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15<sup>th</sup> February 2011

**Re: Request for clarification on variable annuity requirements**

Dear Ms Lynch,

The Central Bank of Ireland (“Central Bank”) has reviewed your letter of 28 January 2011 requesting clarification on the recently issued requirements for Variable Annuity undertakings.

The appendix attaching to this letter sets out our response in relation to each point raised.

A copy of this letter and attaching appendix will be available on the Financial Regulation Homepage which may be accessed via [www.centralbank.ie](http://www.centralbank.ie).

Yours sincerely,

A handwritten signature in blue ink, appearing to read 'Donncha Connolly', written in a cursive style.

Donncha Connolly

Head of Retail Insurance Supervision



## Appendix: Requirements on Reserving and Risk Governance for Variable Annuities

### 1 Introduction

*“This letter set out qualitative disclosure requirements with respect to year end 31 December 2010. This paper formalises the requirements of that [8 November 2010] letter for future periods . . . ”*

We note that, while the letter of 8 November 2010 and Section 6 of the Requirements have significant similarities, they are not identical.

- a) Can you please confirm whether the requirements in Section 6 apply in respect of year end 31 December 2010 only to the extent that they were already set out in the letter of 8 November 2010 (i.e. additional or differently articulated requirements set out in Section 6 apply only in respect of future periods)?

*Central Bank of Ireland (“Central Bank”) response: The requirements for year-end 31 December 2010 are as set out in section 6 of the paper. These are no different to the requirements as articulated in the letter of 8 November 2010. Companies may contact the Variable Annuities Examination Team at the Central Bank of Ireland (“Central Bank”) where they feel there remains some confusion following review of this document.*

- b) Does the above reference to “qualitative disclosure requirements” mean that, for year end 31 December 2010, the various quantifications required under the 8 November 2010 letter and section 6 of the Requirements are required only for the purposes of the Actuarial Report – i.e. the technical provisions and solvency reserves as at that date should be determined in accordance with the regulatory requirements that applied immediately prior to the 8 November 2010 letter being issued?

*Central Bank Response: The reference to ‘qualitative disclosure requirements’ in the letter of 8 November was a generic reference to the various topics identified in section 6 which must be discussed and quantified in the Actuarial Report. As indicated in the letter of 8 November, where any of these pose a significant risk that is not captured by the Capital and Reserves (“CAR”), then the CAR must be increased to an appropriate level.*

## 2 Requirements on Reserving and Risk Governance

### 2.1 Applicability

*“All insurance and reinsurance undertakings authorised to transact life insurance and reinsurance business in Ireland are required to consider and report whether they believe they are transacting VA business and on the level of such activity.”*

- a) The duplication between Section 2.1 and Section 3.1 a) has caused confusion as to whether *all* undertakings or *only VA* undertakings must make a declaration on whether they are transacting VA business. Can you please clarify? (Incidentally, it appears, from



conversations that some of our members have had with their employers / clients, that not all insurance undertakings are aware of the Requirements).

*Central Bank Response: As stated in sections 2.1, all life insurance and life reinsurance undertakings transacting business in Ireland are required to make a declaration to the Central Bank stating whether they believe they are a VA company. An email was sent on 26<sup>th</sup> January 2011 to the Compliance Officers of all life undertakings transacting life insurance or reinsurance business in Ireland to highlight this requirement. Undertakings which received a copy of the requirements paper by email and registered post on 24 December 2010 have already been deemed VA undertakings and do not need to make this declaration.*

- b) If an undertaking makes a declaration in good faith that it is not transacting VA business, presumably it is not required to comply with the Requirements unless and until the Central Bank rebuts the declaration. Can you please confirm?

*Central Bank Response: This is correct.*

- c) Is it the Central Bank's intention that the Requirements will expire when the Solvency II requirements (including any additional requirements that are issued as a result of the current consultation on EIOPA Consultation Paper CP83) are implemented?

*Central Bank Response: The Solvency II directive is a maximum harmonisation directive. All requirements relating to VA business will be contained within the requirements of the Solvency II regime.*

### **3 Variable Annuity Business**

*"The undertaking must make this submission to the Central Bank no later than 31 March 2011. The Central Bank will in due course confirm the undertaking's assertion or engage in discussions with a view to resolving differences."*

- (a) If an undertaking makes a submission in good faith that it has no investment guarantee business in force (Section 3 b)) or that it should not be classified as a VA undertaking (Section 3 c)), presumably it is not required to comply with the Requirements unless and until the Central Bank rebuts the submission. Can you please confirm?

