Milliman Research Report

Prepared by:

Kevin Manning
FSAI

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Policyholder Protection in Ireland

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Introduction

The purpose of this booklet is to provide you, the broker, with an understanding of the key issues affecting the security of life assurance policyholders in Ireland.

Executive summary

The key issues addressed in this booklet are:

- The Central Bank of Ireland regulates insurers who are established in Ireland, and the solvency standards are driven by EU regulations.
- There are a number of layers of protection in place in terms of the money that insurers must set aside to be able to meet liabilities to policyholders.
- Being a subsidiary of a well-capitalised parent may be beneficial from a solvency point of view, but insurers are required to hold sufficient capital to meet their obligations without needing further capital from a parent.
- The capital position of an insurer is closely and regularly monitored by its board of directors, its Appointed Actuary, and by the Central Bank itself.
- We also consider the current banking crisis, and examine whether a similar insurance crisis could arise and set out further sources of information that may help you understand the finances of individual companies.
- Our analysis shows that the solvency position of Irish life insurance companies continues to be healthy despite the challenging economic environment.

Who regulates the solvency of life companies operating in the State?

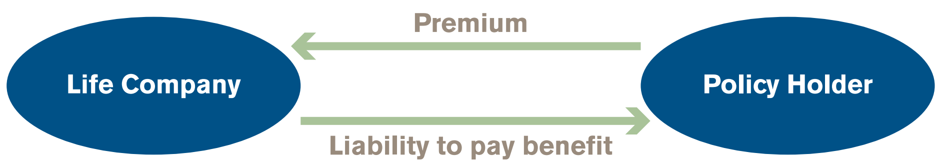
The Central Bank of Ireland regulates the solvency of life companies who are established and have their Head Office in the State.

Life companies who operate here as a branch of a foreign life company are regulated by the authorities in that life company's home State. E.g. Standard Life operate here as a branch of Standard Life in the UK, whose solvency is regulated by the FSA in the UK.

The solvency of all life companies in the EU is regulated according to a common set of EU rules and regulations.

How does a life company work?

When a policyholder pays a premium to a life company, this immediately creates a matching liability for the life company – the policyholder is now owed something in return by the life company, e.g. a death benefit if the life assured dies, or an encashment value if a unit linked policyholder encashes their policy.



What reserves does a life company have to hold ?

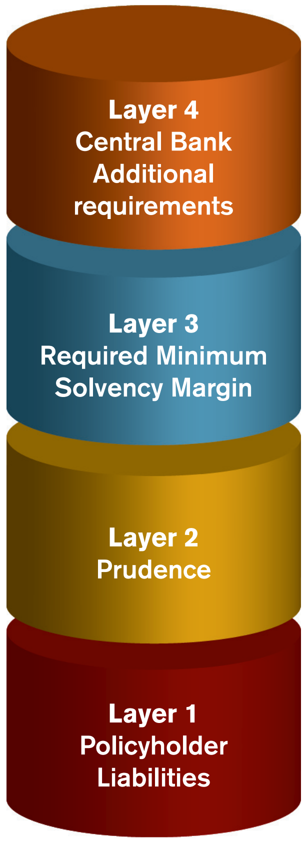
Life companies regulated by the Central Bank are required to hold four different layers of reserves to meet their liabilities to policyholders:

The Central Bank in Ireland requires that the additional assets held by Irish insurers exceeds 150% of the calculated RMSM (for new insurers this requirement is increased to 200% for the first three years of operation).

EU legislation sets out additional requirements for life insurers to hold a Required Minimum Solvency Margin (RMSM). Life companies must at all times hold additional assets (i.e. to those required by Layer 1 and 2) at least equal to the value of the RMSM.

Regulations, supplemented by mandatory actuarial requirements, mean that the amount to be set aside must be calculated on a prudent basis. This means that life companies cannot just set aside their best estimate of what the liability to policyholders will be, but must add in additional amounts in respect of prudence.

The life company works out the size of its liability to the policyholder, taking account of any surrender value it would need to pay, any death or other protection claims it would need to pay, the expenses it would incur in servicing the policy, any guarantees that it has made and any other relevant factors.



Example:

The table below shows a sample Life company year end position

A. Prudent liabilities (i.e. layers 1 and 2 together)	€5,800m
(of which unit liabilities)	€5,300m
B. European RMSM requirement (layer 3)	€90m
C. Additional Irish regulatory requirements (layer 4)	€45m
D. Total Assets	€5,975m
E. Surplus Assets (over Liabilities) (D-A)	€175m
Excess Assets above all requirements (D-A-B-C)	€40m
Solvency Ratio (E / B)	194%

It would not be unusual for life companies in Ireland to seek to maintain surplus assets over liabilities of around 200% of the RMSM i.e. 200% of the level required by EU rules, giving excess assets of around 50% of the RMSM.

Life companies must therefore hold sufficient assets to meet the requirements of the four layers set out above in respect of their policyholder liabilities.

