in the reserving basis at the end of the year.**
- **The company is mostly invested in government bonds of various durations.**
- **The yield curve shifted downwards during the year.**

i. Discuss the differences you would expect to see between the two years' AOS reports by source of surplus and state how the total surplus is expected to compare between the two years.

This question should have been handled better by most candidates. Better candidates managed to pick up on all aspects that needed considering. Poorer candidates left out key areas like "change in valuation assumptions". Many candidates showed a lack of understanding in some elementary aspects when considering issues such as changes (and the direction of changes) in reserve and asset values given the information in the question.

Because the projection method is being used the order in which items of surplus are analysed can impact the results.

It should be checked that the order and methodology are the same and not influencing any differences in results.

The AOS shows the financial effect of divergences between actual experience and what is assumed in the valuation basis. As such it is not looking at absolute levels of surplus and any changes in expectations would also impact the AOS.

Change in Valuation Assumptions

These are level premium policies with positive reserves and unlikely to have surrender values in the SA environment.

Expecting higher lapses into the future for the in-force book and strengthening the lapse assumptions will reduce the reserves.

(Once a reserve is set up the future outgo will exceed future income and as higher future lapses would result in a lower reserve)

An unexpected reduction in reserve is a positive source of surplus. This source would not have existed at the end of the prior year as this reserving assumption is only changing at the end of the current year.

The yield curve has shifted downwards, and the company is mostly invested in bonds. This would cause the company to re-evaluate the valuation rate assumption.

If the company does decide to reduce their valuation interest rate assumption then the reserves will increase resulting in a negative impact on surplus.

It is difficult to comment on the likely change from the prior year AOS as we are not aware of the interest rate movement over that year and whether longer-term expectations have changed at all.

The company experienced poor mortality experience during the year. An increased IBNR or other short-term reserve (to the extent that this impact may continue into the following year) could be set up.

This would have led to a further negative impact on surplus that would not have been present in the prior year.

Release of compulsory and discretionary margins

For policies in-force over the full course of the year the usual release based on margin built up would occur.

This would be a positive source of surplus and under normal circumstances this would probably be higher than the prior year as the business is young and should be growing.

If the lapse and / or mortality experience was significantly worse than the prior year, there would be an additional increase in the release of margins as the reserves for these additional

lapses and claims would be released as well. (All future margins released, not just current year).

As such we could expect a higher surplus relative to prior year, the extent of which would depend on the lapse and decrement experience.

Expected profit margin on group products

There are no prospective reserves for lump sum group business and as such the profit will be driven by the claims experience.

There has been unexpected poor mortality experience. This would have had a negative impact on surplus and as such it will be lower than the prior year.

Actual vs. expected investment return

With the yield curve shifting downwards the value of bonds held or maturing over the year relative to the end of the prior year would have increased.

How this compares to the prior year source of surplus would depend on how the bond yields moved in that year relative to expected.

The actual surplus in both years would depend on the actual return relative to that expected, which would likely be a longer-term expectation. (this would be linked to any changing valuation interest rate assumptions as set out above).

Actual vs. expected expenses

The company reduced the number of sales and underwriting staff during the year. This would have reduced actual expenses relative to expected expenses in this area.

The company is likely to have incurred additional expenses though in setting up the direct channel and marketing this.

As such it is difficult to say how this source of surplus would have changed in total relative to the prior year.

If these expense changes were planned in the prior year they may be reflected in the expected expenses for the current year and as such there may not be much impact on this source of surplus for the current year.

Actual vs. expected mortality

Mortality experience is materially worse than prior year. This would imply it is worse than expected unless prior years were much better than expected.

This would have a negative impact on this source of surplus compared to prior year. It is unlikely that valuation mortality (expected) rate has changed over the 5 years.

There wouldn't be high reserve build up yet (young policies) and as such the sum at risk would be close to the sum assured. This will exacerbate the impact.

This source of surplus would be lower than the prior year and would very likely be negative.

If this impact was seen across the individual retail and group business the impact for the group business may be contained in the "profit margins on group business" source.

