Solvency Assessment and Management (SAM)

Report: Linked Business Thematic Review

August 2017

FSB

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Introduction

The Solvency Assessment and Management (SAM) framework is in the final stages of development before its full implementation. There are a few topics that are still being considered and one of these topics relates to linked business.[1]

At the SAM Steering Committee held on 16 March 2016 the FSB advised industry stakeholders that it intends undertaking a comprehensive review of the operations, valuation and reporting of linked business before any policy proposals are finalised. The comprehensive review is expected to be a two to three year project, mainly under the ambit of the new Prudential Authority to be established under Twin Peaks. To commence this comprehensive review, the FSB has identified the following matters to be investigated through a thematic review called the Linked Business Thematic Review (hereafter referred to as the Thematic Review):

1. The use and statutory reporting of reinsurance arrangements for linked business;
2. The interpretation and application of contract boundaries for linked business; and
3. The allocation and reporting of operating expenses for linked business.

This report considers the data collected from and interviews held with the Participants of the Thematic Review.

Structure of the report

The report first describes the process the Thematic Review followed before it sets out the findings, with recommendations.

Terms used

Throughout the document the following convention is used to refer to a specific party:

- Ultimate policyholder: the person or entity that buys the original or first insurance contract. This would not include the individuals in a pension fund or retirement fund where the pension fund or retirement fund buys the contract on behalf of the individual members;
- Insurer / Cedant: the insurer that sells the insurance contract to the ultimate policyholder. The insurer can also be the cedant when it invests in a policy issued by another insurer, which could be linked in nature or not; and
- Reinsurer: the insurer that sells an investment policy to the cedant where the contract could be another linked contract, but not necessarily so.

[1] Linked business as defined in the Insurance Bill, 2016

Executive summary

The Linked Business Thematic Review was commissioned by the FSB in consultation with the SAM Steering Committee. This Thematic Review was undertaken in an effort to analyse certain specific aspects of linked business in order to inform the final requirements contained in the Financial Soundness Standards for Insurers (FSI). This report on the Thematic Review provides the findings of the review and makes recommendations for each of the findings.

The findings are based on the analysis of the submissions by the Participants augmented by interviews with the Participants. Participants were a mix of life insurance investment product providers, including not only insurers that only write linked business (pure linked insurers) but also large typical insurers that write linked business or market-related business as only part of their diversified business lines.

Summary of the main findings:

1. The use of "reinsurance" for linked business is necessary for facilitating compliance with certain legislative requirements, specifically tax legislation and regulations under the Long-term Insurance Act. These "reinsurance" arrangements are not typical, as there is no actual risk transfer from the cedant to the reinsurer. Nonetheless, allowing such "reinsurance" arrangements is necessary in order to facilitate the purpose of linked business in the broader investment market, at least until such time as there is a broader reform of the tax and insurance regulatory frameworks.
2. Expenses are not consistently disclosed or included in the operational risk capital requirement calculation as specified in the SAM Financial Soundness Standards for Insurers (FSI) and this needs to be addressed in the SAM standards or guidance.

Summary of the main recommendations:

1. Classification of business: clear guidance is needed on how to classify investment business and which product features would impact the demarcation;
2. Many of the findings of the Reinsurance Regulatory Review on linked business also extend to market related business, and this should be accommodated in the SAM Standards;
3. Nature of reinsurance: "reinsurance" arrangements should continue to be allowed for linked and market related business, even where there is no effective risk transfer, but should not be recognised as an eligible risk mitigation instrument for purposes of SAM solvency calculations. In the longer term, broader reforms to the Income Tax Act and the Regulations under the Long-term Insurance Act should be explored so as to remove the need for using the artificial reinsurance label;
4. Reporting: the cedant should report the outward reinsurance arrangements in the SAM QRT, while the reinsurer should report the inwards reinsurance in the QRT. No reinsurance recoverables should be recognised on the cedant's balance sheet or recognised as risk mitigation in the SCR. Instead, insurers should use the look-through approach for reporting these assets;

5. Counterparty default risk: specific disclosures should be required so that the ultimate policyholder is aware of the reinsurance arrangements and that he or she is exposed not only to market risk, but also the default of an insurer(s) other than the cedant;
6. Contract boundaries: a zero contract boundary should be applied for linked business and an appropriate contract boundary for non-linked business. Where a single investment contract has both linked and non-linked investment benefits, insurers should apply the principle of proportionality to determine the most appropriate contract boundary; and
7. Expenses: more guidance will be issued on which expenses to include in the Operational Risk calculation. The main principle is that expenses disclosed on the various bases should be consistent for all the expenses and fees, other than commission and asset management fees. Commission is specifically excluded and asset management fees are specifically included for the Operational Risk calculation. Expenses for the outsourcing of functions should be included in the calculation.

