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RECENT DEVELOPMENTS IN LIFE OFFICE FINANCIAL REPORTING

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ABSTRACT

The European Community 3rd Life and Insurance Accounts Directives have necessitated changes to United Kingdom life insurers' statutory solvency valuations and published accounts. This paper details these, together with associated guidance. It also describes certain other developments in U.K. life office financial reporting and discusses some inter-professional issues.

KEYWORDS

Statutory Valuation; Financial Reporting; Life Insurance

1. INTRODUCTION

Behind the most ancient part of Holborn ... is a little nook called Staple Inn. It is one of those nooks, the turning into which out of the clashing street, imparts to the relieved pedestrian the sensation of having put cotton in his ears ...

1.1 *A Little Nook*

1.1.1 In recent years the valuation actuary has resided in a nook of relative immunity from external pressure to change. Once the changes of 1981–1983 were bedded in, and minimum solvency margins and maximum rates of interest were understood, the actuary could initiate the same process every year and satisfy himself, his board and the Department of Trade and Industry (DTI) that all was well.

1.1.2 He could sit largely on the sidelines when the Financial Services Act was introduced, perhaps contributing some descriptions of bonus philosophy to the with-profits guide. If his accounting colleagues took responsibility, he could even let most of the implications of the 1990 tax changes pass him by, although a few minor changes to bases might have been necessary.

1.1.3 Admittedly, some fairly serious thought had to be given to resilience testing, to AIDS and to policyholders' reasonable expectations — and, for proprietary companies, to embedded values. New types of product also put a demand on the valuation actuary. However, these things tended to come one at a time and could be catered for mostly by minor tinkerings to the normal process. All in all, then, this was a relatively peaceful decade for valuation actuaries.

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1.2 *All Change*

1.2.1 But now no longer; the Insurance Companies Regulations 1994 have introduced significant changes to the statutory minimum valuation bases for the 1994 returns to the DTI. Simultaneously, some changes have been made to the format of reporting, especially certification. There are also DTI proposals for a major revision of the returns from 1996.

1.2.2 The 1995 Companies Act accounts have to comply with the Insurance Accounts Directive as implemented in the United Kingdom, as a minimum by means of the so-called 'modified statutory basis'. Proprietary groups are also developing plans to report, either instead or in addition, on an 'achieved profits' basis (if the approach and, indeed, even the nomenclature can be agreed).

1.2.3 The Institute and the Faculty of Actuaries are developing advisory guidance on dynamic solvency testing (DST) (to answer the question of what happens to the life fund in different future scenarios) and financial condition reports (which are formalised — and possibly DTI-viewable — reports to the board of the outcome of valuations and DST).

1.2.4 Last, but not least, there is also a professional working party examining replacements for the net premium valuation.

1.3 *Objectives and Contents of this Paper*

1.3.1 Our paper aims to summarise the changes required to reporting practices as a result of the above measures. For those measures which are already implemented, this will serve as a record of the changes. For changes still to come, we have tried to highlight those issues which we ourselves have found challenging from a practical point of view.

1.3.2 In more detail, the contents of this paper are:

— Section 2: Insurance Companies Act reporting — the 1994 changes.
— Section 3: The Accounts and Statements Amendment Regulations.
— Section 4: The Insurance Companies Regulations 1994.
— Section 5: DTI Prudential Guidance Notes.
— Section 6: Revisions to Actuarial Professional Guidance.
— Section 7: Proposed further revisions of the DTI Returns.
— Section 8: Companies Act — satisfying the Insurance Accounts Directive.
— Section 9: Companies Act — The Achieved Profits Method.
— Section 10: Dynamic Solvency Testing and Financial Condition Reports.
— Section 11: Alternatives to the Net Premium Valuation.

1.3.3 As always, the opinions in the paper are ours alone and not necessarily those of our employer nor, unless explicitly stated, of the actuarial profession. The paper also reflects legislative and regulatory developments as they stood in early 1996. Further change is inevitable.

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2. Insurance Companies Act Reporting — The 1994 Changes

... it is one of those nooks where a few smoky sparrows twitter in smoky trees ...

2.1 On 1 July 1994, the following three items of legislation came into force:

(a) the Insurance Companies (Third Insurance Directives) Regulations 1994, which amend, *inter alia*, the Insurance Companies Act 1982 ('The 1982 Act');

(b) the Insurance Companies (Accounts and Statements) (Amendment) Regulations 1994 ('the Accounts and Statements Amendment Regulations'), which amend the Insurance Companies (Accounts and Statements) Regulations 1983 ('the 1983 Regulations'); and

(c) the Insurance Companies Regulations 1994 ('the 1994 Regulations'), which supersede the Insurance Companies Regulations 1981 ('the 1981 Regulations').

2.2 The first of these has little direct effect on financial reporting. However, it introduces new requirements for sound and prudent management of insurance companies and for asset and premium adequacy which are reflected in consequential reporting changes (see Section 3.3). It also exempts companies from other European Community (and certain other) countries from, *inter alia*, most of the requirements of Part II of the 1982 Act.

2.3 It also gives to the DTI a new power of intervention in cases of concern. This is to require a company to furnish a report by an "actuary or accountant or other person with relevant skills" (new paragraph (2B) of Section 44 of the 1982 Act). Presumably the person referred to is intended to be independent of the company.

2.4 Full details of the relevant changes to reporting requirements introduced by the other two sets of regulations are given in Sections 3 and 4. Many other changes are introduced by these pieces of legislation. These are not addressed in this paper, where we do not consider them to impinge directly on reporting requirements. In particular, the revisions to permitted assets for linked funds are not discussed.

2.5 We have taken into account the amendments to the 1982 Act made by the Insurance Companies (Amendment) Regulations 1994 and to the 1994 Regulations and the 1983 Regulations by the Insurance Companies (Amendment No. 2) Regulations 1994 and the Insurance Companies (Amendment) Regulations 1995 ('the 1995 Regulations'). Yet further 'tidying-up' amendments are expected in early 1996.

3. The Accounts and Statements Amendment Regulations

3.1 *Disapplication to Insurers from other E.C. Countries*

3.1.1 Previously, a company based in another E.C. country, transacting business

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in the U.K. via a branch, was subject to Part II of the 1982 Act, and so had to submit returns to the DTI. The 1983 Regulations exempted such firms from having to include details of other than their U.K. business, however. Firms from all non-E.C. countries were required to submit returns covering all their business.

3.1.2 Now, as mentioned in Section 2, such non-U.K. E.C. companies are no longer subject to most of the provisions of Part II of the 1982 Act. This includes being exempted from having to submit returns covering even their U.K. branch business (being subject to their home state requirements only). However, the Secretary of State may direct that companies from certain countries remain subject to Part II of the 1982 Act in respect of their U.K. branch business if those countries have not implemented the 3rd Life Directive.

3.2 *Information on Derivatives*

3.2.1 Each Form 13 which is required to be completed must now be accompanied by new Form 13A. This requires the value of derivative contracts to be given, separately as to:

— whether they are assets or liabilities;
— whether they are futures contracts, options or contracts for differences; and
— whether they relate to fixed-interest securities, equities, property, currencies or 'other'.

3.2.2 Adjustments for margins must be disclosed separately, as must any provisions for adverse changes in contracts which are, or may become, liabilities. Except for the first returns under the revised regulations, the position at the end of the previous year must also be shown.

3.2.3 Derivatives used in connection with linked long-term contracts and those which the 1994 Regulations require to be left out of account should not be included.

3.2.4 All amounts must be shown gross, unless there is a legal right of set-off.

3.2.5 The total of derivative assets is then transcribed to line 35 of the appropriate Form 13. The liability total is included in Form 14 or Form 15 as appropriate at line 47 ('other creditors').

3.2.6 Regulation 22B requires that a statement is appended to the returns setting out:

(1) the "investment guidelines operated by the company ... for the use of derivative contracts";
(2) the extent to which Form 13 and Form 45 (expected income from assets) would have differed if all open futures contracts were fulfilled and all options which it is prudent to assume will be exercised were exercised at the year end;
(3) if material, the extent to which the statement in (2) would have differed had it been required at any other time during the past year;
(4) the maximum exposure to any one counterparty both under existing market

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conditions and in the event of other foreseeable market conditions, again stating whether the answer would have been materially different at some other time during the year; and

(5) "the circumstances surrounding the use of" derivatives or contracts having equivalent effect which are not a permitted link and which the 1994 Regulations require to be left out of account.

Additional disclosure is expected to be required for Returns submitted after 30 April 1996.

3.2.7 Schedule 4 (abstract of the actuarial report) must now include, for each internal linked fund, a description of the investment guidelines of the fund, including the use of derivatives. It must also include a description of the method by which allowance has been made for derivatives when valuing the liabilities.

3.2.8 Form 49 requires a note of the value of rights under derivative contracts held by each internal linked fund.

3.3 *Certificates*

3.3.1 The Certificate of the directors must now additionally list any "published guidance" with which the "systems of control established and maintained by the company" comply or "in accordance with which the return has been prepared". The guidance referred to is that published by the DTI, although it may be appropriate also to refer to guidance published by professional bodies. So far, the DTI have issued relevant 'prudential' guidance notes on investment controls, valuation of assets and derivatives.

3.3.2 At the time of writing, further notes on linked funds and on reporting of derivatives were in the course of development, although 'final' drafts were made publicly available in May 1995.

3.3.3 All five notes are briefly described in Section 5. The DTI stated that compliance with the note on investment controls was not required to be certified as at 31 December 1994 (as the note was only issued during December 1994). However, a 'progress report' on implementation of adequate controls had to be submitted to them by 31 March 1995. Certification of compliance with the note on valuation of assets was also not required at 31 December 1994. At 31 December 1995, certification with all but the linked funds note is likely to be required.