It would be important to understand if this is just an outlier in terms of experience in order to assess if any other reserving actions may be necessary. Was it more claims than expected, very large claims, an event impacting mortality etc.?

Actual vs expected sickness / morbidity / disability

This experience ran similarly to prior years. As for mortality, the valuation (expected) basis is unlikely to have changed and as such we could expect a similar source of surplus.

Actual vs. expected withdrawals

The withdrawal experience has been worse than expected every year.

For policies that incept and lapse between analyses a pure loss would likely be seen due to the policy not covering the initial expenses associated with it.

Higher lapses here would reduce the surplus.

For other policies which have had reserves set up a lapse results in future valuation margins being capitalized to the current year (no surrender value) and as such contributes to surplus.

Higher lapses would increase the surplus.

This business would have more policies out of their first year and as such the surplus should be higher than expected in each year if lapses are worse at all durations.

This has been an ongoing issue and as such would have been present in the prior year numbers as well. The level to which the source of surplus differs to last year would depend on whether the lapse experience, while still worse than expected, was better or worse than that experienced in the prior year.

Actual vs. expected tax

This business will sit in the risk fund and as such be taxed on profits.

The profits in this fund, given the experience items under consideration, will be lower than the prior year and lower than expected.

This will result in:

- A lower transfer from the RF to the CF which would lower this tax item relative to prior years.

- No transfer to the CF if the RF in a loss position which would also lower this tax item relative to prior years.

If the RF is in a loss position and a transfer is required from the CF to RF then the taxable amount in the CF would not be impacted by this transfer in the current year. As such no immediate tax relief for the loss.

There would be many other items that would impact on the total tax liability but it is likely to be lower.

New business

New business would result in new business strain and as such the expectation would be a negative impact on surplus when a policy is written.

The strain for the current year is likely to have been similar to the prior year because the new business levels were similar.

Because this is a young company this item is likely to have a large impact on the overall surplus.

(The releases of margins that contribute to surplus in other areas are effectively set up as a cost in the new business surplus source in the year they are written)

Total Surplus

There are a few items that push up the surplus relative to last year (lapse assumption change, exits, etc.) These could easily have smaller impacts in total compared to the negative mortality experience and new business cost. As such the AOS is likely to show a poorer surplus relative to the prior year.

The company wants to introduce an Income Protection product. It is however concerned about the insurance risks and potential volatility that this product will introduce. To mitigate some of these risks various reinsurance solutions are being considered. In terms of reinsurance structures, the company has decided to look for possible reinsurance cover on the following bases:

- **A quota-share with 50% of each risk ceded.**
- **A surplus structure with cover amounts in excess of R25,000 a month ceded for each risk.**
- **A structure where the reinsurer assumes the full risk for each claim once it has been in payment for 24 months.**
- **A surplus structure based on an agreed reserving basis. The reinsurer will pay a lump sum for the portion of any claim reserve value that exceeds R1.5 million at point of claim.**

ii. Set out the risks the company would be looking to mitigate through these structures and describe the advantages and disadvantages of each of these structures.

This question was handled well by most candidates. Better candidates managed to cover more detail with regards to the proposed structures.

Insurance risk refers to fluctuation in the timing, frequency and severity of insured events. Insurance risk can also refer to fluctuations in the timing and amount of claim settlements.

The risk that this product would introduce are:

- Claims incidence being higher than expected.
- Claims termination rates being lower than expected.
- Volatility through higher than average claims values or large claims

<u>Quota Share (QS) structure</u>

The QS structure limits exposure to each of these risks proportionally.

Any adverse experience (incidence, termination) will ultimately be shared 50/50 with the reinsurer through the reinsurer paying for 50% of every claim.

The cover will dampen any volatility through covering part of any losses and taking a share of profits when experience is running well or as expected.

It will also reduce the size of any large claims, but the company could end up with larger claims than under the surplus structure.

It is a simple structure and possibly the easiest to understand and administer.