There are also restrictions on the sorts of assets the life company can hold to meet its policyholder liabilities. The purpose of these restrictions is to limit exposure to riskier or more volatile assets. Ultimately life companies should ensure that the assets held to meet liabilities to policyholders are suitable to the nature and term of their liabilities.

The four layers of protection set out above mean that a life company must have significant levels of reserves to be able to meet its policyholder liabilities. The life company itself must hold the assets required, and *cannot* rely on having resources available through a parent company. The solvency of each life company is determined on a *stand-alone basis* and must be met at all times without recourse to external resources.

If a life company established here is a subsidiary of a large international insurance group, does it still have to keep the same reserves?

Yes. As pointed out above, life companies in Ireland are required to have enough capital to meet their liabilities and solvency margin requirements on a *standalone* basis. A life company cannot rely on the promise of capital from a parent to meet these obligations, and must have enough capital on its own balance sheet to do so.

If an Irish established life company's assets fell below its liabilities plus solvency margin requirements there is *no* specific obligation on the life company's parent to provide additional capital (in effect to provide a bail out). In some cases there may be a letter of commitment from a parent to do so, and in any event, reputational issues may encourage a parent company to provide such capital but it is important to note that a well-capitalised parent is more of a comfort blanket than a guarantee of solvency in all circumstances.

It is important to note that the assets of an insurer which is part of a group are effectively ring-fenced for the use of the insurer itself, and cannot be called upon by the Group if it requires the assets. This does not prevent insurers from making dividend payments to a parent company, but there are strict controls in place which ensure that both the board of directors of the life insurer and its appointed actuary must approve any dividend payment before it can be made.

How often does the Central Bank monitor the solvency of life companies?

Life companies established in the State must submit reports setting out details of their solvency position to the Central Bank on a quarterly basis, with very detailed returns on an annual basis.

The Central Bank closely monitors the key solvency indicators. A company failing to meet the 150% requirement set out in layer 4 above would be required to take very swift action to address the situation. Effectively there are three levels of oversight:

- The Board of Directors of the life company supported by the management team is responsible for maintaining the solvency position of the company.
- The Appointed Actuary of the life company is responsible for setting prudent liabilities and for monitoring the company's solvency position
- The Central Bank as prudential regulator monitors the company's solvency position.

Could life companies develop the same types of problems as the banks?

Life companies operate very differently to banks. As we have seen, each time a life company receives a premium it receives an asset, i.e. the premium, but then has a policyholder liability in respect of that premium.

In simple terms banks accept deposits from customers and pay a rate of interest on those deposits. Separately, banks lend to customers and charge a rate of interest on those loans. Typically banks will lend more than they have on deposit, so they will seek external funding to allow them to do this, and they will need to pay interest on that external funding.

The key risks that a bank faces can be characterised as:

- A lending risk – the risk that loans they have made to customers are not repaid
- A funding risk – the risk that external funding may not be available or may be too costly

The fundamental differences between bank and life companies means that what has happened to banks in recent years is unlikely to happen to life companies. In particular, banks and insurers have very different business models and unlike banks which can typically have a very "geared" balance sheet structure, life companies must set aside reserve amounts which are higher than their liabilities to customers.

The idea of a "run on the banks" whereby depositors fear that banks will not have enough assets to cover the deposits and will seek to withdraw their cash (unless a government can step in with a deposit guarantee scheme) should not arise in the case of a life company, as every life company liability must have specific and suitable assets set aside to meet that liability. Each time a life company experiences a 'withdrawal', i.e. a policy encashment or claim payment, its policyholder liabilities reduces accordingly.

How have life companies weathered the financial crises of the last few years?

Recent years have been among the most turbulent and challenging for financial services providers, and there is some comfort in the fact that life companies have come through this challenge relatively well so far.

The main impact of the financial crisis on life companies has been significant reductions in the levels of new business that life companies have been able to write. This does not typically have an impact on the financial security of existing policyholders. Because a life company must hold sufficient assets to meet its liabilities to existing policyholders at all times, it should not rely on writing new business to support its obligations in respect of its existing business.

In the longer term, life companies would expect new business to be profitable and to contribute to meeting their ongoing expenses. Typically in the Irish market we have seen life companies reduce their expenses over the last two years to better allow them to maintain their sustainability over the longer term.

There is no doubt that a healthier financial and economic environment leads to healthier life companies and strengthens policyholder protection. It is likely that some life companies have found the last number of years very challenging in terms of maintaining a sustainable business, and it may be the case that we will see an increased number of companies closing to new business and possible increased levels of consolidation in the market place. However, despite the challenges, the solvency position of existing Irish life companies has broadly held up very well.

The table overleaf shows the combined available assets, Required Minimum Solvency Margin and the Solvency Ratios (the Available Assets as a percentage of the RMSM) for the Irish authorised life companies operating in the domestic market over recent years. You can see that the solvency ratios dipped significantly in 2008, while remaining above the 150% level required by the Irish regulator, but have improved in 2009 which suggests an overall healthy solvency position. All monetary amounts are in billions of Euro.

The reasons for the reduction in solvency ratios in 2008 will depend largely on the particular circumstances of individual companies. Certainly the general economic climate will have had an impact on many companies but individual factors such as the level of dividend payments to parent companies will also have had an impact.