3.3.4 The actuary's certificate must additionally confirm that the premiums for contracts entered into during the year, income thereon and other financial resources of the company available for this purpose are sufficient to meet the company's liabilities in respect of those contracts, in particular to establish adequate mathematical reserves. This is, of course, already implicitly the case due to compliance with GN1. In this context, it is worth noting that a new Section, 35B, has been introduced into the 1982 Act which requires a company to satisfy itself of the adequacy of premiums (when taken together with the existing resources of the company) before entering into a long-term contract.

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3.3.5 The actuary's certificate must now just "list the professional guidance notes which have been complied with". The Institute and the Faculty of Actuaries have advised Appointed Actuaries that GN1 and GN8 should be listed.

3.3.6 The auditors' report may contain an explanation that, if it is the case, the information which they have received is inadequate for them to express an opinion on whether it was reasonable for the directors to make the statement on compliance with published guidance referred to above.

3.4 *Transitional Provisions*

3.4.1 New format returns must be submitted for all financial years ending on or after 1 July 1994. For any year ending before 1 July 1995, the prior year's figures required by Forms 10, 13 and 15 may be completed in the old way, provided that it is stated that the figures are not comparable where this is the case. Reporting of past derivative exposures also only extends back to 1 July 1994.

3.4.2 The 1995 Regulations need not be complied with until 30 June 1996.

4. THE INSURANCE COMPANIES REGULATIONS 1994

4.1 *Solvency Margins*

4.1.1 Part IV of the 1994 Regulations equates to Part II of the 1981 Regulations ('Margins of Solvency'), with the following differences:

(1) Solvency margin calculations are specified for the two new classes of business which some U.K. companies could conceivably now write though branches in other E.C. countries (Class VIII 'Collective Insurances, etc.' and Class IX 'Social Insurance'). Neither of these classes of business can be written in the U.K.

(2) When determining the extent to which assets exceed liabilities, liabilities in respect of cumulative preference shares issued by an insurer shall now only be left out of account up to either 25% of the required margin of solvency (if the shares are redeemable) or 50% (if not).

4.1.2 No other changes are made in this area, although it is worth noting that the 3rd Life Directive requires the European Commission to have reviewed these regulations by 1997.

4.2 *Currency Matching and Localisation*

4.2.1 Part V of the 1994 Regulations (Currency Matching, Localisation) largely echoes portions of the existing Part IV. New Regulation 30 exempts a company from having to match liabilities in a particular currency if the amount involved would be 7% or less of its remaining assets.

4.2.2 Matched assets in sterling may now be localised in any E.C. country

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rather than just in the U.K., and those in any other currency either in the country of that currency or anywhere in the E.C. Further, business carried on outside the U.K. was previously exempted from the localisation provisions. Now this exemption applies only to non-E.C. business.

4.3 *Valuation of Assets*

4.3.1 Part VIII of the 1994 Regulations covers valuation of assets. The changes from the existing Part V are listed below.

4.3.2 The definition of 'approved financial institution' now refers only to E.C. central banks and certain specified international bodies. All other banks and building societies are now excluded. They are, instead, included under the definition of 'approved credit institution' (if eligible). This impacts upon the definition of 'approved securities', which includes, as before, loans to or deposits with approved financial institutions. Bank deposits are, therefore, no longer approved securities. This means that they become subject to admissibility limits for the first time. The previous long list of other approved securities is now shortened by cross-reference to securities of Zone A governments (essentially full OECD members plus some others — a list can be obtained from the Bank of England).

4.3.3 It is made clear that 'index-linked benefits' are not 'property-linked benefits'.

4.3.4 Conditions are laid down defining when a debt may be regarded as being secured.

4.3.5 Property-linked assets are now only exempted from the valuation of asset regulations to the extent that they match property-linked benefits.

4.3.6 Regard must be had to the underlying security of assets, and, where appropriate, the credit rating of the issuer, when assessing whether an asset should be valued lower than the regulations would otherwise prescribe. Whether or not the issuer is from a Zone A country is relevant in assessing its credit rating.

4.3.7 Shares in dependants must be valued ignoring any value arising from holdings in the parent. The definition of 'dependant' is brought into line with the Companies Act definition. This may result in additional holdings now requiring to be treated in this way.

4.3.8 Premiums outstanding for more than three months (including inwards reinsurance premiums) and subordinated debt from a company of which the insurer is a dependant are now to be left out of account.

4.3.9 New regulations are introduced for the valuation of 'repo' transactions and rights under stock lending. Broadly, if certain conditions are satisfied, the transactions may effectively be ignored. However, if the conditions are not met, the transactions will normally be valued as a number of futures contracts.

4.3.10 Unlisted shares were formerly valued as a multiple of the price/earnings ratio. Now all unlisted investments are valued using a new approach, which also applies to listed investments. If the investment is readily

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realisable, that is it can be assigned or transferred to a genuine third party within 7 days for at least 97.5% of its market value (as determined in accordance with U.K. generally agreed accounting principles), then this market value must be used. If it is transferable, but not readily realisable, then the lower of the market value and the amount which the investment could reasonably be expected to realise if transferred within the next 12 months must be used. If it is not transferable, then a current redemption or surrender value must be used.

4.3.11 Investments which have the effect of derivative contracts, either fully or partially, are to be valued as if they were derivative contracts.

4.3.12 Changes are made to the definitions of allowable life and reversionary interests.

4.3.13 Unit trust schemes recognised (as opposed to authorised) under the Financial Services Act, and any other collective investment scheme which satisfies certain conditions, may now be taken into account.

4.3.14 Rights under life reinsurance contracts, except to the extent that debts are due, cannot now be valued as assets. They may, of course, continue to be offset against the liabilities as appropriate.

4.3.15 Regulations concerning the valuation of derivatives are considerably expanded (see Section 4.4).

4.3.16 A prudential guidance note on asset valuation was first issued in December 1994 by the DTI (see Section 5.2), and has been updated to take account of the 1995 Regulations.

4.4 *Valuation of Derivatives*

4.4.1 For the first time, derivatives (i.e. futures, options, etc.) are permitted to form a material proportion of the admissible assets (previously they have been limited to 0.1% of the long-term business amount). Regulations are, therefore, required for their valuation.

4.4.2 The concept of an 'approved counterparty' is introduced, being an approved credit institution, firms exempt by Section 43 of the Financial Services Act (i.e. authorised to engage in wholesale market activities), firms authorised by that Act to enter into unlisted derivative contracts as a principal and issuers of new securities which are to be listed.

4.4.3 The concept of an 'approved derivative contract' is also introduced. This is a contract which is either listed or with an approved counterparty, is capable of being readily closed out and is either:

- a futures contract or option on assets, all of which are within the scope of the valuation regulations, with a price determined by one or more specified methods; or
- a contract for differences under which amounts payable are calculated either by reference to some aspect of assets within the scope of the Regulations or to a national index of retail prices of a Zone A country.

4.4.4 Only approved derivative contracts which are covered (i.e. do not

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require a significant provision under Regulation 61 (see ¶4.6.1)) may be taken into account. Further, they must either:

(1) be held in connection with an asset to reduce investment risk or for efficient portfolio management; or
(2) have "the equivalent effect to an approved derivative contract held in connection with such an asset" for such a purpose.

The 'other asset' must either be one which is within the scope of the valuation regulations or a further derivative contract which when combined with the first derivative contract synthesises either such an asset or an approved derivative contract held in connection with such an asset.

4.4.5 An asset which satisfied ¶4.4.4(2) would be a 'deposit' which returned, say, the larger of 90% of the amount deposited or that amount adjusted in proportion to the change in some index. This would be regarded as a contract for differences, which has an effect equivalent to holding 90% of the amount deposited in cash and purchasing an appropriate call option with the residue.

4.4.6 For a listed derivative contract, the value is to be market value. For an unlisted contract, the value is to be the price reasonably payable for closing out the contract. Any cash or assets (e.g. margin payments) already received in respect of the contract must be deducted.

4.4.7 Derivative contracts which fail to satisfy the conditions of ¶¶4.4.3–4 can only be taken to have any value if there is an unconditional right to a specified payment, which should be valued as for any other debt.

4.5 *Admissibility Limits*

4.5.1 Admissibility limits, too, are significantly changed in their new form.

4.5.2 A permitted asset exposure limit (formerly 'maximum admissible value') is calculated, as before, as a percentage of the long-term business amount (which is now defined slightly differently to before), such percentage being specified for different types of asset in Part II of Schedule 12 (Appendix A summarises the new limits and compares them with the former values).

4.5.3 The exposure to any type of asset means the value of all assets of that type which would be held assuming:

(a) that futures contracts are fulfilled;
(b) that, if prudent to do so, options are exercised; and
(c) that contracts for differences are assumed to be made up of an equivalent combination of futures contracts or options which are dealt with according to (a) and (b) above.

4.5.4 However, unless an unlisted 'put' futures contract or option is with an approved counterparty and has less than 12 months to run, it is not to be assumed to be fulfilled or exercised. DTI guidance also states that it would not be 'prudent' to assume that a company would exercise an option which would reduce its admissible assets.

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4.5.5 The regulations also embrace exposure to assets not in themselves allowed to be taken into account.