The reinsurer's price for this cover would be a useful check against the company's risk price as it is proportional cover. (Reinsurer price without margins should be half of company's risk cost)

Large quota shares normally enable reinsurers to provide other support such as claims and underwriting services.

Surplus structure

The surplus structure will cap the company's exposure at R25,000 monthly claim value.

This will reduce any volatility directly through all retained portions of any claim being less than R25,000p.m.

It eliminates the risk of large claims.

This cover would not necessarily protect against higher incidence or lower terminations in all cases, e.g. worse experience than expected at the R10,000p.m. cover amount level.

The reinsurer's price for this cover could also be a useful check against the company's risk price as it is proportional cover, unless the reinsurer assumes that larger claims have a higher incidence rate than smaller claims, i.e. sum assured is a risk factor.

Durational structure

This structure implies that the longest claim the insurer will pay is for two years.

This provides protection against terminations rates being worse than expected (claims lasting longer than expected) for medium-long durations.

It won't provide direct protection against incidence being higher than expected or large claim values. The insurer will pay its share of these, but only for two years.

This in non-proportional cover and as such the reinsurance price can't be tied back to the underlying cost. The reinsurer would need to estimate how many (and which type of) claims last longer than two years and by how much.

The reinsured portion of the risk would be harder to predict and more volatile. As such it is likely to have higher margins attached to it.

The reinsurer would want to ensure that the insurers claims management practices don't change now that they would not be liable for the medium-long term portion of any claim.

The first claim paid by the reinsurer would only be two years after the cover starts.

All claims would still need to be sent to the reinsurer from outset as the reinsurer would need to reserve for each claim based on its likelihood of lasting more than two years.

Reserve structure

This structure is similar to the surplus structure but protects the insurer against having to fund a claims-in-payment reserve of more than R1.5m.

This provides volatility protection like the surplus cover.

However, it provides protection against anything that may result in a higher reserve value

- Large claim values (like surplus)
- Younger claimants
- Higher escalation rates
- Illnesses with longer expected durations
- Etc

If the reserve value and the monthly surplus level above are more-or-less equitable, more lives should be reinsured under this structure.

It doesn't provide direct protection for higher than expected incidence rates.

The reinsurance payment is a lump sum that will fund part of the insurers reserve value. As such the insurer is still exposed to future termination rates being worse than expected.

The sum reinsured would need to be recalculated each time the reserve for a policy would change (e.g. age change or interest rate change)

The company also wants to introduce different premium payment patterns for the lump sum product range. In addition to the level premium structure it currently offers it also wants to offer age-rated premium structure. The premiums will increase each year in line with the increases in the underlying decrement curve.

iii. Outline the potential consequences of this change that the company would need to consider.

This question was handled well by most candidates. Better candidates managed to pick up on some of the issues related to different lapse and mortality experience as well as the ability to switch cover more easily than with a level-premium policy.

Initial premiums would be lower, and the company would compete better. This could lead to higher sales. If significant enough this could lead to additional new business strain and solvency implications.

The company could attract a different mix of business (e.g. younger policyholders). Would the pricing assumptions and any cross-subsidies still hold under these circumstances?

Because these policies don't pre-fund like level premium policies, it is easier to lapse and move to a different insurer that has a lower premium curve. (More exposed to competitor pressure)

Premiums will escalate quickly and be much higher after a number of years. This could impact lapses at later durations if affordability becomes an issue or value-for-money becomes a concern.

As such, may need a different lapse curve for policies on these premium patterns.

Higher lapses, especially at later durations, would worsen any anti-selective lapsation behaviour.

If this is deemed to be significant enough then different mortality assumptions for later durations on increasing premium policies would also need to be considered.

QUESTION 2

A large South African life insurer sells the following products:

- **Established book of non-profit immediate annuities with payments increasing by the Consumer Price Index (CPI); and**
- **Newly launched whole of life risk product which includes life cover offered on either a level premium or age-rated payment pattern.**

i. Describe how you would determine the insurance liabilities for this insurer for the purpose of Published Financial Reporting.

