

Class: M.Sc SEM 4

Subject : Actuarial Practice 2

Chapter: Unit 1 Chapter 1

Chapter Name: Dealing with Insolvency

Today's Agenda

1. Introduction
2. Insolvency of an Insurance company
3. Closure of a sponsored benefit scheme

1 Introduction

➤ Insurance Companies

When an insurer is unable to meet his liabilities as they fall due, i.e. unable to make genuine claim payments due to lack of assets with respect to the liabilities, the company becomes insolvent.

Insurance companies are required by regulation to prove their solvency, by demonstrating the holding of assets in excess of liabilities. This excess of assets over liabilities is known as the required solvency capital.

The level of required solvency capital depends on the level of prudence associated with the calculation of liabilities, with very prudent liability valuations being associated with comparatively low solvency capital requirements.

➤ Benefit Schemes

When a benefit scheme sponsor becomes insolvent, or they stop financing benefit provision for some other reason.

In this case the scheme may be closed for new members and benefits of existing members start getting accrued. The scheme may either remain in force for the existing members or may be wound up.

Winding-up is the process of terminating a benefits scheme, usually by applying the assets to the purchase of individual insurance contracts for the beneficiaries, or by transferring the assets and liabilities to another scheme.

2 Insolvency of an Insurance Company

➤ Regulation

Insurance companies are normally subject to some form of State regulation, and they are usually required to maintain a certain level of solvency capital. There are also regular reporting requirements that enable the regulator to monitor the financial position of companies. These are designed to enable the regulator to intervene in the running of a company before it reaches the position of being unable to meet its liabilities. The required solvency capital provides an extra cushioning to the policyholders, allowing the regulator to intervene when required and take suitable measures, before the company defaults on its payments.

➤ Intervention

Consequently, in such environments, insurers rarely become insolvent. If the required level of solvency capital is breached, the regulator intervenes to protect the interests of existing or prospective policyholders. If the insurer's financial position is serious, then the regulator may require it to close to new business, so that new policyholders are not entering a fund whose solvency may be in doubt. In most cases, the company will be required to establish a recovery plan, and this will be monitored closely by the regulator.

2 Insolvency of an Insurance Company

The recovery plan may include some of the following actions:

- The company may alter its investment strategy, switching to more stable assets such as government bonds over volatile asset classes.
- Increasing the proportion of reinsurance.
- Reducing the number of new policies sold.

Limiting new business volumes, makes hardly any difference, as a company nearing insolvency hardly attracts any new business.

Closure to new business is normally a last resort, because it is unlikely that the insurance company will be able to re-open. The exception would be if there are large front-end expense charges in the business recently written, when capital can be rebuilt quickly as the new business strain is released.

If the insurer is selling products, that involves charging high initial expenses from the insured, then he may start selling business again in order to benefit from retaining these charges within its capital base.

2 Insolvency of an Insurance Company

In normal circumstances, a regulator is unlikely to permit re-opening to new business until the company has substantially more than the minimum capital requirements built up.

If a company maintains the infrastructure (staff, premises, systems) to enable it to re-open, these costs will be a further drain on capital while no business is being written.

All the above should be considered when producing the recovery plan.

If a provider closes to new business, it will still have outstanding liabilities from the business written that will need to be met. However, in these circumstances it should be possible to make significant cost savings. These, coupled with the release of capital previously tied up in financing the new business strain of the business on the books, should enable the company to meet these liabilities in the short term.

In the longer term, diseconomies of scale will bite, and further actions will be needed.

Discuss



A mutual life insurance company has only ever sold with-profit business.

The company closed to new business following intervention by the regulator when it was unable to meet the solvency capital requirement. Consequently, it has suffered from diseconomies of scale as fixed expenses have been spread over an ever-reducing number of policies.

Describe the other problems that the company is likely to face in the longer term.

2 Insolvency of an Insurance Company

➤ Projecting Solvency

In any of these scenarios it will be important to project the insurer's solvency position into the future on a range of deterministic scenarios, or with the aid of a stochastic model. It will be important to estimate the actions that might be taken in various scenarios, and to include these in the model.

The issues that need to be addressed and modelled include:

- estimation of future post-tax profits available to equity shareholders
- the current value of all surplus assets
- the amount, and timing, of any loan or debt redemption
- problems relating to industrial relations (and redundancies)
- issues relating to any staff benefit schemes – particularly if these schemes are in deficit
- outstanding financial obligations, minority interests and tax.