4.5.6 A permitted counterparty exposure limit is also calculated as a percentage of the long-term business amount. Exposure to individual counterparties is determined by aggregating all investments issued by, or rights against, the counterparty, after first restricting to its permitted limit, if necessary, the deemed exposure with that counterparty of any asset type. Certain secured exposures may be ignored and legal rights of offset deducted. The limits applicable, together with an additional limit on concentration with a number of counterparties, are summarised in Appendix B.

4.5.7 If assets which have been taken as security for a debt are added to a company's other exposure to that type of asset and the permitted exposure limit is exceeded, then the debt is regarded as unsecured to the extent of the breach.

4.5.8 If the exposure to assets of any one description exceeds the permitted limit for that type of asset, then assets to the value of the excess must be left out of account. If there are insufficient assets of that type (e.g. because the adjustments referred to in ¶4.5.3 are substantial), then the excess should be deducted from the aggregate value of the remaining assets taken into account.

4.5.9 If the exposure to a counterparty (or the concentration with a number of counterparties) exceed the specified limits, the excess should be deducted from the aggregate value of the assets otherwise taken into account.

4.5.10 For example, assume a company holds shares in XYZ Limited worth 1% of the long-term business amount and has an open futures contract to purchase further such shares worth 3% of the business amount. If the contract was fulfilled, the exposure would be 4%, 1.5% of which would be inadmissible. The 1% actual holding must, therefore, be left out of account and a further 0.5% of the business amount must be deducted from the aggregate value of the remaining assets.

4.5.11 A deduction should also be made for margin payments received in respect of derivatives not themselves allowable.

4.5.12 Limitations do not apply to approved securities and interest thereon (as before) nor, now, to:

- — debts due from reassurers;
- — policy loans, to the extent to which they do not exceed the surrender value;
- — those outstanding premiums which may be taken into account (the previous 30% of premium limit is no longer needed as a result of the limitation of allowable outstanding premiums, referred to in ¶4.3.8);
- — monies guaranteed by Zone A states;
- — shares in or debts due from a dependant; and
- — a unit trust falling within the scope of the UCITs Directive.

4.5.13 The excess asset exposure limits do not apply to assets matching index-linked benefits. Only counterparty limits and the deductions described in ¶4.5.11 are applicable. This prevents what might otherwise have been a severe

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problem for this type of business, which may no longer be treated as property-linked. Some residual difficulties may remain if single counterparty exposure is high.

4.5.14 The introduction of counterparty limits which embrace deposits are known to have caused some small, unit-linked companies to revise their investment strategy.

4.6 *Determination of Liabilities*

4.6.1 *Derivative contracts*

New Regulation 61 requires prudent provision to be made for obligations or potential obligations to make payments or deliver assets (e.g. under derivative contracts or stock lending transactions). Companies should identify the assets most suitable to cover the obligation, and regard should specifically be had to past volatility of the assets concerned (or similar assets) and the possibility of adverse changes in volatility in the future.

4.6.2 *Valuation methods*

4.6.2.1 As before, valuation should be on actuarial principles with prudent assumptions. Moreover, regard must now be had to policyholders' reasonable expectations, and margins for adverse deviation in all relevant factors must be included.

4.6.2.2 A prospective calculation separately for each contract is specified as the primary valuation method. However, a retrospective method can be used where a prospective method cannot be applied or where the results would be no lower than if one was. Approximations or generalisations may also be used where they are likely to provide no lower a result than individual calculations. Additional amounts should be set aside on a collective basis for risks which are 'not individualised'.

4.6.2.3 Methods and assumptions used must not be subject to arbitrary change from year to year, and must permit the appropriate distribution of surplus over the duration of each policy.

4.6.2.4 Liabilities under with-profits contracts must take account of the level of premiums under the contracts, the assets held in respect of those liabilities and the practice of the company in the manner and timing of profit distribution.

4.6.2.5 The net premium method is specified as the primary method for regular premium policies with benefits guaranteed from outset. However, an alternative method may be used if it would result in reserves no less, in aggregate, than if the net premium method were used. It is not explained how broadly 'in aggregate' can be interpreted (e.g. policy type by policy type or across all business to which this particular regulation applies).

4.6.3 *Rates of interest*

4.6.3.1 Gross yields now only have to be reduced by 2.5% rather than 7.5%.

4.6.3.2 The yield on variable interest investments other than equities or

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property (e.g. index-linked gilts) is now to be calculated as a gross redemption yield rather than as a running yield. Certain assumptions are specified about future interest and capital payments.

4.6.3.3 The cap of the yield on $2\frac{1}{2}\%$ Consols is dropped, but the requirement to adjust the yield for the risk of non-maintenance or default remains. Yields should also be reduced to the extent to which the exposure to the underlying asset type exceeds the specified limit.

4.6.3.4 Gross yields in sterling obtainable on sums to be invested more than three years in the future must not exceed the lowest of:

(a) the FT-Actuaries U.K. Government fixed-interest 15-year medium coupon yield ($G\%$);
(b) $6\% + 0.25 \times (G\% - 6\%)$; and
(c) 7.5% p.a.

4.6.3.5 Linear interpolation should be used to obtain the yield applicable to sums to be invested within three years of the valuation date. Previously, a simple cap of 7.2% applied to all future assumed yields more than 3 years in the future.

4.6.3.6 Where liabilities are denominated other than in sterling, similarly prudent assumptions shall be made about future yields.

4.6.3.7 The overall limit of the weighted average adjusted yield on the assets remains, with hypothecation continuing to be possible.

4.6.4 *Mortality and disability*

Rather than to published tables and own past experience, reference is now made to prudent rates of mortality and disability for the 'state of the commitment'. This latter expression refers to the E.C. country in which the contract is deemed to be made. Clearly, however, regard must also still be had to offices' own experience, where relevant, to establish prudence.

4.6.5 *Expenses*

4.6.5.1 It is now specifically stated that the costs to be allowed for must be those prudently expected to be incurred in fulfilling contracts if the company were to close to new business in one year's time. Regard must be taken of recent actual expenses (as before) and to the effect of future inflation.

4.6.5.2 The DTI has made it clear that the way the regulation is now worded implies that provision should be made for any expected acquisition expense overrun in the coming year. This requirement has been further interpreted by guidance from the Institute and the Faculty, which makes clear that no provision is needed if either:

(a) the new business is expected, on a prudent basis, to be self-supporting after allowing for the repayment of any valuation strain with interest; or
(b) the valuation strain on the new business is expected, on a prudent basis, to be less than the surplus arising from existing business over the year.

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4.6.6 *Assets*

Prudent provision must be made specifically against future changes in the value of assets on both the ability of the company to meet its obligations as they arise and the adequacy of the liabilities as determined according to the regulations.

4.7 *Comments*

4.7.1 Our own experience and that of other actuaries is that the regulations have proved generally helpful. For example, the reduction of the deduction from asset yields from 7.5% to 2.5% has increased maximum permitted yields, enhancing the actuary's flexibility (subject always, of course, to appropriate prudence).

4.7.2 The removal of the Consols test has focused our minds on the remaining need to adjust for risk of non-maintenance or default. Questions which arise include:

— Is the current level of unoccupied property 'normal'?
— Will leases be able to be renewed at current rentals?
— Will dividends or rents fall across the market?
— What is the credit rating of issuers of unquoted stocks?

We do not expect the resulting deductions to be as large as the Consols test would have required.

5. DTI PRUDENTIAL GUIDANCE NOTES

5.1 *Investment Controls*

5.1.1 This guidance, issued on 1 December 1994, is stated to be of relevance in the satisfaction of three revised regulatory requirements:

(1) the sound and prudent management criteria contained in new Schedule 2A to the 1982 Act;
(2) new Section 35A of the 1982 Act, which requires assets to be of appropriate safety, yield and marketability and appropriately diversified and adequately spread; and
(3) the new framework for the use and reporting of derivatives (see Sections 3.2 and 4.4).

5.1.2 The procedures set out in ¶¶5.1.3 to 5.1.12 must be demonstrated for compliance.

5.1.3 The board of the company should determine, implement and monitor an investment strategy reflecting:

(1) the requirements of Section 35A;
(2) the matching and localisation requirements of the 1994 Regulations;
(3) the implications of Section 16 of the 1982 Act (e.g. not trading in investments in a way which might not be deemed to be for the purposes of

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insurance business);
(4) Section 29 of the 1982 Act (application of the life fund assets); and
(5) DTI Prudential Guidance Notes.

5.1.4 Management control and information systems should be established to carry out the strategy and to enable the board to monitor its progress.

5.1.5 The board should be aware of the responsibilities of the Appointed Actuary to advise on investment policy in accordance with GN1, and should ensure that he or she is in a position to do so.

5.1.6 The credit-worthiness of counterparties (including reinsurers) must be regularly verified, and systems must be established to monitor aggregate exposure (both to counterparties and to specific categories of assets) and to set lower limits than implied by Schedule 12 of the 1994 Regulations if appropriate. Further detailed guidance is provided in the note on this latter issue.

5.1.7 Systems should be in place to ensure that linked liabilities are properly covered with permitted assets.

5.1.8 Terms of reference of a fairly specific nature should be produced for investment managers, even where these are 'in-house'. These will probably need to include specific category limits and any legislative constraints, but should also bring out the desired risk/reward balance, taking account of liabilities and policyholders' reasonable expectations. Particular care should be taken when different organisations have responsibility for managing different parts of the portfolio. Adequate monitoring of compliance must take place.

5.1.9 Special attention should be paid to the use of derivatives. In particular, the risks involved in their use should be assessed and regularly reviewed and their use should be consistent with the investment strategy. Further detailed guidance is contained in the DTI note.