This question was handled well by most candidates.

For Published Financial Reporting purposes, the actuarial liabilities need to be determined using the Financial Soundness Valuation (FSV) methodology described in SAP104.

The FSV is intended to be prudently realistic and is based on best-estimate assumptions and includes compulsory margins and the possible use of discretionary margins.

The FSV aims to introduce a degree of prudence to allow for possible adverse deviations in experience during the expected future lifetime of the business.

Best-estimate assumptions

Best-estimate assumptions should be realistic, generally guided by past experience, and modified by any knowledge of or expectations regarding the future. Best-estimate assumptions should depend on the nature and term of the business.

For Published Financial Reporting, the insurance liabilities to be held on the IFRS balance sheet are determined for in-force policies and assumptions will be needed for the following items:

- Mortality and morbidity rates (including an allowance for AIDS) as well as mortality improvement rates (particularly important for the immediate annuity business given the insurer is exposed to longevity risk).
- Lapse rates (only applicable for the risk product since immediate annuities cannot lapse).
- Renewal expenses making allowance for escalation of future expenses at an inflation rate that is consistent with the discount rates used.

- Renewal commission and claw-back given it is likely sold through either independent financial advisors or tied advisors.

- Interest rates to discount the liabilities which are consistent with market yields and consider the expected future investment returns on a portfolio of assets appropriate to the liabilities.

    - The immediate annuity and whole of life risk product are long-term in nature and hence are expected to be backed by a mix of CPI linked bonds (particularly for annuities since the liabilities are exposed to CPI) and long-term growth assets such as equity and property.

- Inflation rates in order to project the future obligation for the CPI-linked immediate annuities.

- Allowance for tax, the effect of tax should be considered separately for each of the tax funds in the insurance company.

Where there are future options that can be taken up by policyholders (for example, voluntary premium increases), these should only be considered where they lead to a higher liability.

The liabilities (including the compulsory margins) must be calculated before allowing for the impact of reinsurance, with the value of reinsurance separately quantified and reported.

Additional margins

The use of best-estimate valuation assumptions, adjusted by the compulsory margins and possibly also by discretionary margins, aims to introduce a degree of prudence to allow for possible adverse deviations in experience during the expected future lifetime of the business.

Consideration should also be given to the extent to which the direction of the margin needs to be applied. This is particularly important as the direction in which a particular risk's compulsory margin is applied could differ for different groups of policies.

For example, for the products the insurer sells they would need to add the compulsory margins to the best estimate mortality assumptions for the risk business whereas they would need to deduce the compulsory margins for the annuity business.

In addition to the compulsory margins, discretionary margins may be included where the actuary believes that:

- The compulsory margins are insufficient in a particular case for prudent reserving; or

- The discretionary margins should be used in order to defer the release of profits consistent with policy design or company practice / accounting policy.

Discretionary margins can be included either through adding an additional margin over and above the explicit compulsory margins or eliminating some or all of the negative reserves which are likely to arise from the valuation of the whole of life risk contracts in their early duration.

All discretionary margins must be approved by the Board of Directors. In particular, the decision on the treatment of negative liabilities lies with the Board of Directors. (And signed off by the external auditors with a view as to any tax implications of deferring profit.)

A valuation report has been presented which indicates that the whole of life risk product is loss making at point of sale and the non-profit immediate annuities are profitable.

A pricing actuary has questioned this. According to their calculations (which use the same underlying projection model and consistent assumptions for each product) both the products are profitable.

ii. Discuss the possible reasons for different conclusions being reached.

This question was handled poorly by a reasonable number of candidates. Many candidates discussed the more obscure points rather than the obvious issue of margins in the valuation basis.

Despite the pricing actuary using the same underlying projection model and consistent assumptions to the valuation actuary, there may be differences because of the type of basis used by each actuary.

In general, due to competitive pressure, the pricing actuary would likely derive the premium and profit test products on a pure best-estimate basis without any allowance for compulsory or discretionary margins.

