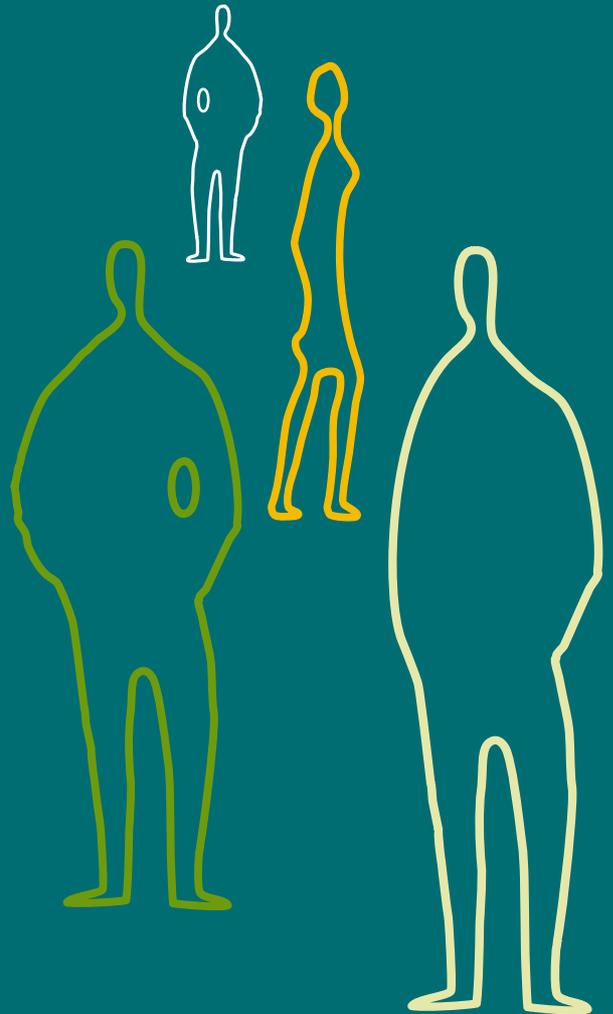


An Introduction to Internal Auditing in Insurance



Barclay Simpson
Recruitment Consultants

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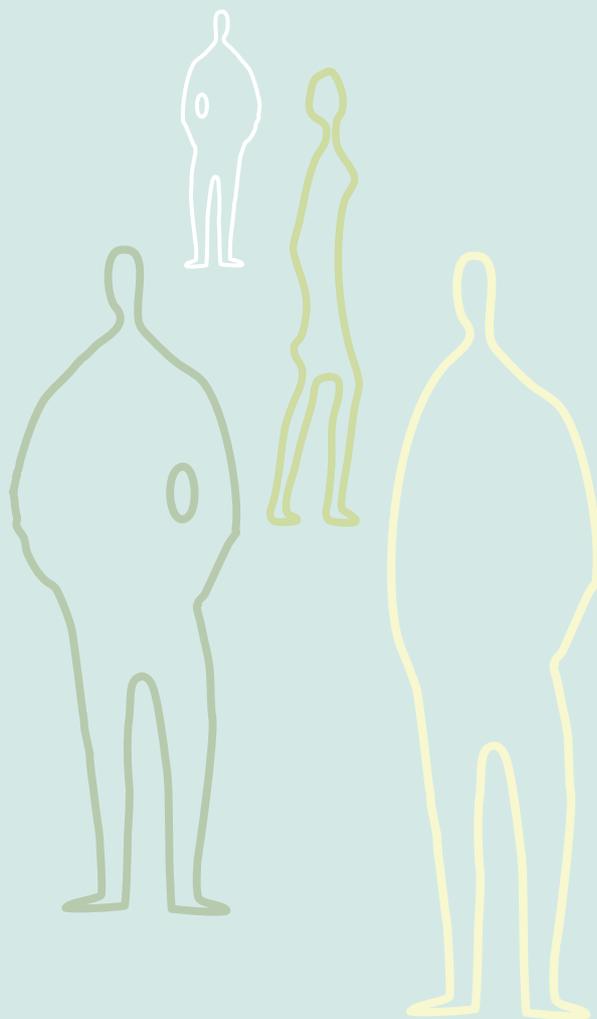
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1. Overview

1.1 Introduction

Internal auditing has enjoyed a long tradition within the insurance industry. Historically the industry has provided internal auditors with surprisingly stable employment. It has been a sector with an excellent record of training and developing internal auditors. Perhaps both the sophistication and complexity of the industry coupled with the ethos of providing for today what may be needed tomorrow, has lent itself to generous study packages and ongoing training.