5.1.10 Appropriate resources must be allocated to these tasks.

5.1.11 Last, but not least, the board must discuss all these matters regularly so as to be satisfied of compliance.

5.1.12 Along with us, many actuaries will have embarked upon the preparation of more specific guidelines for investment managers to enable certification of compliance with the DTI guidance on control. Our thinking has focused particularly on the issue of suitable risk profiles and performance targets for with-profits funds.

5.2 *Valuation of Assets*

Extensive guidance is given on the proper interpretation of Part VII of the 1994 Regulations, especially Regulation 57 (admissibility) in general and its approach to debts and aggregation in particular. A number of useful examples are provided. We have incorporated some of the points into Sections 4.3 to 4.5, but frequent direct reference will be necessary.

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5.3 *Linked Funds*

5.3.1. In the main, the guidance relates to issues outside the scope of the paper. However, further light is shed on the implications of the valuation rules for index-linked business and for excess assets held in a linked fund (only material excesses requiring revaluation, for example).

5.3.2 Solvency margin considerations are also addressed, including making clear that business which is dependent upon a reinsurer meeting its obligation to provide an investment return can, in some circumstances, be regarded as carrying an investment risk, and hence requiring a non-zero solvency margin, even where no guarantee is given to the policyholder.

5.4 *Use of Derivatives*

5.4.1 Guidance covering the use of derivatives includes interpretations of key phrases in the 1994 Regulations such as 'in connection with', 'reducing the investment risk' and 'efficient portfolio management'. The first of these would not be satisfied if, for example, a put option on a particular stock was bought without holding the underlying stock or an appropriate future or call option (but a put on an index would be acceptable if a reasonable spread of index stocks were held). A call option would fail the 'test' unless sufficient liquid assets were held.

5.4.2 Efficient portfolio management is defined as a transaction which helps a company progress towards its investment objectives:

— more quickly;
— more easily;
— more efficiently;
— more cheaply (including tax-efficiently); or
— more flexibly.

5.4.3 However, there must be no increase in investment risk which could not have been achieved by transactions in the underlying assets.

5.4.4 In particular, it is made clear that any derivatives which 'gear' performance relative to an index will not be deemed to be for the purposes of efficient portfolio management. Nor, even if there is a matching liability, can they generally be deemed to be for the purposes of reducing investment risk. However, some limited upward gearing will be allowed, provided that the only *quid pro quo* is to be the loss of any element of investment return significantly in excess of that expected from an appropriate risk-free investment.

5.4.5 Guidance is also provided on the definition of 'covered', on valuation (including derivatives which are liabilities) and on admissibility. Copious examples are very helpfully included.

5.5 *Reporting of Derivatives*

A note was issued in 1995, providing guidance on the completion of Form 13A.

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6. Revisions to Actuarial Professional Guidance

6.1 *Introduction*

Revisions to GN1 and GN8 were issued in December 1994 under the 'fast track' procedures. This means that they will be compulsorily reconsidered within 18 months. Nevertheless, they are mandatory for Appointed Actuaries in their 'draft' form.

6.2 *GN1*

6.2.1 The main changes to GN1 relevant to financial reporting are outlined in ¶¶6.2.2 to 6.2.6.

6.2.2 It is noted that the premium adequacy certificate does not pose any additional burden on Appointed Actuaries. This is because it relates purely to business written in the previous financial year, and reserves should already have been set up to cover any expected inadequacies.

6.2.3 However, if new business continues to be written on such terms, a requirement is introduced to advise the directors on the ability of the company's reserves to continue to provide support.

6.2.4 Attention is drawn to the need to allow for the effect of derivatives. Reference is made to GN25 ('Investments — Derivative Instruments') which was issued on 30 December 1994. Among many other valuation considerations, GN25 draws attention to:

- the degree of matching of derivatives and policy liabilities (allowing for the possibility that the policy will terminate early);
- the volatility of derivative prices, and the need, always, for up-to-date valuations ('marking to market' is recommended where appropriate); and
- the fact that derivatives could alter the yield of the assets and hence the maximum permitted liability valuation rate.

6.2.5 Annual actuarial valuation reports should present the results in a way which does not hide the true, underlying position (i.e. no 'window dressing').

6.2.6 Guidance is also likely to be given in the 'final' version on the situation where discretionary contract terms are determined by the Appointed Actuary and on equitable treatment of policyholders in unit pricing.

6.3 *GN8*

6.3.1 The main changes to GN8 relevant to financial reporting are outlined in ¶¶6.3.2 to 6.3.6.

6.3.2 It is made clear that an Appointed Actuary's certificate must be qualified if the Actuary is unable to comply fully with the guidance.

6.3.3 The regulatory requirement to "have regard to the reasonable expectations of policyholders" is interpreted as requiring "proper provision for future reversionary bonus". Implicit margins will, however, where sufficient, satisfy this requirement. The Actuary must also be satisfied that the fund is able

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to support a 'proper level' of terminal bonus.

6.3.4 Specific guidance is given on meeting the new detailed regulations (65 to 75) of the 1994 Regulations; in particular, on:

(a) allowing an appropriate level of reversionary bonus to emerge;
(b) discontinuities from year to year;
(c) adjusting yields for risk (can leave a differential for marketability and other factors);
(d) yields in currencies other than sterling;
(e) hypothecation of assets; and
(f) future expenses.

6.3.5 Regulation 71(1) is interpreted as requiring a specific provision for acquisition expense overrun expected to be incurred in the following 12 months.

6.3.6 In the 'final' version, additional guidance is likely to be given on future expenses, on assessment of prudent rates of mortality and morbidity, on allowing for mortality improvements and on cash flow mismatching.

7. Updating the DTI Returns

... it contains a Little Hall, with a little lantern in its roof: to what obstructive purposes devoted, and at whose expense, this history knoweth not.

7.1 *Introduction*

7.1.1 In August 1994, the DTI published a consultative document entitled 'Updating the DTI Returns'. This contains the outcome of a review by the DTI of the present form and content of the returns in the light of the U.K. Government's deregulation initiative, the E.C. Insurance Accounts Directive, the need to ensure compliance with the Insurance Companies Regulations 1994 and changes in the market since the last major revision in 1983.

7.1.2 In July 1995, a further document entitled 'Updating the DTI Returns — The Next Steps' was issued, setting out reactions to the earlier paper and containing some revised proposals. These were the subject of further discussion with the insurance industry and the actuarial profession.

7.1.3 In December 1995, draft regulations to replace the 1983 Regulations were published. These Regulations, possibly with minor amendments, were expected to be laid before Parliament in early 1996, to come into force for financial years commencing on or after 29 December 1995.

7.1.4 A summary of the more significant aspects of the draft regulations is set out in Sections 7.2 and 7.3. It is also worth noting that the numbering of several forms in the return is expected to change as a result of these revisions.

7.2 *Schedules 3 and 4*

7.2.1 It is intended that a number of the existing asset and movement analyses are moved from Schedule 3 to Schedule 4, thus removing them from the

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requirement for audit, but, instead, making them the Appointed Actuary's responsibility. Some simplifications are also intended.

7.2.2 New 'matching rectangles' are to be required (new Form 57), setting out the types and amounts of assets hypothecated to each significant category of business and their risk-adjusted yields. The weighted average of the risk-adjusted yields can then be compared with the valuation rate used. Specific disclosure of assets matching index-linked liabilities will also be required.

7.2.3 It is also proposed that more information will have to be included in Schedule 4 to enable the DTI to verify compliance with the revised regulations, particularly the requirement that each regulation must be complied with individually rather than in aggregate. This will include:

(a) how the mortality and morbidity assumptions take into account the 'State of the commitment';
(b) the allowance made for future improvements in annuitants' mortality;
(c) the source and expected amount of loadings for future expenses (whether implicit or explicit) and the methods used to devise the provisions described in ¶4.6.5;
(d) details of the prudential margins for risk in the yield, including the methodology used to assess risk;
(e) existing bonus practices, and how they and policyholders' reasonable expectations have been taken into account; and
(f) details of resilience testing, including showing the values of assets in the most onerous scenario on Form 57.

7.2.4 More information will be required about unit-linked business, including the unit pricing process followed by the office, about financial reassurance arrangements, about currency matching and about its surrender practices, particularly on unitised with-profits business.

7.2.5 Instructions will no longer have to be reproduced in the returns.

7.2.6 Distinct valuation summaries for 'accumulating' with-profits business (e.g. unitised with-profits) and for index-linked business will now be required.

7.3 *Schedule 5*

7.3.1 Schedule 5 is currently required to be published every 5 years, providing detailed information about the business in force. In theory, this should permit the DTI or any other interested person to carry out an independent valuation of the liabilities.

7.3.2 Schedule 5 could also be used by supervisors to examine the maturity profile of the business, and so to consider the appropriateness of the investment strategy and the degree of cash flow mismatching.

7.3.3 However, the DTI admit that they themselves make little use of the information, not the least because it can be up to 5 years out of date. This datedness, together with structural deficiencies, mean that it is of less than perfect

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value to those wishing independently to assess the liabilities.

7.3.4 Schedule 5 type data will not be required under the replacement Regulations. Furthermore, initial proposals to require some annual tabulations for with-profits business have not been carried through to the final drafts.

7.3.5 Until the 1982 Act can be amended, the DTI is generally willing to grant 'Section 68 orders' (waivers), permitting deferral of production of Schedule 5s.

7.4 *Comments*

7.4.1 We welcome the deregulatory effect of the removal of the quinquennial Schedule 5. However, the additional information required to be produced annually in Schedule 4 is likely to offset much of the gain.

7.4.2 We also welcome the increased reliance on actuarial certification implied by the shift of information from Schedule 3 to Schedule 4.