Whereas the valuation report would have been produced using the FSV discussed above and hence would be on a prudently realistic basis and would include compulsory and potentially discretionary margins

For the annuity business, it is likely that the product is profitable enough on a best-estimate basis so that even once the compulsory and discretionary margins are allowed for it is still profitable.

In addition, due to it being an established line of business the level of discretionary margins required in the valuation may be limited.

For the whole of life risk business, given the underlying projection and assumptions used are the same, it implies that whilst the business may be profitable on a best-estimate basis, once the valuation actuaries allow for compulsory and discretionary margins as per SAP 104 the business is loss making on a valuation basis.

Given the product is newly launched, it is also quite likely that the valuation actuaries felt the need to include additional discretionary margins in the valuation basis either through:

- adding additional margin over and above the explicitly compulsory margin required; or
- Eliminating some or all of the negative liabilities

These compulsory and discretionary margins will at the same time serve to an extent to defer profits and thus reduce the risk that profits are recognised prematurely.

The pricing actuary has questioned how particular methodology choices allowed within the Published Financial Reporting framework can impact the insurance liabilities and profit recognition profiles over time for each of the products.

iii. Describe and explain the likely shape of the insurance liabilities and profit recognition profile for each of the products over time, assuming experience emerges as expected from point of sale.

This question was handled poorly by many candidates. Many candidates struggled with issues which should have been more easily understood such as:
- *Difference in cash flows and reserves at time 0 and 1*
- *Difference in reserve build-up between level and risk premium policy*
- *What the reserves ultimately run down to*
- *Difference between profit margin priced for and valuation margins*

The insurance liabilities under the Published Financial Reporting Framework are calculated as:

$$IL_t = PV(outflows)_t - PV(inflows)_t$$

Where:
- *IL - Insurance liability at time t*
- *PV is determined prospectively over the projection term*
- *Inflows and outflows include all cashflows as well as compulsory margins and discretionary margins*

<u>Annuities</u>

From above, the annuity business is expected to be profitable on a valuation basis and hence even after allowing for compulsory and discretionary margins, at point-of-sale the PV of inflows is expected to exceed the PV of outflows.

Hence, at point-of-sale, the insurance liability for the annuity business is expected to be negative.

Since it is immediate annuity business, an upfront premium/contribution is paid by the policyholder at point-of-sale in exchange for a guaranteed lifetime pay-out with benefits increasing at CPI.

Hence, after new business stage, we are no longer expecting any premiums on a prospective basis.

At time t +1 (where t+1 represents the first in-force valuation after point-of-sale), we are expecting the PV(inflows) in the calculation of the insurance liabilities to make no allowance for any further premiums whereas at time t (new business stage) it would have made an allowance for the upfront premium contribution we were expecting.

At new business stage, the PV(outflows) would have included a projection for annuity outgo benefits increasing at CPI, renewal expense assumptions increasing at CPI and an allowance for upfront acquisition costs in the form on initial expenses and potentially initial commission.

At time t +1 (where t+1 represents the first in-force valuation after point-of-sale), the PV (outflows) would only include a projection for the remaining annuity outgo benefits increasing at CPI and renewal expense assumptions increasing at CPI.

Hence, the PV (outflows) is expected to decrease substantially between point-of-sale and time t+1 (where t+1 represents the first in-force valuation after point-of-sale) as the upfront acquisition costs are no longer included within the insurance liability.