The process

The Thematic Review followed a specific process, outlined below:

1. Development of the template

   With the help of the FSB's consultant (Deloitte), a set of survey questions was developed. The survey template was split into three sections:

   1.1. Use of reinsurance: a Participant could be the cedant or the reinsurer or both;
   1.2. Contract boundaries: what contract boundary was used and what is the Participant's preference; and
   1.3. Expenses and outsourcing: disclosure of fees on four different bases.

2. The template populated by Participants

   Participants provided data about their linked business and, if material, their market related business, using the template provided.

3. Desktop analysis of data submitted

   The FSB together with Deloitte analysed the data provided by the Participants and derived questions to use in the interviews with the Participants.

4. Interviews with each Participant

   An interview with each Participant was held asking questions of both a general and specific nature in order to supplement or clarify the data already provided.

5. Further analysis and report

   The data provided by the Participants in the template and the interviews was subjected to further analysis and the findings and recommendations were written into this report.

Findings and recommendations

Context

The linked business industry can be split into three broad product provider categories: typical insurers that offer linked policies as part of their full product offering, pure linked insurers who as part of an asset management group use a life licence to provide linked business products, and multi-managers who target selected markets using other asset managers with a life wrapper as the core part of their value propositions.

Typical Insurers

These are insurers that provide a wide range of life insurance products including risk and investment products. In aggregate these insurers have the largest market share of the life insurance industry.

Pure Linked Providers

A life insurer that is only authorised to sell linked business is referred to as a pure linked insurer. Most pure linked insurers are closely related to a specific group whose main activities relate to asset management. The group uses different structures to provide its asset management services, including the use of a life licence to wrap investments in a linked policy as part of its overall product offering.

Multi-Managers

These companies, a subset of pure linked insurers discussed above, specifically offer a multi-manager investment approach where they enter into arrangements with a host of other asset managers as part of their product offering. Such multi-managers are the insurers that predominately make use of "reinsurance" arrangements since they invest in life investment vehicles by design.

Ways to invest

The Thematic Review highlighted that other than direct investment in the relevant markets, insurers use three ways to invest clients' money and the choice of method is dependent on the preference of the asset management company that they contract with. The three ways they predominantly invest in are:

1. For large mandates, the asset management company is prepared to enter into segregated mandates directly with the insurer. Also known as segregated funds and usually only an option for very large investment amounts;
2. For smaller mandates, the asset management company prefers to offer a choice of collective investment schemes (CIS); and
3. For mandates that are too small for a segregated fund, but where the insurer requires a more bespoke arrangement, a pooled arrangement is offered. In these instances investments are made using a life licence for the following reasons:
   a. Better fees – Insurers can negotiate a lower fee structure with the asset manager using the life licence to access the CIS ;

b. Availability – If an insurer requires access to an investment vehicle that is not a CIS and only accessible through a life licence, e.g. a fund with guarantees or a Discretionary Participating Feature (DPF) fund, then a life policy could be used. Alternatively, if a new mandate is required (i.e. that does not yet exist), a life policy could be used as it is administratively easier and quicker to set up than a CIS.
c. Systems – A new insurer that does not have the infrastructure to offer its clients the funds it would like to offer can invest in a policy with another insurer, thereby enabling it to offer its clients the underlying investments.

Classification of business

The following are definitions of lines of business as contained in the latest version of the Insurance Bill, including amendments proposed following the receipt of public comments:

''linked'' means where the insurance obligations under an insurance policy are:

(a) Not fully guaranteed or partially guaranteed; and
(b) Determined solely by reference to the value of particular assets or categories of assets which are specified in the insurance policy and are actually held by or on behalf of the insurer specifically for the purposes of the insurance policy, less deductions specifically provided for in the insurance policy.

''market related'' means where the insurance obligations under an insurance policy are not partially guaranteed, fully guaranteed or linked.