The industry, however, is undergoing unprecedented change. The move to lower margin products such as stakeholder products, stakeholder pensions, e-commerce, issues such as guaranteed annuities and increasing regulatory pressures has resulted in consolidation in the industry. Companies continue to merge to achieve economies of scale and weaker companies look for stronger partners. In spite of this, the traditional importance of internal auditing within the industry remains strong.

1.2 Purpose

The aim of this guide is to give an overview of the main activities of insurance companies, the way they work and a perspective from an internal audit viewpoint. It has been written to assist candidates who are planning to attend an interview with an insurance company, but to date have had only limited exposure to the insurance industry. Whilst any insurance company that has agreed to interview a candidate who has only limited experience of the insurance industry will judge them accordingly, there is substantial scope for candidates to improve their chances by demonstrating that they have done some research and are cognitive of the fundamental issues and mechanics.

The insurance industry is divided into two major classes of business, **long term business** such as life assurance and pensions, and **general business** such as household insurance, car insurance etc; and insurance organisations can do one or the other or both. In addition there are specialist companies called **reinsurers** who accept specific risks from both the life and general companies. Consequently we have the following structure:

- Life assurance organisations
- General insurance companies
- Composites - these are organisations that write both life and general business
- Reassurance/reinsurance companies

This guide will be organised in the same way; the first section will cover aspects of the industry specific to life, pensions and annuity business, the second section will deal with the specific attributes of general business, the third section will deal with reinsurance and the concluding section will highlight areas common to all, and indeed probably common to most other business activities of comparable size.

This guide does not cover the Lloyds insurance market. This is considered a specialist area in its own right.

1.3 Internal Audit and the Control Evaluation Activity

In the insurance industry the Internal Audit function can fulfil several roles since there are three major risk and control monitoring activities that need to be discharged and the Head of Internal Audit can be responsible for one or more of them.

There is the traditional Internal Audit role; the role of the Compliance function under the management of the compliance officer - there is the specific task of ensuring that the organisation is in compliance with all major regulations - products - and there is the role of the Risk Manager who, in an organisation selling general business, is responsible for not only monitoring the product risk but also the wider business risk.

In many organisations these three roles are clearly demarcated, in others the Head of Internal Audit has responsibility for both Internal Audit and Compliance, with separate teams for each. Some organisations' audit and risk areas have been put together under an Audit and Risk Director but in these instances the product risk is usually left with a line manager and it is only the operational risk that is moved in with the Internal Audit function. As stated earlier, some organisations have all three activities under the same person. The role of the compliance department has grown increasingly over recent years.

1.4 Terminology

Whilst non industry candidates should not be bombarded with technical jargon at the interview it is difficult for the interviewer to probe a candidate's knowledge and ability level without resorting to some of the basic insurance industry terms. This booklet will deal with the most commonly used terms and explain them as simply as possible. It also includes a glossary. It is always wise, to ask for clarification if you are confronted at an interview with a term with which you are not familiar.

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2. Life Assurance

This covers the provision of life assurance policies, pension policies and annuity contracts; referred to in the industry as Long Term Business.

The life assurance industry has come under very severe scrutiny over the last 10 years or so, primarily over the pension selling problems of the 70's and 80's - generally referred to as the 'pension misselling scandal' - and the problems associated with Endowment products. This has resulted in a mass of regulation being brought in and with it the growth of a whole Compliance industry. Indeed, all organisations now have a compliance department that monitors and provides guidance on a range of regulatory matters, such as advertising and selling activities. The size, structure and location of the department vary from organisation to organisation, dependent upon the nature, scale and complexity of the business.

2.1 Risk

As far as the technical aspects of life assurance are concerned the internal auditor needs to be aware of two major risk areas:

- Product risk
- Investment risk

Product Risk

To better understand how this risk arises it is important to be aware of how a life product is priced. Many internal auditors in the life industry are not experienced in this area and consequently a major area of potential risk is not being audited.

Life assurance products are priced by Actuaries using Mortality Tables - statistical tables showing the probability of individuals at varying ages and with differing lifestyles dying at various times in the future.

Consider the following very simplified pricing example:

Of 1000 people aged	Probably this many will die this year
0	14.20
5	0.40
10	0.20
15	0.80
20	1.30
25	1.30
30	1.30
35	1.70
40	2.50
45	4.00
50	6.30
55	9.50
60	15.10
65	21.30
70	31.50
75	50.00
80	75.00
85	125.00
90	185.00

Now, if a life assurer wished to offer 1000 customers aged 30-40 cover of £50,000 for the coming year the premium would be calculated using the table, from which you would expect 1.5 deaths in the year from this group (i.e the average of 1.3 and 1.7). Therefore the company would expect to pay out £75K; with 1000 people in the group each one needs to contribute £75 for the company to break even.