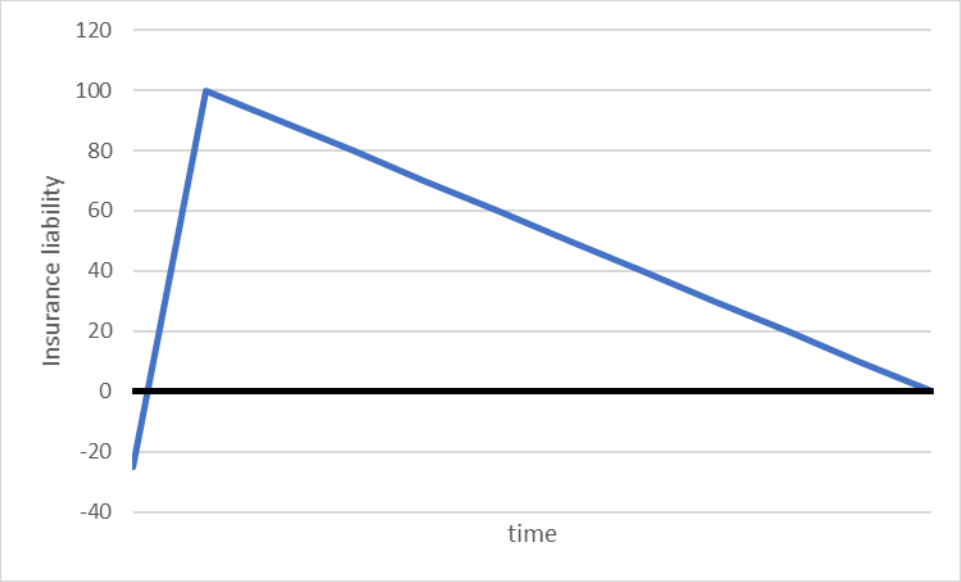
The combined effect of the move of the PV(inflows) and PV(outflows) described above, means that at t+1 (where t+1 represents the first in-force valuation after point-of-sale), the insurance liability at t+1 is expected to be a large positive number.

Intuitively this is also correct, since on an immediate annuity we have received an upfront single premium which needs to 'pay for' a lifetime of annuity outgoes increasing at CPI. Hence, it makes sense that we need to hold a positive insurance liability in order to ensure there are sufficient reserves to meet our future obligations and to ensure we don't recognise profit prematurely.

From then onwards i.e. t+2, t+3 etc. the insurance liability is expected to remain positive, decreasing over time as annuities payments are made in each period and hence, we are required to hold a smaller insurance liability.

By the end of the projection term, the insurance liability would be projected to be 0

The above can be diagrammatically shown below (illustrative purposes):



Profit recognition

Since the annuity business is profitable on a valuation basis, we would expect a positive Value of New business, however this only represents the assessed value of the new business sold rather than the actual profit recognition.

New business strain arises when the gross premium paid at the start of a contract – less the initial expenses including commission payments – is not sufficient to cover the actuarial liability.

Since the contract is a profitable single upfront premium contract, there should not be any new business strain.

On an IFRS 4 basis, profit is recognised in each period as follows:

- Premium income; less
- Actual claims and expenses; plus/minus
- Change in actuarial reserve

Assuming experience emerges as expected from point of sale (as indicated in the question) then the change in actuarial reserve from one period to another would be equal to the expected claims and expenses less premium income and hence the only profit that is expected to emerge over time is the release of compulsory and discretionary margins.

Whole of life risk product

From above, the whole of life business is expected to be loss-making on a valuation basis and hence even after allowing for compulsory and discretionary margins, at point-of-sale the PV of inflows is expected to be less than the PV of outflows.

Hence, at point-of-sale, the insurance liability for the whole of life business is expected to be positive.

Since whole of life business tends to incur significant upfront costs, the PV (outflows) is expected to decrease substantially between point-of-sale and time t+1 (where t+1 represents the first in-force valuation after point-of-sale) as the upfront acquisition costs are no longer included within the insurance liability.

For whole of life risk business, regular premiums are received from the policyholders and hence the PV (inflows) is expected to decrease gradually (regardless of the premium payment pattern) over time as the policy gets closer to end of its projection term.

The combined effect of the move of the PV(inflows) and PV(outflows) described above, means that at t+1 (where t+1 represents the first in-force valuation after point-of-sale), the insurance liability at t+1 is expected to be a negative number regardless of the premium paying pattern.

Intuitively this is also makes sense because on a prospective basis the PV of inflows is expected to now exceed the PV of outflows given there is no further requirement to reserve for acquisition costs since they are already paid but would have been allowed for in the initial pricing of the product.