''fully guaranteed'' means where the total insurance obligations under an insurance policy payable at the end date of the insurance policy or, in respect of an annuity, at each annuity instalment, are at the start of the policy:

(a) Stated in the insurance policy in Rand terms; or
(b) Stated in or ascertainable from the insurance policy with reference to the growth rate used in calculating the policy's investment value or, in the case of an annuity, each annuity instalment, which growth rate is stated in the insurance policy as a fixed rate of return or stated return linked to inflation over the full term of the insurance policy.

''partially guaranteed'' means where some, but not all, the insurance obligations under an insurance policy at the end date of the insurance policy or, in respect of an annuity, at each annuity instalment, are at the start of the insurance policy:

(a) Stated in the insurance policy to be no less than an amount in Rand terms; or
(b) Stated in or ascertainable from the insurance policy to be no less than an amount calculated with reference to a growth rate used in calculating the policy's investment value or, in the case of an annuity, each annuity instalment, which growth rate is stated in the insurance policy as a fixed rate of return or stated return linked to inflation over the full term of the insurance policy.

Market Related versus Linked Policies

One of the findings of the Thematic Review is that the classification of policies into linked versus market related business is inconsistent across insurers. This issue only applies to the typical insurers as pure linked insurers are not allowed to write any business other than linked business.

Directive 146.A.i (LT) was issued in 2010 to assist with the interpretation and application of the demarcation of linked business. The key part of the definition of linked business is that the relevant assets must actually be held by or on behalf of the insurer. The insurer must at all times own the relevant assets and hold the relevant assets directly or through an approved nominee company.

The definitions in the Insurance Bill have been amended to reduce the potential for misinterpretation; in order to be classified as linked business, a policy must meet all requirements of the definition, including that the underlying asset must actually be held by the insurer (directly or indirectly). Where a policy offers an investment return that is linked to the market return on referenced assets, but the referenced assets are not actually held (directly or indirectly) by the insurer (and the product does not offer any form of guarantee) then the policy must be classified as "market related".

The Thematic Review found that there were particular areas that caused confusion about the correct classification of policies, which would require further guidance. Specifically, different interpretations were encountered on whether the following features would allow insurers to continue to classify the policy as linked business, or would change the nature of the policy to being market related:

1. Products offering different types of guarantees, including return of contributions on death or other small death or disability benefits, or small investment guarantees such as an underpin of return of contributions on maturity.
2. Products where the insurer retains some or all of the counterparty default risk of the underlying assets.
3. A linked policy that is invested in a non-linked policy with another insurer (for example, an investment in a smoothed bonus type policy).

Recommendation: The Participants do not all apply the same rules for the classification of business, which complicates the analysis and supervision of insurance business. This report recommends that guidance be issued along the following lines:

- Benefit guarantees on the occurrence of a risk event: Return of contributions guarantees on death, disability or retrenchment should not be seen as investment guarantees, but rather as risk benefits. If these benefits are provided as part of the same policy that has a linked investment feature, then this will be a combined policy (and the insurer would have to be licensed for both the Risk and Investment classes under SAM), but it would not change the linked business nature of the investment component.
- Investment guarantees on surrender or maturity: any form of investment guarantee (in which the insurer bears any degree of market risk, however small) would change the nature of the policy to either partially guaranteed or guaranteed, whichever is applicable. This would include a return of contributions minimum guarantee.

- Loyalty bonuses and other types of bonuses excluding those inherent to DPF products – the presence of such bonuses breaks the linked classification, as the insurance obligations are no longer determined solely by reference to the value of particular assets or categories of assets, but are also dependent on predetermined contractual adjustments to the value of the investment fund at predetermined periods. This type of business should be regarded as market related business.
- Surrender penalties or any other administration fees for withdrawing all or some of the funds – these penalties and fees will not alter the classification of such business and it may still be regarded as linked business (as long as the value of the investment account is still determined solely by reference to the value of particular assets or categories of assets actually held by the insurer). The definition of linked business in the Insurance Bill has been revised to clarify this.
- Policies where the insurer retains some or all of the counterparty default risk of the underlying assets –this risk retention will alter the nature of the business (the insurer will take on market risk) and change the classification to market related business.
- A linked policy that is invested in a non-linked policy with another insurer (for example, an investment in a smoothed bonus type policy) – such a policy remains a linked policy (the insurer holds an asset, being a policy with another insurer, and the value is determined solely by reference to the value of the policy).