However, most organisations require some form of return on capital; if in the above example we assume that £50,000 has been put up to launch this product and the organisation requires a 15% return on capital, the annual premium would then need to have this 'loaded' in:

$\frac{£50k \times 1.5}{1000}$	=	£75.00
$\frac{15\% \times £50k}{1000}$	=	£7.50
Premium	=	£82.50

Insurance organisations will invest premiums whilst waiting to pay them out, producing a return which can go towards lowering premium rates.

Since funds will be required to run the company and manage the policies throughout their lives, each policy will be expected to contribute, thus each policy will carry an **Expense Load**. Typically such a loading is split between:

- Initial expenses
- Renewal expenses

To illustrate these last two points, if we assume all details as before but this time the initial capital is invested at 10% p.a. and expenses are estimated to be £20k during the year, the premium would be:

$\frac{£50k \times 1.5}{1000}$	=	£75.00
$\frac{15\% \times £50k}{1000}$	=	£7.50
$\frac{£20k}{1000}$	=	£20.00
$\frac{(10\% \times £50k)}{1000}$	=	(£5.00)
Premium	=	£97.50

Other 'margins' such as profit are added in the same way.

These premiums build up a fund, the **Long Term Business Fund**, out of which claims are paid as they arise.

In the above example if we assume that during the first year of operation one policyholder dies, the investments yield 10.75% and expenses amount to £15k, the first years results would look like this:

Premiums - 1000 x £97.50	97,500
Investment Income £50K x 10.75%	<u>5,375</u>
	102,875
Death claims 50,000	
Expenses 15,000	<u>65,000</u>
	<u>37,875</u>

Before deciding what can be done with this profit by way of distribution the Actuary needs to know why the profit was made, this is a vital element of life assurance financial management known as the **'Analysis of Surplus'**.

In the above example the results would be:

The organisation expected to make:	
15% x £50k	= £7,500
it actually made	= <u>£37,875</u>
Difference	= <u>£30,375</u>
This results from:	
Underwriting	= £25,000 (fewer deaths than expected)
Expense Underrun	= £5,000 (less expenses than expected)
Investment Performance	= <u>£375</u> (better investment performance than expected)
	<u>£30,375</u>

Whilst it would make sense to consider distributing the surpluses arising from the expense and investment performance, it would be prudent to keep back, or **'reserve'** the £25,000 resulting from the underwriting since more deaths than expected might occur in the future.

On the subject of this distribution of surplus it is worth considering how the life industry is structured and why this guide refers to 'organisations' rather than companies.

There are two basic types of organisation that offer insurance:

- **Mutuals**
- **Proprietary**

A mutual is owned by the policyholders, a proprietary company has shareholders.

In mutuals all profits go back to the participants; proprietary companies have shareholders who participate in the profits.

The foregoing example was very simple, deliberately so, and was intended to illustrate the various processes the Actuaries will go through to build a product. The example only covered a one year product whereas in reality life assurance is a long term business and the pricing would need to reflect likely events over 10,15,20 years.

It is easy to see, though, why the first of the two major risks - Product Risk - can stem from Mortality issues, product 'loading' issues (expenses, profit etc.) or Investment issues.

Investment Risk

There are two elements to consider here. Firstly, as has been demonstrated earlier, if the organisation does not earn a rate of return equal to or above that assumed in its product pricing this will adversely affect emerging profits.

There are a group of products, however, which remove this risk from the insurer and put it back to the policyholder. These are called **Unit Linked** products.

A unit linked policy is similar in appearance to a unit trust. The policyholder chooses from a range of different funds where they wish their premiums to be invested. Prices per unit in each of these funds are published daily in the press. These prices are calculated by dividing the current market value of the assets of the fund by the number of current unit-holders. Obviously in this scenario if the value of the investments go down then the price per unit goes down and all unit-holders have a lower value attaching to their policy, thus the investment risk has been moved from the insurer to the policyholder. By law though, these policies must carry a minimum sum assured to make sure that in the event of death prior to the end of the contract a known sum will be paid, therefore the insurer has still retained the 'mortality' risk.

The second element to consider under this broad risk heading is the organisation's own investment in its growth; in other words its capital structure.