*Central Bank Response: This is correct.*

- (b) In relation to Section 3 c) ii., would it be acceptable for undertakings to refer to the guidance in EIOPA Consultation Paper CP83 in this regard?

*Central Bank Response: We do not believe that this section requires further clarification.*



#### **4 Independent Oversight**

- (a) Is independent oversight (whether through Independent Non-Executive Directors or Peer Review) required for the 2010 year end Actuarial Report, or is it required only from year end 2011 onwards? It appears, from the Introduction and Section 2.4, that only Section 6 of the Requirements applies as at 31 December 2010.

*Central Bank Response: The requirement for Independent Oversight applies from 1 January 2011 and will continue to apply until such time as undertakings have Independent Non-Executive Directors with sufficient experience of complex financial products to be able to understand and assess the risks of VA business.*

*If independent oversight is not required for the 2010 year end Actuarial Report, the next four questions may be ignored.*

*Central Bank Response: The following four questions have thus been ignored.*

- (b) “Until such time as the transitional period ends ...”

Presumably this is a reference to the date of 31 December 2011 by which undertakings must comply with the provisions of the Corporate Governance Code relating to board composition (Section 5.1 of the Code). Therefore, does this Section of the Requirements imply that the 2010 year end Actuarial Report must be subject to independent consultant peer review (if the undertaking does not meet the requirements of the Code relating to board composition), while subsequent year end actuarial reports will be subject only to the oversight of the INEDs?

- (c) Can you confirm, please, that if an undertaking has one or more INEDs with relevant competencies in place and believes that it meets the requirements of Section 5.1 of the Code before submission of the year end 2010 Regulatory Returns, peer review of the year end 2010 Actuarial Report by an independent consultant is not required?
- (d) Consider the case of a reinsurance undertaking where the Signing Actuary is an external consultant who has “no other involvement in the management or design of the products or any hedging process”. May the peer review be provided by another actuary or suitably qualified person within the consultancy that employs the Signing Actuary, or must it be provided by a different consultancy?
- (e) In relation to the scope of the peer review, is it permissible for this to be limited to those parts of the Actuarial Report that relate to VA business, where these are clearly identifiable?



## 5 Minimum Capital & Reserves Standards

(a) *“The allocation between [solvency reserves and technical provisions] is of lesser importance.”*

- (i) Does this mean that the Central Bank will accept any reasonable split between technical provisions and total required solvency margin in the completion of regulatory return forms? Is it acceptable, for example, to say that CAR on a CTE90 (or CTE95) basis = Technical Provisions + 150% \* Required Solvency Margin, for an undertaking currently expected to hold 150% of the Required Solvency Margin?

*Central Bank Response: See 5.1 (a)*

- (ii) If, for the same undertaking, technical provisions are, say, €100M and 150% \* Required Solvency Margin is a further €100M, but CAR on a CTE90 (or CTE95) basis is, say, €300M, is the undertaking required to increase the technical provisions such that Technical Provisions + 150% x Required Solvency Margin = €300M? Or may the undertaking leave the technical provisions at €200M in the regulatory returns and advise the Central Bank by separate correspondence regarding the higher CAR computation and the adequacy of assets to cover the higher amount?

*Central Bank Response: See 5.1 (a)*

### 5.1 Minimum CAR

(a) *“However, undertakings must ensure that the following minimum standard is applied to the calculation of reserves included in regulatory returns:”*

Presumably this applies only to the calculation of reserves in respect of VA business that the undertaking has written and the CAR should be the normal reserve plus required minimum solvency margin for any other business on the undertaking’s balance sheet. Can you please confirm?

*Central Bank Response: The sentence above should refer to CAR as opposed to reserves. The requirements have been amended accordingly.*

(b) *“For business written on or before 31 December 2010, the reserves must be calculated using an appropriate stochastic model . . . subject to a minimum of a CTE 65 basis plus the required solvency margin plus resilience test. . . ”*

- (i) Can you please confirm that “reserves” here means “CAR”?