8. SATISFYING THE INSURANCE ACCOUNTS DIRECTIVE

... I am besides totally unacquainted with the habits of birds, except the birds of Staple Inn ...

8.1 *Background*

8.1.1 U.K. insurance companies (both mutual and proprietary) have, in the past, been exempted from reporting to shareholders on a completely 'true and fair' basis (as otherwise required by the Companies Act 1985).

8.1.2 This is because paragraph 28 (1) of Schedule 9A to that Act previously permitted insurance companies to prepare only a limited form of balance sheet and profit and loss account. The main exemption was that technical provisions and other reserves did not need to be distinguished in the balance sheet. Further, only so much unrealised gain as was required to meet the cost of bonus and/or profit needed to be recognised in the revenue account.

8.1.3 Paragraph 28(2) of Schedule 9A then went on to state that the accounts of a company taking advantage of the above exemption would, for that reason at least, not be considered not to be true and fair. Paragraph 28A then exempted the auditors from having to state that such accounts were 'true and fair', but merely that they had been properly prepared in accordance with the Act.

8.1.4 The implementation in the U.K. of the E.C. Insurance Accounts Directive means that these exemptions will be removed, for financial years beginning after 22 December 1994. The changes are part of The Companies Act 1985 (Insurance Companies Accounts) Regulations 1993 ('the Regulations').

8.1.5 The Regulations introduce a replacement Schedule 9A into the Companies Act 1985. This specifies the items to be included in company balance sheets and profit and loss accounts, the latter being subdivided into a long-term business technical account and a non-technical account. Some notes and guidelines are given on how the various entries are to be determined. However,

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much is left to individual interpretation as guided by accounting practice.

8.1.6 The Association of British Insurers (ABI) has developed an accounting basis, the Modified Statutory Basis (MSB), to satisfy the requirements of the Regulations. Revisions to the existing Statement of Recommended Practice (SORP) on accounting for insurance companies have been drafted and submitted to the Accounting Standards Board (ASB). The revisions are in the form of an Exposure Draft, circulated to ABI member companies, auditors and other interested parties for comments in May 1995. If the ASB raises no objections, auditors are likely to use the revised SORP as defining 'best practice' for insurance company accounts.

8.1.7 As well as life business, the revised SORP covers general insurance and accounting for the investments of insurance companies, although, at the time of writing, the ABI has not completed its proposals on accounting for investments. The ASB has not yet given its negative assurance, but the Exposure Draft is being used as guidance by companies at year-end 1995.

8.2 *Basic Description of the Modified Statutory Basis*

8.2.1 MSB is a development of the existing Statutory Solvency Method (SSM) for reporting profits on long-term business. The SSM profit is the amount of surplus transferred from the long-term fund following an actuarial investigation under Section 18 of the Insurance Companies Act 1982.

8.2.2 MSB seeks, *inter alia,* to remove the following two key features of current SSM reporting:

(1) sales of products can give rise to an accounting loss in the year of sale, even though the products may be anticipated to be profitable in the long term; and
(2) proprietary offices do not have to recognise shareholders' interest in all unrealised gains, but only in the gains which have been included in the revenue account.

8.2.3 The other main distinctive features of the MSB, when compared with the SSM, are set out in ¶¶8.2.4 to 8.2.8.

8.2.4 MSB requires separate recognition of amounts previously combined within the life fund. The three distinct types of heading are:

— Technical Provisions;
— Shareholder Funds; and
— Fund for Future Appropriations (FFA).

8.2.5 To the extent that recognised amounts, other than technical provisions, have been determined to belong to shareholders at the balance sheet date, these will be recognised in published financial statements as shareholders funds.

8.2.6 The revised SORP permits use of the FFA "in line with the underlying Regulations". The underlying regulations say that the FFA is used when — "the allocation either to policyholders or shareholders has not been determined at the balance sheet date".

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8.2.7 MSB requires realistic deferral of acquisition costs. Where the deferral is explicit, the outstanding balance of Deferred Acquisition Costs (DAC) on in-force business is all recognised as an asset in the balance sheet. Where the deferral is implicit, the amount recognised as an asset in the balance sheet, plus the adjustment to technical provisions shown in the notes to the accounts should together show the total amount of DAC.

8.2.8 As mentioned in ¶8.1.7, the accounting for investments part of the revised SORP was unfinished at the time of writing. However, early proposals in this area are that movements in unrealised gains and losses on assets will have to be identified. To the extent that these assets are attributable to with-profits or to linked business, the movements will have to be identified in the long-term business technical account (the replacement for the revenue account). For other business, the movement can be taken to one only of the long-term business technical account or the revaluation reserve. The latter option is unlikely to be attractive to companies, as there is a risk that ASB proposals will not allow these amounts later to be recognised as profit.

8.2.9 Mutual offices will see a change to the format of their accounts as a result of ¶¶8.2.4 to 8.2.8, but will not see a change to the amount shown as surplus. For proprietary offices, the effects on recognised surplus in the accounts will be:

(1) For with-profits business, movements in unrealised gains/losses will not appear in the non-technical account, but instead go to increase the FFA.
(2) For linked business, movements in unrealised gains/losses will appear in the non-technical account to the extent that they are not matched by the consequent moves in the liabilities.
(3) For other classes, our own office plans to put the unrealised gains and losses through the technical account. We feel that other offices will also, in the main, make no use of the valuation reserve.
(4) Movement in DAC will have the same effect as movement in unrealised gains/losses.

8.2.10 MSB will not change the amount transferable to shareholders from the long-term fund — that is still limited by the result of a Section 18 valuation. Any additional amount recognised is not removed from the long-term fund.

8.3 *Further Aspects of the Revised ABI SORP — Technical Provisions and the FFA*

8.3.1 Technical provisions are defined in the Regulations and the revised SORP prefers this definition over the more general one in the Companies Act. The Regulation definition is that their amount "must at all times be sufficient to cover any liabilities arising out of insurance contracts as far as can reasonably be foreseen".

8.3.2 The technical provisions are further split into three types:

— technical provision for linked liabilities (only for unit-linked benefits);

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— claims outstanding; and
— long-term business provision (the remainder).

8.3.3 The Regulations require the long-term business provision of companies with U.K. head offices to be computed annually by a Fellow of the Institute of Actuaries or of the Faculty of Actuaries. The computation has to have due regard to the actuarial principles required to be followed to determine prudent provisions for policyholder security. The U.K. legislation defining these is now the Insurance Companies Regulations 1994.

8.3.4 The revised SORP allows use of amounts calculated primarily for solvency valuations (for example, for the U.K. DTI Returns). However, the revised SORP does require companies to review amounts calculated for solvency purposes, to decide how far they should be included in order to give a 'true and fair' view. This means that offices must justify amounts which are included as technical provisions, rather than simply 'plugging in' all of the amounts calculated for solvency purposes.

8.3.5 The revised SORP's definition of the FFA (see ¶8.2.6) would seem to allow non-profit funds to use the FFA, as it could be argued that until profit is actually distributed, the "allocation ... has not been determined". This would allow non-profit offices to continue to avoid recognising the source of profit. However, this could be an area for debate between companies and their auditors, as some audit firms, at least, have been strongly in favour of limiting use of the FFA to with-profits business, on the grounds that the allocation to policyholders of profit from non-profit funds is bound to be zero.

8.3.6 At the very least, the ASB looks likely to require further disclosure of company policy on the use of FFA than is required by the ABI exposure draft. The ABI is drafting additional conditions for use of the FFA to anticipate the ASB requirement. Current ABI thinking is that:

(1) those non-profit and linked funds where there is reasonable certainty over the allocation to policyholders or to shareholders of all items in the technical account should not be using the FFA; but
(2) there are funds where the allocation is not clear cut, and there may be grounds for using the FFA.

8.3.7 Indications in early 1996 are that the major U.K. auditing firms are following different approaches in deciding the types of funds that can use the FFA. Most proprietary offices (and, of course, mutuals) are using the FFA for as much of their long-term business as possible under the revised SORP.

8.3.8 The revised SORP allows the liabilities of overseas subsidiaries incorporated into group accounts to be computed on a local GAAP or regulatory basis, provided that the revised SORP principles are followed. Their long-term business provisions must be determined by an actuary or other specialist using recognised actuarial methods.

8.3.9 Tax provisions are to be shown separately under liabilities item for

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'Creditors — other creditors including taxation and social security', to the extent they are not in the long-term business provision or the technical provision for linked liabilities.

8.4 *Accounting for Acquisition Costs*

8.4.1 The revised SORP defines acquisition costs to include 'fixed and variable costs' associated with acquisition. This makes more precise the definition in the Regulations.

8.4.2 The revised SORP requires that:

(a) Acquisition costs must be deferred by one or both of the following:
- creating an explicit DAC asset in the balance sheet, which may be calculated in full or in part by means of an actuarial method (e.g. zillmerisation) which enables the costs so deferred to be separately identified; or
- an implicit actuarial method (e.g. bonus reserve valuation) which does not permit the separate identification of costs deferred.

(b) For an explicit actuarial method, any limitation in deferral arising because the statutory policy liability may not be less than zero (or less than a guaranteed surrender value), or because of a maximum placed on the zillmer adjustment, must be shown as an additional deferred acquisition cost asset.

(c) Where an explicit actuarial method is used, the technical provisions shown should be ones calculated without the use of the method.

(d) DAC carried forward as an asset in the balance sheet should be amortised "over the period in which they are expected to be recoverable out of margins in matching revenues .... at a rate which is commensurate with the pattern of such margins."