Life companies need to maintain a satisfactory margin of assets over liabilities - known as the **Solvency Margin**.

Unlike almost any other business though, a life assurer loses money initially every time it sells a piece of new business. This is referred to as **new business strain**.

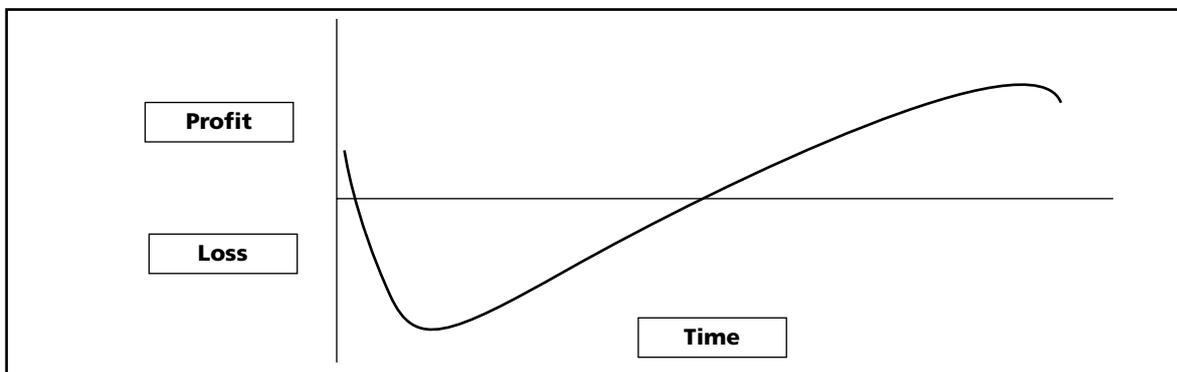
New business strain is caused by the heavy expenses incurred in the early months of writing business on such things as:

- Commission
- Underwriting costs
- Reserves

For example:-

	Month 1 £	YEAR 1 each of months 2-12 £	YEAR 2 each of months 13-24 £	YEAR 3 each of months 25-36 £
Premium	10.00	10.00	10.00	10.00
Less				
Commission	65.00	0.75	0.75	0.75
Expenses	5.00	5.00	0.25	0.25
Mortality cost	0.10	0.10	0.20	0.20
Plus				
Investment income	0.10	0.10	0.70	1.40
CASH FLOW	-60.00	4.25	9.50	10.20
Reserves	<5.00>	<5.00>	<5.00>	<9.70>
SURPLUS/DEFICIT	-65.00	-0.75	4.50	0.50

This means that if new business volumes are increasing year on year then losses will continue to mount until the profits from the stream of existing business are sufficient to cover new business strain. Graphically this is represented thus:



For this reason it is vitally important that the capital structure of a life assurer is fixed correctly and that this is linked to the long term business plan. Obviously it is equally important for new business to be closely monitored.

2.2 PRODUCTS

Life assurance products fall into 2 basic product groupings:

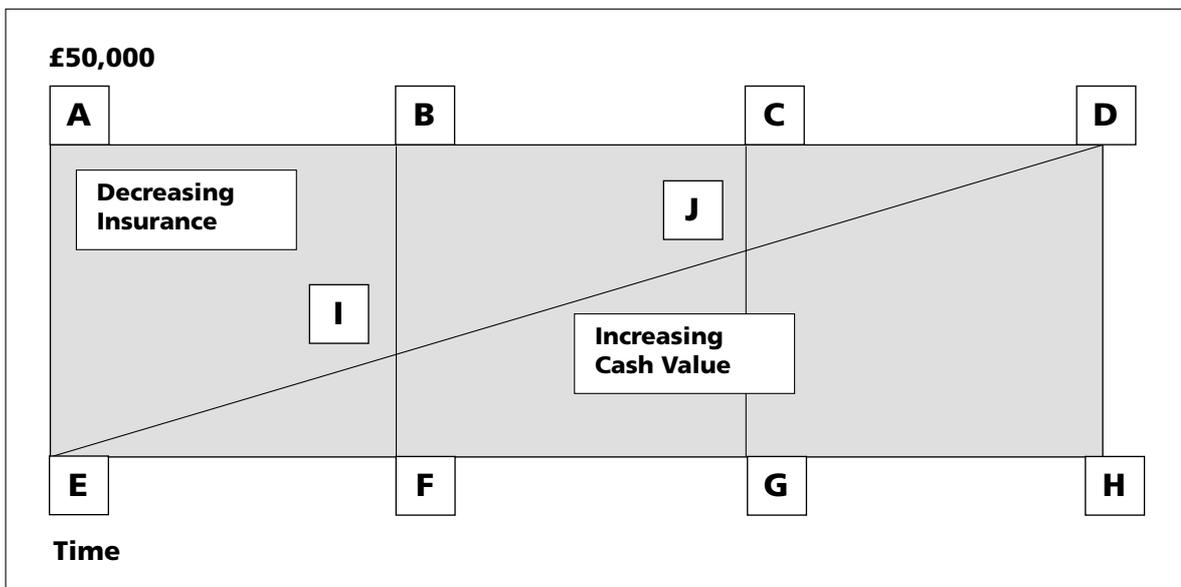
- Permanent
- Temporary

Permanent Products

There are 3 basic types:

- Whole Life
- Endowment
- Pensions/Annuities

The general principle with a permanent product is that **an amount is payable on death or at a fixed future date**. Diagrammatically this can be shown as:



- E = Date policy goes into effect
- H = End of policy period
- A = Face amount of policy (£50,000)
- D = Endowment amount (paid if p/holder **lives**)

Area EDH = Increasing cash value

AED = Decreasing insurance element

If the policyholder **dies** at point in time F the death payment would consist of the cash value (I,F) and the remaining insurance (I,B)

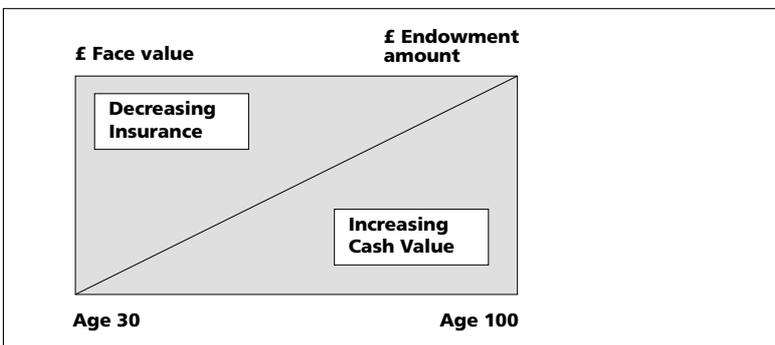
Whole Life

A whole life product pays out at a predetermined age or death if earlier.

To enable the Actuary to estimate the likely payout on a type of policy it is necessary to decide how long it is to run. Assume the policy will run to the assured's age 100. The distinguishing characteristics then become:

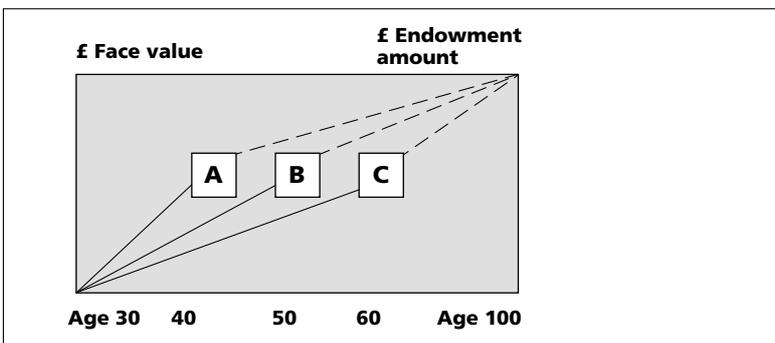
- insurance protection exists to the insured's age 100
- the policy period extends to 100 and premiums are payable to then
- the policy pays out (endows) at age 100

So diagrammatically the Whole Life product looks like this:



A variant of this policy is the Limited Pay Whole Life. This:

- Provides insurance protection to, in our example, age 100 (like Whole Life)
- Endows at age 100 (like Whole Life)
- **BUT** premium payments end at some time specified prior to 100 and policy holders have a wide choice of premium paying periods



Solid line = premiums going into the policy Dotted line = investment income

Policyholders can stop paying prior to 100 and take accumulated cash value but notice that the more the premium paying period is condensed the higher the premium