*Central Bank Response: This should refer to CAR.*



- (ii) For a reinsurance company, when is “business written”? Is this defined by the start date of the reinsurance treaty, or of the underlying policies?

*Central Bank Response: The term ‘business written on or before 31 December 2010’ refers to risks incepting on or before the aforementioned date i.e. undertakings should adopt a look-through approach to the underlying policy.*

- (iii) Where a reinsurance treaty has a commencement date earlier than 31 December 2010 but it is not finalised and signed by both/all parties until after that date, may the reinsurance company use the CTE90 capital standard?

*Central Bank Response: Undertakings must adopt a look-through approach to the underlying individual risk/policy.*

- (iv) Presumably, for a direct writer, business is deemed to be written with effect from the policy start date, is that correct? How should undertakings treat policies that have an effective start date in 2010 but which are issued in 2011?

*Central Bank Response: The risk inception date is the key determinant.*

- (v) Whilst the CTE risk measure is specified, the Requirements are silent on the projection term for the calculations. Is it intended to be a full policy lifetime projection?

*Central Bank Response: The measures set out in 5.1 are the minimum standards of acceptable practice in meeting existing obligations as set out in the 1994 Framework Regulations or the Reinsurance Directive. As a consequence, the CTE metrics referred to relate to lifetime projections.*

- (vi) Can you confirm, please, that the resilience test applies only on the CTE65 basis, and not on the CTE90/95 bases?

*Central Bank Response: This is correct.*

- (vii) No specific resilience test has previously been prescribed for reinsurers. Is the basis per the Central Bank’s “Dear Appointed Actuary” letter now required for reinsurers?

*Central Bank Response: It is not intended to require the resilience test for reinsurers.*

- (c) “Equivalent Value at Risk (“VAR”) measures may be used”

*Central Bank Response: This is intended to accommodate companies already using a different measure. Actuaries are required to interpret this using professional judgement. Parts (i) to (iii) have been ignored as a result.*



- (i) What constitutes an equivalent VAR measure? Presumably VAR95 is not acceptable as a replacement of CTE90, for example, but what evidence must be presented to support a given VAR measure?
- (ii) How frequently must the equivalent VAR measure be revalidated?
- (iii) Is it permissible to use a 1-year VAR measure as opposed to the (presumably) lifetime CTE measure specified?

## 6 Actuarial Report

- (a) *“Analysis and justification of basis risk (where necessary, this should be included in technical provisions).”*

Why should this be included specifically in the technical provisions? This seems to be inconsistent with the statement in Section 5 that the split between solvency margin and technical provisions is “of lesser importance”. Is the core requirement that the CAR take account of this factor?

*Central Bank Response: Basis risk will impact upon the overall functioning of the dynamic hedge. To the extent that the undertaking assumes a reduction in the statutory provisions due to the existence of the dynamic hedge, then the allowance for basis risk should be included in the technical provisions. The core requirement is that the CAR is set at an appropriate level.*

- (b) *“If any of these pose significant risk that is not covered in the CAR, then the CAR must be increased to an appropriate level.”*

This appears to contradict the statement in the Introduction that the Section 6 Requirements (as first set out in the Central Bank’s letter of 8 November 2010) are “qualitative disclosure requirements”. Is the above statement intended to apply in respect of year end 31 December 2010, or only in respect of subsequent year ends?

*Central Bank Response: Refer to question 1(b). Note that the letter of 8 November 2010 also stated: “If any of these pose significant risk that is not covered in the mathematical reserves, then the mathematical reserves must be increased to an appropriate level”.*

- (c) *“the undertaking must commission a report from the Signing Actuary or Appointed Actuary as appropriate which covers and quantifies all of the above”*

Given the relatively limited and point-in-time role of the Signing Actuary up to now, is it mandatory that this report is provided by the Signing Actuary, or may it be provided by another suitably qualified individual?



*Central Bank Response: As per section 6 of the requirements paper, where existing actuarial guidance does not call for the inclusion of some or all of the points listed as a) to l) in the annual Actuarial Report, the undertaking must commission a report from the Signing Actuary or Appointed Actuary as appropriate which covers and quantifies all of the above.*

### 6.3 Model of Sufficient Prudence

*“undertakings must have regard to the Internal Model tests as prescribed under Solvency II Directive (2009/138/EC)”*

To what extent are these “tests” fully prescribed and finalised? Should undertakings refer to the current draft of Level 2 Implementing Measures for the 2010 year end?