2 Insolvency of an Insurance Company

➤ Compensation Schemes

Where an insurer cannot meet its liabilities (as opposed to not having adequate solvency capital), and a buyer cannot be found to take them on, there may be a statutory scheme set up from which some or all of the benefit payments are paid.

Such a scheme is usually funded by a levy on all other providers.

For instance the UK has what is known as the Financial Services Compensation Scheme (FSCS)

Under this scheme, policyholders insured by an authorised insurance company are protected in the event of the company being unable to meet its liabilities. Under this scheme, insurance mandated by regulation such as motor third party insurance are paid completely, whereas those taken voluntarily such as endowment assurance are paid up to 90% of the total benefit amount.

3 Closure of a Sponsored Benefit Scheme

➤ Types of Closure:

There are two types of closure of a benefit scheme:

- The scheme being closed to new members, but existing members benefits continue to accrue
- The scheme is closed to new members as well as benefits of existing members cease to accrue.

The type of closure will depend on the circumstances: whether the employer / sponsor is insolvent or needs to reduce costs, whether the employer wishes to follow market trends in benefit provision, or any other reason.

For a defined benefit scheme, the scheme rules will need to set out the benefits that will be provided on discontinuance.

3 Closure of a Sponsored Benefit Scheme

➤ Close to New Members Only

The scheme is closed to new members.

Existing members' benefits are unchanged. In defined benefit schemes, benefits continue to accrue with additional service and salary increases.

There are no human resource issues as a scheme is not offered on joining employment and the new employee accepts the salary and benefits package offered.

The sponsor expects to continue to pay contributions for the declining number of active members.

The contribution rate as a percentage of salary is likely to both increase and also become more volatile as the membership reduces.

3 Closure of a Sponsored Benefit Scheme

➤ Close to New Members and No Accrual of Any Future Benefits

The scheme is closed to new members, and also no further benefits accrue to existing members. Existing members are given reduced benefits on the date of closure. There are human resource issues, as previously promised benefits are reduced. The sponsor expects to pay a one-off settlement (perhaps over a period if the scheme is in deficit), but essentially to make no further contributions.

➤ Level of Benefits

Where a benefit scheme is set up to provide benefits for a group of individuals, consideration needs to be given to the benefits that will be payable were the scheme to cease. This may arise due to the insolvency of the sponsor or a decision to stop financing the benefit provision.

3 Closure of a Sponsored Benefit Scheme

The benefits that will be paid to the members of the discontinued scheme will be affected by the following factors:

- the rights of the beneficiaries, which will depend on the terms under which the scheme operates and any overriding legislation
- the expectations of the beneficiaries, which are likely to be the benefits that would have been available had the scheme not discontinued.

If there are insufficient assets to meet the rights and expectations of beneficiaries, a lower benefit may be paid.

In case of insufficient assets, rights would be given a preferential treatment over expectations. Distinguishing between rights and expectations is a matter of judgement.

3 Closure of a Sponsored Benefit Scheme

➤ Rights

There are many definitions as to what comes under rights. On one end of the spectrum, beneficiaries only have the right to the benefits that have been or should have been received. At the other end they have a right to what they would have received if they remained in the scheme until retirement and continued to accrue benefits.

3 Closure of a Sponsored Benefit Scheme

Expectations

Choice needs to be made as to what consists of expectations:

- The future accrual of benefits
- The future growth of the benefits, unless the member is leaving the scheme
- Any discretionary benefits such as bonuses etc

The distinguishing of rights and benefits only makes sense if there are sufficient assets to ensure the provision of benefits at that level if the assets are insufficient, some of the benefits will have to be reduced, unless another sponsor may wish to take up the scheme.

3 Closure of a Sponsored Benefit Scheme

➤ Level of Assets – Schemes in Deficit

A scheme in deficit has two options:

- Members accepting a reduced benefit
- The sponsor is required to make up for the shortage of assets

Where the whole benefit scheme is being discontinued and there are insufficient assets in the scheme to provide all the promised benefits, and the scheme sponsor is unable to provide further funding, then the accrued benefits will also be reduced.

If the benefits are to be reduced, legislation or scheme rules may indicate which types of benefits are to be reduced or which types of beneficiaries are to have their benefits reduced.