A = 10 yr payment

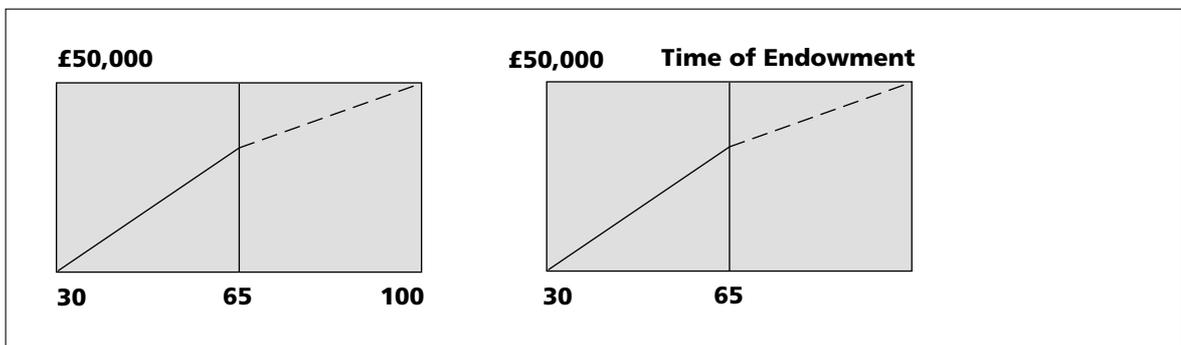
B = 20 yr payment

C = 30 yr payment

Endowments

An Endowment policy is exactly like a Whole Life policy except that the cash value of the Endowment is paid on a predetermined date, not related to the age of the policyholder and will usually be for a shorter period than a whole life policy.

- Like Whole Life, Endowment premiums are payable to the end of the policy period
- Like Whole Life, an Endowment policy provides insurance protection for the whole policy period
- Like Whole Life, an Endowment policy pays out the face value to the policyowner when the policy matures at the end of the policy period
- **BUT** with an Endowment all of this happens at an earlier date, i.e prior to age 100 in our example.



An Endowment policy is valuable for the liquidation of a fixed debt such as a mortgage since it extends over a specific number of years, has a known pay out figure whilst at the same time guaranteeing funds to liquidate the debt if the debtor dies in the meantime.

Permanent products can be either with profit or non profit.

With Profit

The policyholders share in the annual profits of the organisation in the form of bonuses which are added to the face value of the policy. These bonuses can be:

- **Reversionary**
- **Terminal**

Reversionary bonuses are added to the policy throughout its life and are largely a function of how well the Life Company has performed in terms of profits. Once declared they cannot be removed and are added to the sum assured. Terminal bonuses are added at the end of the life of the policy.

Non Profit

Such policies do not qualify for either terminal or reversionary bonuses.

It is important to note that Proprietary companies also offer With Profit policies and so essentially profits in these companies can be split between policyholder and shareholder and do not all simply go to the shareholder.

Pensions

The concept is the same as that behind an endowment - build up a cash value by regular contributions and become entitled to a cash benefit at the end.

Again there are 3 basic types:

- **Personal**
- **Executive**
- **Group**
- **Stakeholder**

Personal

These can be either **regular** or **single** premium contributions paid into a scheme approved by the Inland Revenue. Contributions cannot be made by an individual who is not working or who is in an occupational scheme. Contributions are limited to a set percentage of earnings. Contributions throughout the term provide for a tax free lump sum and/or a pension (paid as an **Annuity** - see below) at retirement - which can be at any time after age 50.

Executive

Here a company will pay a regular premium to a Life company to cover pension provisions for a set number of stated, key, employees. At retirement an annuity is purchased in the usual way.

Group

These are policies purchased by companies for their employees. At set up the likely population distribution is established and a flat premium priced accordingly. Periodic reviews of the scheme take place but individual movements in and out are not important from an actuarial point of view.

Annuities

Strictly this is not an insurance product because **it does not provide any insurance protection**.

Its basic purpose is to distribute a regular, guaranteed lifetime income through a scientific liquidation of invested capital.

There are 2 periods to consider:

Accumulation Period

This is the period of time during which amounts are being paid into the fund, and interest is accruing, prior to the date when the annuity income is needed. This period differs as regards:

- **Immediate annuities** - income commences immediately the single premium is paid
- **Deferred annuities** - a fund is built up over time.