Form of reinsurance arrangements

The majority of the Participants use linked "reinsurance" arrangements in some or other form. These Participants do so to address the following regulatory constraints:

1. Income Tax Act – using the reinsurance classification allows the reinsurer to use the tax fund appropriate to the ultimate policyholder and not that of the cedant. If there were no reinsurance structure in place the reinsurer would have to use the corporate tax fund (CPF) to invest the cedant's investment, as the cedant is a corporate entity[2].
2. Long-term Insurance Act – reinsurance contracts are excluded from the restriction period provisions of Part 4 of the Regulations under the Long-term Insurance Act. Similar to fund policies, the reinsurance label allows the cedant to contribute to the contract without triggering further restrictions and allows it to make unlimited withdrawals, which otherwise would have been limited to only two withdrawals during the restriction period.

The Thematic Review also indicates that such reinsurance agreements are in place not only for linked business but are also used by insurers for their market related policies.

Recommendation: The term "reinsurance" with respect to linked business (or market related business) is used loosely by the industry with the understanding that it is not like traditional

[2] For example: If the ultimate policyholder is a pension fund then this business will be allocated to the untaxed policyholder fund of the cedant. If these funds were to be onward invested in a policy with the "reinsurer" without using the reinsurance structure, then the reinsurer would need to place the investment in the CPF, since its policyholder is a company. The investment returns on the business would then be taxed in line with the tax rules pertaining to the CPF. The ultimate policyholder, the pension fund, would then be prejudiced by receiving returns that have been taxed.

reinsurance, but merely a necessity to comply with the two relevant Acts as discussed above. While this is not ideal, in the short-term it is understood that there is a need for insurers to use these reinsurance arrangements for the reasons given above even though the label of reinsurance is artificial. In the longer term, this report recommends broader reforms that would help remove the need for using the artificial reinsurance label.

Short-term approach:

- Consistent with the Reinsurance Regulatory Review Position Paper released in September 2016, linked reinsurance should be allowed, but not recognised as eligible for risk mitigation in the SAM framework, i.e. the presence of reinsurance should not impact the technical provisions, assets or capital requirements other than requirements for counterparty default and concentration risk (see the Disclosure and reporting section below); and
- Insurers should be made aware of the requirement for the reinsurance structure in order to be compliant with the two relevant Acts.

Eligibility of reinsurance

The Reinsurance Regulatory Review Position Paper states that the transfer of significant risk is required before reinsurance would be eligible for use in the capital requirements and technical provision calculations as set out in the FSI. It also states that if there is no risk transfer, then this constitutes "other business" for which the insurer needs approval from the Prudential Authority. However, a carve-out is envisaged so that this "reinsurance", although not transferring any risk, would not be seen as "other business". However, such reinsurance cannot be included in financial soundness calculations. These proposals of the Reinsurance Regulatory Review Position Paper have been formulated into the Financial Soundness Standard FSI 4 (Calculation of the SCR Using the Standardised Formula).

A potential long-term approach:

The need for the reinsurance label can be replaced by defining a new term, say "policy asset", and changing the Income Tax Act and Regulation 4 of the Long-term Insurance Act to add this new term in those sections that currently refer to reinsurance policies or arrangements and allowing the same relief as the reinsurance label. Qualifying requirements can be derived for the new term to apply to make sure that the correct type of contract is captured. This suggestion involves changing the relevant two Acts as follows:

- Income Tax Act – expand definition of fund policy so that a policy asset is also deemed to be a fund policy or that a similar treatment is allowed; and
- Insurance Act – apply the same waiver of the restriction period to a policy asset that applies to a fund policy.

Retrocession arrangements

The Thematic Review also found that it is not uncommon that a reinsurer would in turn reinsure the linked business / market related reinsurance arrangement with another insurer. These retrocession arrangements are usually concluded for reasons of access to either investment approaches or investment products.

Recommendation: Such "retrocession" agreements should be treated in the same way as the original "reinsurance" arrangement.

Reporting of reinsurance arrangements

The Thematic Review also showed that not all insurers or reinsurers were aware of all the "reinsurance" contracts they have entered into. For example: one insurer disclosed a reinsurance contract with another insurer, but the reinsurer did not disclose the contract as a reinsurance contract.

Even though reinsurance forms the basis of the legal contract between the cedant and the reinsurer, the Thematic Review found that often the reporting of these contracts did not follow the reinsurance reporting as required by the SAM reporting templates, but rather Participants reported these contracts as direct contracts. Often the cedant does not treat these investments as reinsurance contracts and accordingly reports its assets and liabilities ignoring these reinsurance contracts i.e. the assets and liabilities are not reduced by these contracts. The reinsurers also did not consistently disclose these as inwards reinsurance contracts.