*Central Bank Response: This is acceptable.*

### 6.6 Operational and Model Risk

*“Undertakings must analyse and quantify in the Actuarial Report the following causes. . . “*

The Requirements acknowledge the possibility of “a more high-level approach” initially, moving over time to greater sophistication. Is it permissible for the year end 2010 Actuarial Report to be completed on the basis of a purely qualitative approach in relation to sub-section 6.6, with no substantive quantification?

*Central Bank Response: Section 6.6 refers to risks that must be quantified and included in the Actuarial Report. Where these pose significant risk, these must be included in the CAR to an appropriate level.*

*It is acknowledged that these risks may not be included in existing models. Where their immediate inclusion presents significant difficulties, it may be acceptable to adopt a more high-level approach to deal with these risks and move towards a more sophisticated approach, subject to an agreed timetable with the Central Bank.*

*This last statement does not invalidate the overarching requirement for the risks to be quantified and included in the report and in the CAR where appropriate. Therefore, a purely qualitative approach is not acceptable.*

### 6.8 Behavioural Risk and Dynamic Lapsations

- (a) *“The Central Bank has recently become aware of the possibility of hedge fund activity in the secondary VA market. The impact of such activity must be reflected by the undertakings in the derivation of lapse and premium cessation rates.”*





What if the undertaking has no evidence of viatical activity? May the actuary rely on robust lapse investigation and monitoring, irrespective of underlying cause?

*Central Bank Response: The Central Bank is referring to the potential for a secondary market to exist for VA contracts. Such developments would significantly increase the likelihood of rational policyholder behaviour. This needs to be actively considered by undertakings in setting the CAR.*

- (b) *“The impact on the hedging program of changes to persistency assumptions also needs to be quantified”.*

Is this entirely separate from reserving and capital - is this instead a requirement for a perspective on actual hedge-effectiveness as observed within the hedging program? Where, in accordance with Section 5.1 c), direct writers do not make any allowance for lapses, presumably Section 6.8 does not apply other than to consider whether dynamic lapse may produce higher capital requirements than zero lapses?

*Central Bank Response: The overall functioning of the dynamic hedge in the context of dynamic policyholder behaviour needs to be considered to the extent that the undertaking is assuming an offset to the CAR on the basis of a dynamic hedge programme.*

#### 6.10 Solvency II

- (a) This Section was not included in the Appendix to the Central Bank’s letter of November 2010. Can you please clarify whether this Section applies in respect of year end 31 December 2010, or subsequent year ends only?

*Central Bank Response: This section was included in the body of the letter of 8 November 2010 as opposed to the appendix, so still applies in respect of the year end 31 December 2010 report.*

- (b) What are the requirements for undertakings with a mixture of VA and other business? Will full Solvency II figures be required for all of the undertaking’s business or only for the VA business, where it is possible to separate out the latter?

*Central Bank Response: Where VA contracts represent a material risk to the solvency of the company, it is expected that the Solvency II figures would reflect the full business of the company.*

- (c) *“The Central Bank hereby requires that undertakings submit . . . What technical provisions and Solvency Capital Requirement (“SCR”) of the undertaking would be under Solvency II, both standard formula and internal model. . . ”.*



- (i) If an internal model is to be prescribed for VA writers, is the standard formula basis relevant at all?
- (ii) What figures should an undertaking present if its internal model is still under development?
- (iii) Should the undertaking apply the parameters that were used in QIS5 when completing the year end 2010 report?

*Central Bank Response: In meeting this requirement, it is expected that companies would refer to the most recent QIS exercise and to their internal models. It is acknowledged that internal models are in various stages of completeness.*

- (d) *“If the SCR required under either method is more than under Solvency I, analysis and justification of the reasons why and a timetable for bringing up the strength of reserves to Solvency II standards”*

Is it the intent here that justification is required if Best Estimate Liabilities + RiskMargin + Solvency Capital Requirement is greater than CAR?

*Central Bank Response: Yes.*