	Available Assets	RMSM	Solvency Ratio
2004	€2.4	€1.0	240%
2005	€3.1	€1.1	272%
2006	€3.7	€1.2	304%
2007	€3.4	€1.2	285%
2008	€2.3	€1.2	194%
2009	€2.6	€1.2	216%

Source: Milliman analysis of life company regulatory returns

Where can I get information on the financial position of a particular life company?

The most easily available information is accessible through the company's financial statements. Each Irish established life company will prepare annual accounts which can be readily accessed through www.cro.ie, at a nominal fee. The financial statements will contain a number of key pieces of information including:

- Information on the key risks faced by the company, and how the company manages those risks
- Information on the level of capital available to the company and details of the level of solvency capital it is required to hold by the Central Bank
- Information on the sensitivity of the company's capital position to future changes in economic and other conditions
- Information on options and guarantees provided by the company
- Information on the quality of assets matching non-linked reserves

In addition to the information contained in the financial statements, it may be possible to obtain a copy of the life company's Annual Returns to the Central Bank. These can typically be more difficult to obtain than financial statements, although some companies do publish their returns on their websites. The returns will contain detailed information on the company's solvency position, including a breakdown of the key drivers for its Required Minimum Solvency Margin calculation, as well as detailed information of the assets, liabilities, product range and valuation basis.

How could a life company potentially become insolvent? What happened to Equitable Life in the UK?

One area where life companies can experience higher levels of risk is in relation to guarantees and options provided to policyholders. For example an insurer could provide a guaranteed surrender or maturity value on a policy after a certain term. Unless the assets underlying this guarantee were appropriately invested to match this guarantee, this could give rise to significant reserving problems for the life company.

Despite the increasing sophistication in the range of risk management tools for meeting guarantees, it is always possible for life companies to get this wrong.

The level of guarantees that life companies provide is therefore one factor which can increase their risk profile and can thereby affect their solvency position. The rules for calculating a life company's Required Minimum Solvency Margin result in a higher reserve requirement where the life company provides guarantees, to reflect the additional risk involved in providing such guarantees.

One of the best known examples of an international insurer getting into solvency difficulties was the Equitable Life in the UK. At its heart Equitable Life's problems originated from the company providing guarantees (in this case high guaranteed minimum annuity rates) without having a suitable hedging program in place to meet the additional costs of the guarantees as interest rates fell.

This highlights the fact that while life companies are generally low risk entities, they are not entirely without risk. It is worth noting that the majority of Irish life insurers run low-risk business models with limited provision of guarantees and extensive reinsurance of risk.

Has a life company in Ireland ever become insolvent?

Not in the modern era. Some small insolvent life companies merged together in the 1930's to become what is now today Irish Life.

If a life company does become insolvent, how would its Irish policyholders be affected? Is there a Guarantee Scheme for policyholders, like the Deposit Guarantee Scheme?

Life companies have to set aside assets to meet liabilities to policyholders, calculated on a prudent basis. These assets are specifically "ring-fenced". A detailed Register Of Assets is held by each life company, and these assets reserved for policyholder liabilities are recorded separately from all other assets of the company.

Legislation governing the winding-up of life companies in Ireland means that **none** of the life company's creditors can be paid from the assets that have been set aside to meet liabilities to policyholders. Some of the ring-fenced assets can be used to meet the liquidator costs, but otherwise no amount will be paid to any creditor until the liabilities to policyholders have been fully met first.

In the unlikely event that there are insufficient assets to meet all policyholder claims where a life company becomes insolvent and winds up, note:

- No distinction will be made in settling policyholder claims as between unit-linked and non-linked policies. The assets backing the unit-linked policies are likely to be pooled with all other non linked assets and be used to meet claims from all policyholders. Typically non-linked assets are held in relatively low-risk securities like Eurozone government bonds.
- Policyholders rank equally for payment of their claims on the life company; if there is a deficit of assets to meet all policyholder claims a universal reduction will be applied to all policyholder claims, so that a deficit would be shared proportionately between all policyholders.
- If a policyholder's claim on the life company is not fully met on the winding up of the company, there is no currently guarantee scheme in Ireland to which the policyholder can turn to make a claim. However overseas insurers operating in Ireland may be covered by guarantee schemes in their home states.

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About the author

This booklet has been prepared by Kevin Manning, FSAI. Kevin is a consulting actuary at the Dublin office of Milliman. He has extensive experience of the Irish insurance market and worked for a number of years for New Ireland Assurance / Bank of Ireland Life in roles including financial reporting, product development and marketing. He currently discharges the role of Appointed Actuary for two cross-border insurers.

Verschoyle House
28-30 Lower Mount Street
Dublin 2
Ireland

Tel:+ 353 (0)1 647 5900
Fax:+ 353 (0)1 647 5919

milliman.ie

PIBA
Unit 14B Cashel Business Park
Cashel Road
Crumlin
Dublin 12

Tel: + 353 (0)1 492 2202
Fax: + 353 (0)1 499 1569

piba.ie