Members are categorized and are listed in order of priority, which establishes as to which benefits will be paid up first and which benefits will be reduced if there is an asset crunch. Generally benefits in payment are said to have the highest priority.

3 Closure of a Sponsored Benefit Scheme

The assets for these purposes may simply be those that have been funded.

Alternatively, there may be additional assets available to secure the discontinuance benefits.

- Legislation or ethics may lead to extra funds being made available by a solvent sponsor.
- Legislation may require a debt to be placed on an insolvent sponsor, which may rank alongside, above, or below other creditors.
- Insurance may have been taken out that ensures the sufficiency of assets in the event of the insolvency of the sponsor.
- There may be a State-sponsored fund to support benefits where the employer is insolvent. Such a fund may be paid for by a levy on solvent schemes.

The expenses involved in determining the benefit allocations, informing the beneficiaries and securing the appropriate form of provision will further reduce the assets.

3 Closure of a Sponsored Benefit Scheme

Any expenses incurred in the formulation, administration of the scheme, will be prioritised and will have to be paid using the firms assets if the sponsor is insolvent. They are the first item to be paid because the advisors will not perform their duties and required calculations, unless they are paid their due.

For example, consider a scheme with assets of \$100,000

The discontinuance liabilities, in order of priority are as follows:

1. Expenses	\$10,000
2. Pensions in payment	\$35,000
3. Members' voluntary savings	\$10,000
4. Early leavers' benefits	\$25,000
5. Benefits for active members	<u>\$40,000</u>
	\$120,000

3 Closure of a Sponsored Benefit Scheme

Here the funding level is 83.3%. However, the expenses and the first two categories of benefits would be paid in full and the remainder would be reduced to 75% of their promised level.

➤ Level of Assets – Schemes in Surplus

- If, on discontinuance of the scheme, the assets are more than sufficient to meet the benefit rights of the members under the chosen method of provision, the surplus may pass back to the sponsor.
- Alternatively, legislation or scheme rules may require the surplus funds to be used to increase the benefits for members.
- Either way, it would be usual for all members to be granted their basic rights in full, before any are granted additional benefits.
- The allocation of any surplus to individual beneficiaries may be done taking account of the length of membership or other possible indicators of the extent to which the individuals can be viewed to have contributed to the surplus.
- Ownership of surplus is a controversial matter. Apart from the period of membership, other factors playing a role in the distribution of surplus could be the level of benefits a member is entitled to or the level of contributions paid by the member.

3 Closure of a Sponsored Benefit Scheme

Fairness in the allocation of surplus is difficult to achieve , because of the perceived inequity across different generations or different categories of members.

For example pensioners may feel wronged if only existing member's benefits are enhanced.

➤ Provision of Benefits

If a benefit scheme is being discontinued, the following options may exist for the provision of the outstanding benefit payments:

- gradual removal of the liabilities by continuation of the scheme without any further accrual of benefits – the scheme acts as a closed fund and no more benefits accrue, but a fund exists that meets the benefits outgo as it falls due.
- transfer of the liabilities to another scheme with the same sponsor – schemes are not always discontinued as a result of financial failure of the sponsor.
- transfer of the funds to the beneficiary to extinguish the liability - Legislation may not allow an individual to receive the capital value of their benefits. However, an alternative may exist that allows the individual to place the funds with an appropriate insurance company or in the scheme of any new employer.

3 Closure of a Sponsored Benefit Scheme

- transfer of the funds to an insurance company to invest and provide a group policy or an individual policy in the beneficiary's name
- transfer of the liabilities to an insurance company to guarantee the benefits
- transfer of the liabilities to a central discontinuance fund, operated on a national or perhaps industry-wide basis.

The sponsor may want to choose any of the last four options if he wants to lock in any surplus or deficit in order to remove any uncertainty about the scheme's financial obligations.

If benefits remain in the scheme and the employer remains solvent, the employer remains liable for any shortfall in the value of assets to meet the promised benefits. The employer may need to finance any initial deficit and any future deficits that may arise.

If benefits are transferred to a third party such as another scheme or an insurance company but guarantees are not offered by the third party, the ultimate benefit will then depend on future experience and the assumptions used to capitalise the benefits. The benefits may be greater or smaller than the discontinuance benefit.