Given the insurance liability is calculated for Published Financial Reporting, the negative insurance liability can be zeroised (either in part or in full) if additional discretionary margin is required.

Hence the shape of the insurance liability over time depends on whether the liability is zeroised or not, and the below discusses the shape assuming the liability is not zeroised. However, if the entity were to elect to zeroise negative liabilities then whenever the liability is negative, discretionary margins equal to the negative liability may be included to make the insurance liability 0.

From then onwards, the shape of the insurance liability is dependent on the premium payment pattern as the PV of inflows relative to PV of outflows differs over time by premium payment pattern.

Level premium

For a level premium policy, the premium income in the early years is expected to exceed the claim outgo. However, later in the policy, due to the premium being level, one would expect the claim outgo to exceed the premium as the probability of death increases.

Due the premium being level. the PV(inflows) over time is expected to run-off quicker than the PV (outflows) and at some point, there will be an 'inflection' whereby the PV (outflows) exceeds the PV (inflows) due to the prefunding discussed above.

In other words, whilst the insurance liability is negative at time t+1, there will be some time t+x (where x denotes some point in the future) where the insurance liability is 0.

From that point onwards, the insurance liability will build-up and become a large positive value, which illustrates the pre-funding concept discussed above whereby at some point we would have insufficient premiums on a prospective basis to cover our expected claims outgo and hence we would have a positive liability.

At some point, we would have built-up sufficient reserves to meet our future obligations and the insurance liability would then begin to decrease (whilst remaining positive given we still have insufficient premium on a prospective basis) over time and By the end of the projection term, the insurance liability would be 0.

Given the shape of the insurance liability, particular attention needs to be given to the direction in which particular compulsory margin should be applied for level premium policies. For example, early on in the policy when the insurance liability is negative it is more prudent to assume a higher lapse assumption whereas later in the policy when the insurance liability is positive it is more prudent to assume a lower lapse assumption.

Age-rated

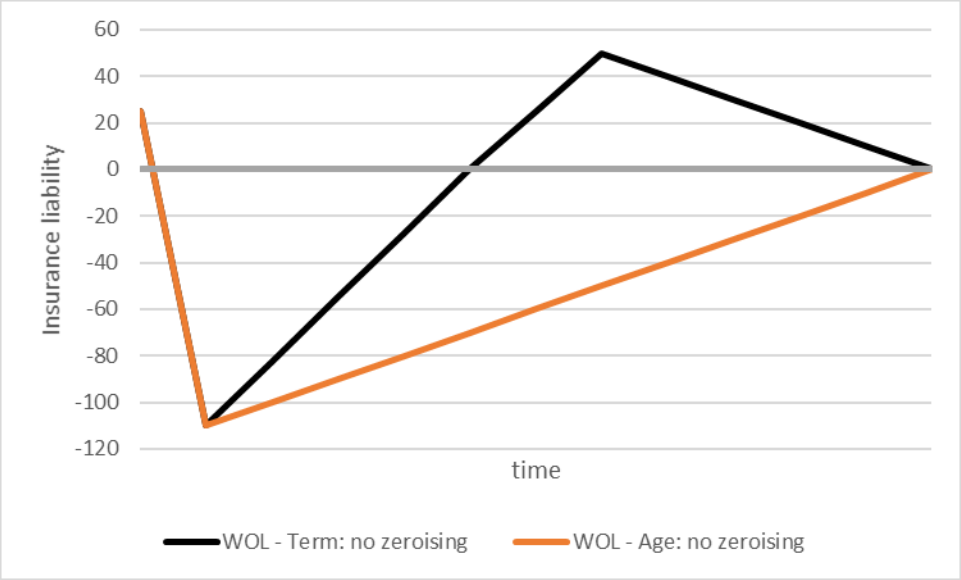
For age-rated policies, since the premium is expected to be sufficient to cover the claim outgo in every particular year, the PV (inflows) and PV (outflows) are expected to decrease at a similar rate over time.