The reporting, whether shown as reinsurance or not, gives rise to a double counting of assets for the industry in aggregate as the same assets are counted for both the cedant and the reinsurer.

Most insurers seem to have systems and procedures in place to establish and to continuously monitor the tax status of their policyholders. This provides some comfort that policies are correctly treated for tax (in most cases being the untaxed fund as the ultimate policyholders are pension funds and their members).

Recommendation: For SAM reporting purposes for reinsurance arrangements, this report recommends the following:

1. The cedant must report the outward reinsurance arrangements in the SAM reporting templates ("QRT");
2. The reinsurer must report the inwards reinsurance in the QRT; and
3. No reinsurance recoverables should be recognised on the cedant's balance sheet or recognised as risk mitigation in the SCR. Instead, insurers should use the look-through approach for reporting these assets.

For SAM reporting purposes for investment in a life insurance investment product other than for reinsurance purposes, this report recommends the additional reporting of a "policy asset".

For exchange control purposes, this report recommends that the calculation of the foreign investment allowance for life insurers should be based on total assets that reflect this look-through approach for reinsurance arrangements, or alternatively, if this is not possible, then it should be based on total assets less any outward reinsurance, so as to avoid double-counting of assets. The total value of "policy assets" per insurer should also be considered for the exchange control purposes when a reinsurance arrangement is not used.

Counterparty Default Risk

Most of the pure linked Participants stated that the ultimate policyholder carries the default risk of the reinsurer. Some of these reinsurance arrangements are entered into due to client specific requests and so the contracts will be clear about the default risk or at least clearly disclose the use of a reinsurer. This was not universal, though, as one Participant indicated that the default risk is not covered in the contract nor is the potential use of a reinsurer disclosed, but only presented in the Participant's marketing material and fund fact sheets.

The typical insurance Participants were more pragmatic about the default risk, and some believe that the policyholder would not understand the counterparty default risk or that a reinsurer was made party to the contract. They thus believe that their shareholders carry the default risk of the reinsurer.

For those Participants that do not pass the default risk onto the ultimate policyholder, the treatment of the reinsurance was not consistent. Some Participants made no adjustments while others calculated a default risk SCR for the reinsurer as a counterparty. None of the Participants impaired their reinsurance recoverables as they would have done for traditional reinsurance.

Overall, the Thematic Review found that it was not always clear that the ultimate policyholder is made aware of the presence of a reinsurer to the contract.

Recommendation: The question of who bears the risk when a reinsurer defaults was met with divergent views. Therefore this report recommends the following for disclosure:

- Specific disclosures should be required so that the ultimate policyholder is aware of the reinsurance arrangements and that he or she is exposed not only to market risk, but also the default of an insurer(s) other than the cedant;
- Specific disclosure should be required when the underlying investment offered through the reinsurance arrangement is not a linked product in itself, clearly indicating that the ultimate policyholder's investment is only linked to the value of this underlying policy.
- Whether or not the insurer bears the counterparty default risk should be clearly disclosed to the policyholder. Where the policyholder retains the counterparty default risk (i.e. a linked policy) and the relevant underlying asset constitutes an investment in an institution, vehicle or arrangement that holds assets, which assets are not under the insurer's direct control, the insurer must disclose to the policyholder that the underlying investment of the policy is a claim against that institution, vehicle or arrangement, which is subject to counterparty default risk. Where the insurer retains the counterparty default risk, the insurer must include this risk in its SCR and classify this business as market related business (see Classification of business section above).

Contract boundaries

The Thematic Review found that all Participants use a short contract boundary for their linked business. Most Participants preferred to do so, especially the pure linked insurers, stating that the simplicity of calculations was preferred.

The Participants that have business classified as market related use a long contract boundary for this business, as they are exposed to risks for a longer period of time. The Thematic Review did not find any of the Participants that used different contract boundaries for different funds or benefits.

Recommendation: The use of contract boundaries is not an area of concern as all Participants determine the contract boundary in a consistent manner, i.e. a zero contract boundary for linked business and an appropriate contract boundary for non-linked business. However, when a single investment contract invests in both market related and linked business, the contract boundary to be used is not straightforward. This report recommends that insurers apply the principle of proportionality to determine the most appropriate contract boundary for a contract investing in a combination of linked business and other lines of business.