(e) Acquisition costs should not be deferred to the extent that:
- the costs in question have already been recovered;
- the contracts are not expected to generate enough present value of margins over their lifetime to cover the acquisition costs after meeting other costs; or
- the receipt of future premiums or future margins is insufficiently certain, based on prudent estimates of future expected discontinuance rates or other experience.

(f) The DAC asset should be shown gross, with a deferred tax provision separately established if required by the relevant accounting standard.

8.4.3 The Regulations are actually less restrictive than the revised SORP on the methods of deferring acquisition costs. In particular, zillmerisation without disclosure of a specific asset would appear to be permitted by the Regulations. However, in this area, as in several others, the revised SORP seeks to achieve consistency across companies by reducing the options available. The revised

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SORP also gives guidance on the circumstances in which it is appropriate to use an implicit actuarial method.

8.5 *Additional Disclosure*

8.5.1 The Regulations and the revised SORP together require significant additional disclosure in the notes to the accounts. The requirements which we think will be of particular interest to actuaries are set out below.

8.5.2 Disclosure regarding acquisition cost deferral should cover the method of deferral and the basis of amortisation.

8.5.3 Disclosure of technical provisions should cover:

(1) the principal method of valuation;
(2) a summary of the principal assumptions underlying the long-term business provisions (e.g. interest, mortality/morbidity, allowance for future expenses);
(3) a statement of whether provision is made (explicitly or implicitly) for future bonuses, and, if so, also a broad description of the means by which such allowance is made;
(4) the reasons behind any significant mismatch between:
    — net assets held to cover linked liabilities at the balance sheet date; and
    — the technical provision for linked liabilities.

8.5.4 For the FFA, disclosure should cover:

(1) the basis on which any FFA has been established; and
(2) the policy for making transfers to or from the FFA.

8.5.5 The basis adopted for 'grossing up' after tax profits should be disclosed.

8.6 *ASB Concerns about the Revised SORP at December 1995*

8.6.1 The ASB has advised that it has three preconditions that need to be satisfied before the revised SORP receives negative assurance:

— the recommendations should cover accounting for investments;
— final clearance should be obtained from the DTI; and
— the ASB should be satisfied on all outstanding issues.

8.6.2 At the time of writing, the outstanding issues for long-term business revolve around:

— use of the FFA;
— treatment of deferred tax in actuarial liabilities; and
— implicit methods of allowing for deferred acquisition costs.

8.7 *Repercussions of MSB*

8.7.1 In this section we cover the possible impact on the various roles in Companies Act reporting. At the time of writing, U.K. offices are still developing their approaches for year-end reporting under MSB, so some of this must be

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conjecture. However, we have faced, or are facing, these issues in our own office, and discussions with other offices show that they also face the same issues.

8.7.2 For valuation actuaries and company accountants it imposes additional work, in development and also in operation during the financial reporting season.

8.7.3 What of insurance company boards? In relation to profit recognition for proprietary life companies, the proposals put greater authority and responsibility in the hands of the directors (as distinct from the Appointed Actuary, who was responsible for determining the maximum transferable amount under a Section 18 valuation).

8.7.4 What of the relationship between Appointed Actuaries and auditors? The new methods allow companies and their auditors to expand the scope of audit investigations. For example, audit review of the company's recognition of DAC could be a new area. The responsibility for authorisation of the amount of provisions also needs to be agreed. In other words, it sets the stage for delicate negotiation between fellow professionals to ensure that bases acceptable for both solvency and profit reporting purposes are achieved.

8.7.5 What of readers of the accounts? These include shareholders of proprietary offices, potential shareholders and share analysts, and also policyholders and their advisers. As offices' practices develop, it is possible that a reader of insurance company accounts will find a wide range of practices being followed, e.g. on treatment of consolidated accounts, or accounting for unrealised investment gains. Whether accounts will become any more comparable across companies remains in considerable doubt.

8.7.6 What of the U.K. tax authorities? In the light of the new accounting regulations, the Inland Revenue have proposed some changes to the taxation of long-term assurance companies in the U.K. These changes are relatively minor. For example, certain classes of business (e.g. permanent health insurance) will be taxed on MSB profits rather than on profits recognised in the DTI Returns.

8.7.7 Finally, going back to the effects of the Regulations, as mentioned in ¶8.2.2:

(1) by allowing for DAC, sales of profitable products should now not give rise to as large an accounting loss in year of sale as was previously the case; but
(2) with regard to recognising shareholders' interest in all unrealised gains, it remains to be seen whether offices will find ways to avoid it!

9. The Achieved Profits Method

... in those days no neighbouring architecture of lofty proportions had arisen to overshadow Staple Inn

9.1 *Historic Background*

9.1.1 Development of achieved profits has primarily arisen from the desire of U.K. proprietary offices to inform shareholders of the true value of their interest in the business, and of the change in that value over time as a result of the

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management of the office's resources. This has both defensive and capital raising benefits.

9.1.2 Embedded values techniques, measuring the present value of expected future transfers to shareholders from the in-force portfolio, were developed to address this desire. Profit can be defined as the change in embedded value over the reporting period plus the profit transfer.

9.1.3 In the case of companies transacting mainly long-term insurance business, there was a problem with the acceptability of this reporting method within the audited statements. Auditors were reluctant to approve the method, as it takes immediate credit for shareholder profits that will only be earned if future experience is, in aggregate, as favourable as the actuary anticipates in setting the basis. However, banking and other non-insurance groups managed to use the embedded values for their long-term business in group consolidated accounts.

9.1.4 The first response to this problem was the concept of 'accruals'. The main difference compared with embedded values is that assumed future experience allows for 'planned margins' in the basis, so that the profit recognised reflects the risk taken to date and the work done on the contract to date. On this basis, the directors could be reasonably confident that the recognised profit stream had already been earned. This concept was developed by the ABI to a draft proposal issued in July 1992.

9.1.5 However, accruals did not gain complete acceptance. Most proprietary offices were reluctant to move onto an accruals basis in the published accounts. However, most offices accepted that the SSM did not address the offices' desire to inform shareholders. They also agreed that an embedded value calculation with a risk margin in the discount rate had a similar effect to the accrual risk adjustment.

9.1.6 To respond to these concerns, an informal working party was set up to produce a methodology for use in group level consolidated accounts which will satisfy the Insurance Accounts Regulations and which will command support from all U.K. proprietary offices. That working party proposed a method called the Achieved Profits Method (APM) in March 1994, an explanation of which was circulated to interested parties. Subsequently a more formal ABI steering group was set up to carry matters forward and its current thinking is set out below.

9.1.7 In July 1995 the steering group released an Exposure Draft of its proposals to ABI members, to auditors and to the Inland Revenue and DTI. Ultimately, the steering group hopes to get negative assurance from the ASB. The main issues in the light of responses to the exposure draft appear to be:

(1) whether ABI should recommend APM as suitable for use in published insurance company accounts or just as supplementary information;
(2) the Inland Revenue's concern at having two accounting methods (APM and MSB) which are both certified as 'true and fair', but where the MSB method defers payment of tax compared with APM; and
(3) options for showing the APM asset in the balance sheet (see ¶9.3.9).

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9.1.8 However, in terms of the scope of APM, it appears likely that the ABI steering group will ask insurance companies to report APM results to shareholders only at group consolidated level and only as supplementary information. Banking and other groups, who have used embedded values for statutory reporting in the past, are offered the chance to use the new methods in their main financial statements.

9.1.9 As well as the method developed in the U.K., methods have been developed for profit reporting in other territories (e.g. United States GAAP, Australian 'Margin on Services'). U.K. companies which have, for example, U.S. or Australian parents will already have learned to report using those methods. Such companies may be reluctant to embrace APM in addition.

9.2 *Basic Description of Achieved Profits Method*

9.2.1 The aim is to put a value on the estimated future transfers to shareholders arising from the in-force portfolio of assets and liabilities. No allowance is made for profits from estimated future sales.

9.2.2 The Exposure Draft's recommended approach is to:

(1) make prudent estimates of each element of future experience that will affect the transfers to shareholders, e.g. investment returns, claim and lapse rates, expenses;
(2) estimate the future transfers to shareholders arising on the in-force business if the estimates in (1) arise; the recommended approach reflects the effect of the statutory valuation basis in estimating the incidence of shareholder transfers (including, for with-profits business, the declaration of policyholder bonus);
(3) discount the estimated transfers to the balance sheet date, to give the shareholder value; and
(4) the APM profit in an accounting period is the change in shareholders value, plus the amount of the transfer to shareholders in the period; any amount above the transfer is not removed from the long-term fund.

9.3 *Further Aspects of APM Guidance*

9.3.1 The Exposure Draft recommends that offices use a combination of two techniques to control recognition of APM profit, namely:

(a) including risk margins in each of the estimates of future experience, which reflect the uncertainty about that element of future experience; and/or
(b) including a margin for risk in the discount rate applied to the estimated future transfers.

The Exposure Draft recommends that the margin in the discount rate should have regard to the risks of the business, e.g. those listed in (a).

9.3.2 Option (a) is very like the accruals concept, but with no reference to the work done to date. Option (b) is very like the embedded value concept — but with the new constraint that the margin in the discount rate needs to reflect the

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uncertainty about each of the elements of future experience. The APM proposal attempts to satisfy proponents of both accruals and embedded value!

9.3.3 The Exposure Draft permits smoothing of investment gains for both linked and non-linked business. However, smoothing is not obligatory. The Exposure Draft does not lay down a specific basis for smoothing, but recommends that the method chosen should be disclosed. The Exposure Draft also recommends that the actual investment performance allowing for any smoothing should be compared with the assumed long-term return for the purposes of calculating the investment-related profit component.