Hence, the insurance liability is expected to remain negative throughout the policy term, decreasing over time as projection term decreases until it is eventually 0 by the end of the projection term.

However, in practice sometimes 'age-rated' premiums are not necessarily sufficient to cover the claim, particularly towards the latter durations of a contract. In the event that this

happens, the insurance liability may flip over and become positive at later durations, however this is still expected to happen significantly later than illustrates in the 'level premium' example.

The above can be diagrammatically shown below (illustrative purposes):



Profit recognition

Since the whole of life risk business is loss-making on a valuation basis, we would expect a negative Value of New business, however this only represents the assessed value of the new business sold rather than the actual profit recognition

New business strain arises when the gross premium paid at the start of a contract – less the initial expenses including commission payments – is not sufficient to cover the actuarial liability. Since there are significant upfront initial expenses and commissions payable on a whole of life risk contract, there is expected to be a large new business strain.

The use of negative non-unit reserves is an effective tool to manage new business strains (at point-of-sale, setting up a negative non-unit reserve will release funds to pay upfront acquisition costs and commission). However, since the business is loss-making on a valuation basis, there is no negative non-unit reserve to set-up at point-of-sale.

Despite the whole of life risk business being loss-making on a valuation basis, it might still give rise to profits as the profits that will emerge over time are equal to the release of compulsory and discretionary margins.

However, the entity's zeroization of negative reserve policy would greatly influence the release of profits over time. If they were to zeroise the negative reserves this would incorporate further discretionary margins and defer the release the release of profit

The regulator is in the process of reviewing the guidance under the Published Financial Reporting framework and is concerned by the level of variability in profit recognition profiles which could emerge between different insurers selling identical products.

The regulator has proposed an alternative Financial Reporting Standard which seeks to align the recognition of profit more between insurers.

iv. Discuss the impact of such a proposal on the key stakeholders.

This question was handled well by most candidates.

Key stakeholders impacted by the introduction of a new Financial Reporting Standard would include, but not be limited to:

- (Re)insurance companies
- Shareholders
- Investor community
- Auditors and consulting firms
- Regulator

For all stakeholders, a new Financial Reporting Standard would require significant upskilling and training which would introduce a substantial layer of costs either through direct training requirement or the opportunity costs of internal resources being dedicated to the new Standard.

Whilst (re)insurance companies will incur significant implementation costs, they could see it as an opportunity to overhaul existing infrastructure, processes and systems to ensure they are fit-for-purpose for the new reporting standard. In addition, insurers might appreciate being able to analyse and compare their financial results to competitors more easily.

(Re)insurance companies, particularly medium to small-sized one, might find there are constraints on resources with the knowledge to implement a new Reporting Standard given the existing Reporting Standard would still need to be reported on in the meantime.

Shareholders and the investor community might appreciate the introduction of a new more comparable standard as it may allow them to make more informed decisions and be able to analyse different companies more easily both locally and globally. However, for shareholders the benefit of this would need to be weighed up against the cost of implementation.

However, they are likely still going to want to understand existing reporting metrics which they've become accustomed to using such as Embedded Value which could place additional strain on the resourcing requirements for insurers.

In addition, the implementation of a new Standard would likely result in significantly time pressures and Board members and key shareholders might not feel sufficiently prepared or knowledgeable to exercise their duty.

Auditors and consulting firms are likely going to see the potential introduction of a new standard as an opportunity to leverage their working groups and ensure they are at the forefront of developments and implementations for the new standard in order to be able to fill the potential resourcing and training gap highlighted above.

Auditors in particular might find it useful if the variety of methodologies and approaches was more standardised compared to the existing framework, as this may reduce the level of judgement required and allow them to implement more standardised auditing frameworks across a variety of clients

The regulator may find it easier to monitor and assess the financial stability and performance of industry participants if the new Standard aligned the recognition of profit between insurers better. In addition, it would then increase their ability to compare insurers and know when intervention is potentially required should certain insurers or sectors of the industry require further regulation to ensure customers are being treated fairly.

END OF MARKING SCHEDULE