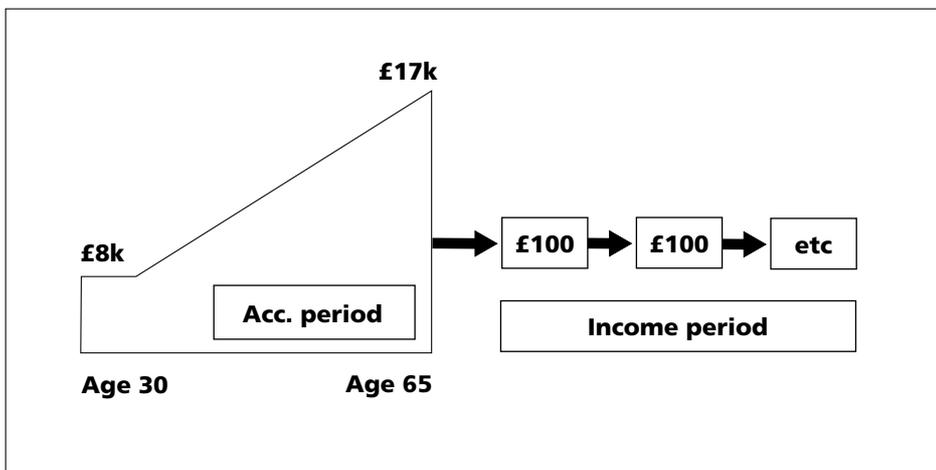
Deferred annuities are also split:

- **Single premium deferred annuity**
- **Instalment deferred annuity**

Income Period

This is the period of time during which the annuity is paid to the annuitant. Regular income payments are guaranteed to the annuitant for life. All annuities have this income for life provision - they differ only to the extent of the company's obligation to pay anything further to anybody if an annuitant dies before having received total income equal to the original annuity fund.

As an example, a man aged 30 wants to buy an annuity for himself with income to start at age 65. The company determines that it takes £17k at age 65 to provide £100 per month for life. To provide this sum he needs to pay £8k now. Using the 'boxes' method used earlier the diagram for this product would be:



Temporary Products

These policies are referred to as **Term Policies**. With this type of contract an amount is only payable if the event insured against happens within the term. **Credit Life** is a good example. If the policyholder dies during the specified term - the company pays and the funds can be used to liquidate the debt. If the policyholder lives to the end of the term the policy expires and the company does not pay.

Term Policies can be:

- **Renewed**
- **Converted**

Policyholders can usually do this without having to provide further proof of insurability. The second option affords the privilege of converting from term to permanent. Term assurance is a useful - and cheap - way to cover loans. A refinement of the basic Term policy is **Decreasing Term**.

With level term there can be an **excess of insurance**, that is the policy might cover the value of a loan at the outset but as the loan is repaid the face value of the policy will be too high and this will be costing more in premiums. Decreasing term is issued with an initial face value that reduces steadily until it equals zero at the end of the term, and as an example, is often used as cover for repayment mortgages.

Premiums are averaged to give a level (and lower) premium throughout the policy.

2.3 SELLING METHODS

It is generally accepted that insurance is sold not bought and the sales are usually on a commission basis. The majority of this commission is paid in the first few months of the policy's life. As has been shown earlier, life assurance contracts are long term contracts that make it difficult for the policyholder to frequently check their investment performance, or be sure of their benefits. The temptation to sell products purely for the commission, irrespective of the customer's needs is obvious.

Prior to the current regulatory regime agents could be financially linked to a particular life assurer but still give the impression to the general public that they were independent. Many did. The up-front commission received on policy sales was enormous; an agent could receive over 200% of the first year's premium at the end of the month following the sale. Not surprisingly fraud was rife.

Regulation was gradually introduced under the auspices of a number of regulators - for example LAUTRO, SIB, PIA – until the introduction of the current regulator, the Financial Services Authority ("FSA"), from 1st December 2001. This is set out later in this guide. What this legislation did was to introduce polarisation of the selling agents – i.e. they have to be linked to a company or truly independent. We currently have:

Independent Intermediaries

These act as the agent of the investor; they must not be influenced in their advice by the amount of commission they will receive.

It was envisaged the Independent Intermediaries would have to give 'best advice', that is they must make the most appropriate recommendation to the client taking into consideration all the client's financial circumstances ("the need to Know Your Customer"). However, with all the difficulties surrounding how to define 'best', this requirement was replaced with the 'suitability rule'. This means that the Independent Advisor must be able to show that he/she has taken reasonable steps to ensure that the product recommended has been properly selected. To this end, the advisor must keep detailed records as to how such a decision was made.

Tied Agents

Also known as **company representatives**, these people or firms represent one company only. A Tied Agent can be an individual employed by the company whose products he/she is selling or a company that has an agreement with, or is 'tied' to such a provider.

Obviously a Tied Agent is only licensed to sell the products of the company to which they are tied, this does not, however, give them license to sell unsuitable products. They still have a duty to provide the best advice to their customers; if a suitable product does not exist in the company's product range the client must be informed of this.