9.3.4 For with-profits business, assumed bonus rates should be consistent with assumed investment returns, the company's bonus philosophy and anticipated practice. The future bonuses should be costed on the statutory valuation bases deemed appropriate for the long term and be consistent with other assumptions used.

9.3.5 Also for with-profits business, the shareholders' proportion of declared bonuses should be the current proportion, except where an intended change has been announced or it would be inappropriate to use such a proportion. If a proportion other than the current proportion (or already announced changed assumption) is used, the basis on which it is determined should be disclosed.

9.3.6 The Exposure Draft recommends that all the projections on which profit recognition and measurement are based must allow for taxation, so the APM basis recognises after-tax profit. Allowance is needed for all taxes in the relevant jurisdiction, based on current legislation and practice, together with known future changes. For presentation purposes, the Exposure Draft recommends that the after-tax profit should *normally* be grossed up at the full local company tax rate. The basis used should be disclosed.

9.3.7 The management of prudent assumptions and risk margins is to be at product level. The Exposure Draft proposes that, if a policy group is expected to make an overall loss, the whole of the loss should be recognised in the current year. When setting risk margins, care should be taken to ensure that these reflect properly the risks attaching to the relevant policy group, and that initial losses are not shown on business which, after allowance for these risks, is expected to be profitable.

9.3.8 The Exposure Draft recommends disclosure of the following items:

— the basis for deriving assumptions, risk margins and discount rate;
— a statement of the main economic assumptions and discount rates;
— the basis for determining the shareholders' interest in undistributed surplus and investment reserves, plus the shareholders' proportion of profits;
— the basis for grossing up after tax profits to pre-tax levels;
— the accounting policy for investment returns and investment valuation; and
— the profit or loss arising from changes in assumptions, in risk margins or in discount rates if they have a material effect on total reported profits.

9.3.9 The Exposure Draft provides guidance on the presentation method. The

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amount of shareholder interest in the long-term fund, not already recognised as shareholder funds under the MSB, would be shown either as a deduction from the FFA, or as an accrual of income receivable in future accounting periods. The approach would apply to both the technical account and to the balance sheet. The technical provisions shown in the accounts will be the same as in the MSB accounts (rather than a 'realistic provision').

9.4 *Some Considerations for an Office in Implementing APM*

9.4.1 How far should the MSB SORP be followed in accounting policy on consolidation? Auditors have raised the question of how far offices should use the MSB SORP and the APM draft guidance in deciding the accounting policy. The MSB SORP says nothing about the suitability of APM for consolidated audited accounts, leaving unanswered the question of how acceptable APM will be for audited consolidated accounts of companies or groups that are mainly insurance undertakings.

9.4.2 How will the result look to shareholders, compared with MSB? The ABI proposes that companies report on APM as supplementary information for an experimental period. In other words, interested parties will see both MSB results and APM results, at least at consolidated levels. Looking at major interested parties, we think that:

— analysts and other professionals will be interested in the office's disclosed assumptions to help them check their own assumptions; and
— 'lay' readers might focus on the 'headline' profits; but which ones?

9.4.3 How will the result look to policyholders (especially with-profits policyholders)? After all, we are telling shareholders of their interest in the with-profits business, but we do not tell with-profits policyholders of their interest. Will with-profits policyholders demand additional information as a result of APM?

9.4.4 How acceptable will different approaches to APM be in the marketplace? Very simply, offices which have so far published APM (in the form of embedded value or accruals figures) results are not using uniform approaches or financial bases. As a result, it is hard for a reader to compare results across offices. Looking ahead, there may be pressure on companies to ensure that their bases are in line with a 'consensus approach', if such a thing ever develops among proprietary offices.

9.4.5 How will companies and their auditors come to an acceptable compromise on audit standards for APM reporting? In the same way as in the MSB, the APM method leads offices and their auditors to new negotiations. Auditors are being asked to certify APM results as 'true and fair'. However, they do not receive, and cannot rely on, any legally required statement from the Appointed Actuary that the amount of liabilities calculated in the APM is sufficient. This forces auditors into a close examination of the offices' APM methodology, calculations and controls.

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10. Dynamic Solvency Testing and Financial Condition Reports

... it was filled with fog, and candles shed murky and blurred rays through the windows

10.1 *What is Dynamic Solvency Testing?*

10.1.1 Dynamic Solvency Testing (DST) is a technique that the actuary can use to quantify the sensitivity of a life fund's progress (assets and liabilities) to different future outcomes. For example, how will the estimated levels of assets and of liabilities change if interest rates fall gradually over time; or, if interest rates rise very quickly?

10.1.2 The technique involves projections of the fund's assets and liabilities allowing for future estimated cash flows. A 'central' set of assumption gives a base for the fund's progress. By varying one or more of the assumptions, the actuary can see how the fund is likely to be affected if experience does not follow the central assumptions.

10.1.3 For example, the actuary might project the liabilities on the permitted statutory basis. The actuary might then model the future progress of the fund by monitoring the change in the 'free asset ratio' (used by independent financial advisers as a crude measure of financial strength) over time.

10.1.4 The actuary may choose to vary a single assumption in a deterministic manner; or may build a 'scenario' involving deterministic changes in several associated assumptions; or may model stochastically one or more of the assumptions.

10.1.5 It is almost certain that experience will *not* be the same as the central assumptions. However, by looking at the results of the base run and of the variations, the actuary can identify which types of experience pose a threat to the fund's well-being, and quantify how onerous a threat each could prove.

10.1.6 If the actuary can quantify the effect upon the fund, then there are two potential benefits:

(1) Having identified which scenarios pose the greatest threat — not only an immediate threat, but also one that might gradually emerge in future years — the actuary can then devise actions that could alleviate the perceived threats.

(2) The actuary has quantitative information to share with the company's directors which can help the directors to understand the financial risks associated with their strategy. The directors may further agree an action plan to manage those risks (e.g. based on the actuary's proposals). This information may also be helpful in the discussion of the company's affairs with the supervisory authorities.

10.2 *What is the Financial Condition Report?*

10.2.1 To obtain the second potential benefit given in ¶10.1.6, it is necessary for the actuary to inform the directors of his or her findings. At present, actuaries within an organisation *may* not have a formal opportunity to inform their directors in writing of the potential state of the fund in the future (as opposed to

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the requirement to report on the current state of the fund under the Insurance Companies Act). While many companies will seek the views of the actuary as part of formulating strategy, there is the possibility that a company could get itself into problems through not having sought the actuary's views, even though the actuary may well have had the information to provide useful advice.

10.2.2 A Financial Condition Report (FCR) gives the actuary a chance to inform the directors formally of his/her views on the future progress of the life fund.

10.3 *Progress in the U.K.*

10.3.1 A working party established by the Joint (GAD/Profession) Actuarial Working Party (JAWP) investigated the usefulness of DST and the FCR within the U.K. The working party identified that, in countries such as Canada, Australia and the U.S.A., 'near-relations' of these techniques have already become part of the statutory work which a life office must prepare for its regulator.

10.3.2 The working party recommended that an annual FCR is presented by the actuary to the directors. The FCR would include the results of, and the actuary's conclusions from, DST. The working party also proposed that this report would initially not be available more widely, but that the FCR could usefully be discussed less formally at the periodic meetings between the office and the DTI.

10.3.3 The working party did not prescribe the contents of the FCR, but suggested that the actuary must include any DST test that he/she believes of importance to that office. The working party suggested that a typical time horizon might be 5 years, but also advises the actuary to look beyond a 5-year horizon, if he or she has reason to believe that any emerging problem might only arise after a longer period.

10.3.4 As part of its report, the working party had suggested possible contents of an FCR and (by example) suggested a level of variation in assumptions which could be a start point for an office in deciding its DST parameters.

10.3.5 During August 1994, a further working party (this time reporting to the U.K. actuarial profession's Life Board) surveyed Appointed Actuaries of U.K. insurance companies, seeking their views on:

— experience to date with DST;
— the office's future plans for upgrading models for DST;
— the office's views on topics and risks to be covered in that office's FCR; and
— what additional professional guidance is required on investigating and reporting the financial condition of a life fund.

10.3.6 The survey gave an useful insight into the extent to which DST and FCR had penetrated U.K. offices. The preliminary conclusions at that time were based on responses from 29 with-profits offices:

(1) Most offices were doing some sort of DST.

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(2) Bonus reserve valuations and deterministic projections were the main investigative tools for offices, after the statutory valuation. Few offices yet used stochastic projections for DST.
(3) The main results projected were the revenue account, statutory surplus, profit and loss account and the solvency margin. The result least projected was the resilience reserve.
(4) The most popular parameters to vary in DST were new business levels, persistency levels, expense levels, investment earnings and bonus rates.
(5) Most offices used scenario testing to look at the relationship of investment returns to bonuses.
(6) Respondents found DST a complex issue to communicate to the board. The Appointed Actuary was usually responsible (at least partly) for presentations to the board.
(7) The majority of respondents favoured professional guidance on DST/FCR. At least some of the respondents felt that introduction of guidance on an advisory basis should be attempted for end 1995.

10.3.7 Following the exposure of a draft in late 1995, the Life Board is expected to issue guidance in early 1996 on the content of FCRs, the circumstance in which they should be prepared and the audience to which they should be presented. The guidance is likely to have 'advisory' status (at least initially).

10.4 *Issues in Introducing DST and FCRs*

10.4.1 As with other developments discussed in this paper, introducing DST/FCR requires commitment from the directors, to ensure suitable people are available to carry out:
— the work involved in developing the systems and methods for a company; and
— the annual work involved in preparing and agreeing the FCR.