Expenses

The Thematic Review included a section about expenses and asked the Participants to disclose how they reported expenses for their linked business in the following four reports:

1. Published Annual Financial Statements (PAFS) i.e. IFRS purposes;
2. Long-term Insurance Act, 1998 prescribed statutory returns, in particular statement B7;
3. SAM QRT, in particular the Expense Analysis sheet TP6; and
4. SAM Operational Risk SCR calculation as specified in the FSI.

The Thematic Review found that Participants disclosed expenses more or less similarly for the first three bases and therefore this section focuses on the disclosures for the calculation of the Operational Risk SCR. The biggest discrepancy amongst the Participants is the treatment of asset management fees for outsourced asset management arrangements. In these cases the asset management fee is often charged and deducted by the asset manager within the unit price. These fees would not be disclosed in the Participants' income statements other than being disclosed in a note in their PAFS. Therefore most Participants do not see these asset management fees as a component of expenses. This is not the intention of the Operational Risk SCR, as this calculation requires all expenses to be included whether a function has been outsourced or not. The issue is further complicated since some Participants indicated that they do not receive information about the asset management fees from either the asset manager or the reinsurer and are not in a position to know the amount of the fees paid to be able to calculate the correct total expense number.

However, a few Participants did include the asset management fees in the operational risk calculation, albeit a minority. The Thematic Review found that these asset management fees could be a large expense compared to the insurer's other expenses.

Many of the Participants noted that the SAM capital requirements are very similar to the capital requirements that asset managers are required to hold (25% of management expenses) by their sectoral rules. As most Participants invest in a CIS of an asset manager (which could be in the same group or not) the view was that the same capital requirements are required, more than once, for the same assets. The double capital requirements are exacerbated when retrocession arrangements are in place, e.g. insurer A reinsures with insurer B that invests in a CIS of asset management company C.

The Thematic Review also found one Participant that outsources its administration to a third party, but since the fee for the administration is charged separately to the client and passed onto the third party, this amount is not included in the income statement and hence excluded from the operational risk calculation. This is similar in nature to the asset management fees finding discussed above.

For the Operational Risk SCR, any commission paid may be excluded, but the Thematic Review found that Participants either did not exclude this expense or excluded more than just commission paid.

It became evident during the Thematic Review that a single measure for Operational Risk SCR based solely on expense numbers is a challenge and the question then becomes what would be an appropriate measure for operational risk. Some Participants stated that assets under management (AUM) would be a good measure for them, but others thought expenses might be more appropriate. The Thematic Review made the following findings:

- Most Participants feel that in some cases AUM might be appropriate whereas others feel strongly that market volatility should not influence the level of capital required and would prefer expenses as a measure;
- Arguably, the market value of AUM does have a link to operational risk – if funds were incorrectly invested and not in accordance with mandate, the operational risk is directly linked to the market value of the affected portfolios; and
- Expenses on the other hand are more likely to give a more stable capital requirement provided that expenses are correctly reported.

Recommendation: The expenses section was a controversial section of the Thematic Review and showed the most inconsistencies in the manner that Participants disclosed and used expenses. The main principle is that expenses disclosed on the various bases (see Findings section above) should be consistent for all the expenses and fees except for commission and asset management fees. Commission is specifically excluded and asset management fees are specifically included for the Operational Risk calculation.

<u>This report recommends</u> that clearer guidance should be considered, which could be part of GN FSI 2.2 but should also be considered as guidance for FSI 4.4 (Operational Risk Capital Requirement). Particularly, consideration should be given to guidance on the following:

- What commission is and that an insurer can only include fees linked to selling practices and not management of sales; and
- Asset management fees. Suggestion: assume all asset management was done internally and not outsourced and asset management fees not changed, i.e. insurer charges what outsourced company does, then those expenses should be added to the Operational Risk calculation.

Outsourcing

Expenses for services rendered within a group of companies warrant closer scrutiny. Some activities, notably investment management services, are often outsourced within a group but in some groups expenses are viewed at a group level and perhaps not appropriately accounted for in the insurer's statements. Where intergroup charges are reflected, the Thematic Review found a common practice of either expenses recouped at cost, or cost plus a margin or a market related charge.

Recommendation: Expenses for the outsourcing of functions should be included in the calculation of expenses for the purposes of calculation of the Operational Risk SCR.