10.4.2 An FCR can contain important information, which the directors must understand before making decisions. The relevant directors will have to be willing to spend the time to understand the FCR, and the actuary must draft the report in a style appropriate to the intended audience.

10.4.3 There is the further issue of 'overload' for the directors. This is the need, in some cases, to reflect on FCRs from many territories. The volume of information for a board to take in could be excessive if each territory's actuary presented a report. Consolidation might be a solution, albeit with some loss of information.

10.4.4 For directors, the FCR represents an opportunity and (perhaps) a threat. It does offer a further chance to seek advice from the actuary and to make that advice-seeking a formal process. However, once the DTI can request to see the FCR, they could see any concerns which the actuary might have about the

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progress of the fund, and draw conclusions about the suitability of the directors' strategy in the light of the actuary's worry. At what stage would the DTI step in, once they begin to have access to FCRs?

11. Alternatives To The Net Premium Valuation For Supervisory Purposes

The westering sun bestowed bright glances on it ...

11.1 *Introduction*

11.1.1 Throughout its long and full life, the net premium method (NPM) of valuation has never been entirely free of criticism.

11.1.2 The main point of contention is its deliberate use of unrealistic assumptions: expenses and future bonuses are to be met implicitly out of interest rate and premium rate margins. Admittedly, when the rate of return is controlled, it does allow the right amount of interest surplus to emerge each year to meet a compound reversionary bonus — but the volatility of investment markets and the advent of terminal bonus make this of only passing practical interest. The passivity of the liability basis also sits uneasily with assets at market value, for resilience testing in particular.

11.1.3 For unit-linked business and for unitised with-profits business the technique is of little relevance.

11.1.4 The cynic would say that the NPM was a practical technique from the Dickensian era which has survived into the computer age through a combination of actuarial lethargy and regulatory tolerance. The adherent would say that it has served and continues to serve the profession well.

11.1.5 More active alternatives such as the gross premium bonus reserve method have been around for almost as long, but have never found official favour for solvency purposes, largely because of their potential to anticipate profit. In the light of the need to recognise profits on a true and fair basis (which usually means earlier), such a method is generally preferable for accounting purposes. Its use also for solvency purposes, provided that an appropriate degree of prudence is injected, is highly desirable on consistency grounds.

11.2 *U.K. Developments*

11.2.1 In 1993, the JAWP established a working group which was set the task of recommending an alternative to the NPM, suitable for supervisory purposes and consistent with the 3rd Life Directive.

11.2.2 After examining the methods used in other countries, the working group proposed the adoption in the U.K. of the method that is set out in ¶¶11.2.3 to 11.2.7.

11.2.3 A Statutory Solvency Reserve (SSR) would be calculated. This would be a gross premium valuation, but on prudent assumptions with margins for

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adverse deviations and incorporating a resilience test. For with-profits business, a proportion of future bonuses would be provided for to avoid capitalisation of bonus loadings in the premium rates.

11.2.4 The SSR would be consistent with 3rd Life Directive requirements (i.e. broadly as described in Section 4, but obviously without reference to an NPM standard). This would require, *inter alia*, the following:

— maximum interest rate in line with Regulation 69 of the 1994 Regulations;
— negative reserves to be eliminated;
— elimination of future financing requirement; and
— future bonuses assumed to be those supportable by the valuation interest rate.

11.2.5 Assets would be taken at market values.

11.2.6 A Realistic Policy Liability (RPL) would also be calculated on a best estimate gross premium basis, allowing explicitly for planned margins (which would be similar, but not necessarily identical to, the risk margins of the achieved profits method described in Section 9). For with-profits business, reserves would have to be held for supportable future bonuses.

11.2.7 The SSM would be the main published indicator of the statutory solvency position. The RPL would also be published, however, as a guide to an office's ability to meet policyholders' reasonable expectations.

11.2.8 A full description of the proposals is given in Scott *et al.* (1996).

11.2.9 Preliminary indications are for support within the U.K. actuarial profession for further development of the SSR proposals, but not necessarily of those for RPL.

12. Conclusions

The fog was reported no clearer ... but he went out into it

12.1 *Distinct Strands*

12.1.1 In writing the paper, it became clear to us that there were, in fact, three distinct developments in financial reporting proceeding simultaneously (but not necessarily in full harmony), namely:

(1) E.C.-inspired (Sections 2 to 7 and, initially, 8);
(2) accountant-inspired (Sections 8 and 9); and
(3) actuary-inspired (Sections 10 and 11).

12.1.2 Due to successful Euro-lobbying and fruitful discussion between regulators and the profession, (1) has proved of relatively little effect, albeit challenging at the detailed level. However, (2) and (3) both imply big changes to the picture that insurance companies present both internally and externally. Whether accountants or actuaries — or both together — take the lead role on their implementation will dictate the relative future roles of the two professions.

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It is, therefore, important that developments, particularly those described in Sections 9 and 11, proceed hand-in-hand. We are concerned that development of the achieved profits method is being pursued largely independently of work on the replacement for the net premium method.

12.1.3 Some other countries have been able to develop profit reporting and solvency standards together — we think that this should be the objective in the U.K., too.

12.2 *Facts of Life*

Finally, we detect a lack of understanding by many U.K. actuaries of modern day accounting practices. We would encourage those involved in education and Continuing Professional Development to examine this knowledge gap to see if it can be filled. This will then ensure that it will be the actuarial profession which will play a leading and constructive role in the development of financial reporting into the 21st century — rather than be left behind to occupy a rapidly decaying 19th century nook.

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APPENDIX A

ASSET EXPOSURE LIMITS

Category of Asset		Maximum Percentage
1.	Land. *Comment: Unchanged.*	5
2.	Debts from individuals secured on residential property. *Comment: Unchanged.*	1
3.	Other debts due from individuals. *Comment: Same effect as before.*	0.25
4.	Unsecured debt (other than debt securities or debts from a regulated institution) due from any one counterparty other than an individual, body corporate or group. *Comment: Previously 2.5% if due in 12 months or less time.*	1
5.	Unsecured debt (other than debt securities or debts from a regulated institution) due from any one company or body. *Comments:* *(1) Includes connected companies (see footnote to this section).* *(2) As for 4.*	1
6.	Unsecured debts (other than debt securities or debts due from an approved counterparty) due from a regulated institution. *Comments:* *(1) Previously debts from what are now known as approved counterparties would normally have been subject to this limit.* *(2) 'Regulated institutions' include U.K. and E.E.A. insurance companies, approved credit institutions or investment firms and friendly societies authorised to transact insurance business.* *(3) Previously there was no distinction between debts due from regulated institutions and from others. Instead, a lower limit of 1% applied if the debts were due in more than 12 months time.*	2.5

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CATEGORY OF ASSET	MAXIMUM PERCENTAGE
7. All debts, other than debt securities, not due from an approved counterparty. *Comments:* *(1) This and 8 and 9, are new (introduced by the 1995 Regulations).* *(2) Previously, a limit of 5% applied to debts from other than individuals served on land.*	5
8. All debts, other than short-term deposits with an approved credit institution and debt securities, due from an approved counterparty.	10
9. All debts due from an approved credit institution.	20
10. The aggregate of debts of the type described in 3., 4. and 5. *Comment: A new requirement (to comply with the 3rd Life Directive).*	5
11. All securities (other than secured debt securities or investments which are listed and readily realisable) and units in collective investment schemes (other than UCITs or authorised unit trusts) from any one issuer, including beneficial interests. *Comment: Previously just applied to unlisted shares.*	1
12. The aggregate of assets of the descriptions in 11. *Comment: A new restriction.*	10
13. All shares and hybrid securities of any one issuer. *Comments:* *(1) Previously just referred to listed equity shares.* *(2) This limit now applies to preference shares.*	2.5
14. All securities issued by any one issuer (not being an approved counterparty). *Comment: Previously referred only to shares and listed debentures. Now also disapplied if counterparty is approved.*	5
15. All securities issued by any one counterparty. *Comment: As for 14.*	10

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CATEGORY OF ASSET		MAXIMUM PERCENTAGE
16.	Holdings in any one authorised unit trust or recognised scheme which is not a UCIT. *Comments*: *(1) Previously inadmissible.* *(2) Most unit trusts will be UCITs and thus fully admissible.* *(3) The E.C. require that non-UCIT unit trusts are less favourably regarded.*	5
17.	Cash. *Comment*: *Literally cash 'in hand' only.*	3
18.	Computer equipment. *Comment*: *Unchanged.*	5
19.	Other office machinery, furniture, motor vehicles, etc. *Comment*: *Unchanged.*	2.5

Reference to the securities or debts of a company, issuer or counterparty in 5 to 14 also apply to any connected company and exclude any dependants of the insurer.

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APPENDIX B

COUNTERPARTY EXPOSURE LIMITS

	Maximum Percentage
Aggregate of all securities issued by and the value of all rights against any one counterparty:	
(1) if the counterparty is not a company which is an approved counterparty; or	5
(2) if the counterparty is a company which is an approved counterparty:	
(a) in relation to exposure excluding short-term deposits with an approved credit institution; and	10
(b) in relation to all exposure.	20

Comments:

(1) Previously a 7.5% limit applied to a narrower range of debt (e.g. listed debentures, certain insurance debts and debts secured on land) together with shares and options.

(2) The previous limitation of 0.1% for options is removed.

(3) A further limit of 40% applies to the aggregate over all counterparties of exposures of the type described in (2)
(a) which individually exceed 5%.

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