De-Polarisation

The issue of polarisation is currently under debate. The polarisation of independent and tied agents was introduced in 1988 on consumer protection grounds. However, the FSA has concluded that these reasons no longer apply and is concerned that the existing regime is outdated and anti-competitive. An extensive review is underway during 2003 looking at de-polarisation and options for an alternative regime. Ideas range from the abolition of commission-based remuneration and introduction of fee-based advice, to changes in the accepted views of independent Vs tied advice.

Direct Marketing

Both agents and brokers are expensive, for this reason Direct Marketing is attractive. The system relies upon advertisements in the press, trade magazines, radio and television to stimulate the prospect into applying direct to the company, thus cutting out a great deal of the cost of indirect selling. The proposal is completed either via the telephone or post. This selling method is now being linked much more to call centres.

At one time companies could say virtually anything in their adverts. Now this area is also regulated by the FSA. There are strict rules on the content and format of all investment advertisements, these rules distinguish between different forms of advertisement - i.e those creating 'name awareness' versus those inviting the public to order 'off the page'.

'Add-Ons'

This type of selling has been around for a long time - notably in the building societies. It utilises the branch network of an organisation not in the insurance field to sell insurance products to customers whilst they buy the organisation's own product.

This is obviously a cheaper distribution method than agents or brokers, but not as cheap as Direct Marketing.

Internet

This medium is being increasingly used to sell life products. However, it is really only suitable for the simplest contracts, the regulations governing sales and marketing literature and the underwriting requirements weigh heavily against putting more complex products 'on the net'.

2.4 KEY FUNCTIONS

There are certain functions that are unique to life assurance organisations:

Actuarial Department

Every life assurance organisation in the UK has to have an **Appointed Actuary**. This is a qualified Actuary who has amassed sufficient experience for the DTI to agree to their appointment to the role. The Appointed Actuary's prime responsibility is to the policyholders and it is his/her role to sign-off the company's annual Actuarial Statement including the formal valuation of policyholder liabilities.

The Appointed Actuary usually heads up the Actuarial Department but this need not be the case.

The two prime responsibilities of the Actuarial Department are:

- Product pricing (already dealt with)
- Valuation

Valuation is the process whereby the Actuary determines what reserves need to be established by the organisation to cater for future liabilities.

Policyholders have been promised certain benefits from their policies either for certain (permanent policies) or in the event of the occurrence of a specified event, within a fixed period (temporary policy). In return they pay a single or regular stream of premiums.

If the company simply credited premiums, debited claims and expenses and paid the difference as a dividend, it will find at some future date that it has an embarrassing situation when it cannot pay claims because it has no funds.

For this reason the Actuary sets aside reserves out of current premiums for what are expected to be the future liabilities of the company.

Simply stated, the Actuary determines the discounted value of promised future benefits and deducts the discounted value of contracted future premiums. The discount rate used is based upon an estimate of future interest rates, in some countries this rate is fixed by statute. In the UK the method for determining Long Term Liabilities is detailed in The Insurance Companies Regulations 1994 ss 64 - 75, with s69 addressing rates of interest.

Underwriting

The role of the Underwriter is to ensure that the population of policyholders conforms to the pattern envisaged by the Actuary when the product was priced. They will check things like medical history, smoking habits, occupation etc. Insurers will not necessarily reject an applicant out of hand if they do not conform to their criteria. What they will do is 'rate' them, i.e. if the Actuary is willing to charge £20 per month for an 'acceptable' candidate of a certain age and sex, then the company may charge £22 per month for a person of the same age and sex but whose medical history, say, is not of a suitable standard.

Claims

As the name suggests this area is responsible for paying out on in-force policies. Payments are made in the following circumstances:

- Death of the policyholder
- Surrenders - where the holder of a Permanent policy such as an Endowment wishes to cash it in prior to maturity
- Withdrawals - some permanent policies allow some of the funds to be taken as withdrawals, or perhaps part surrenders, over the life of the policy
- Maturities; i.e. when an Endowment policy reaches the end of the contracted period.

There are some obvious risks here. Ensuring that the signature on the claim form is that of the policyholder in the case of surrenders; this signature could have changed over the years. Ensuring the validity of death certificates - especially those from overseas.

Policy Servicing

This area would be responsible for any changes needed on a life or pension policy between its initial set up and final claim or maturity. The types of activity undertaken would include:

- Change of marital status
- Change of address
- Increase/decrease in premium
- Setting up of regular withdrawals on certain policies
- Switching funds on unit linked policies.

Compliance

The Compliance function acts in a similar way to the Internal Audit function in the sphere of regulation. Its role is to ensure that FSA regulations, which stipulate that firms must establish effective systems and controls to ensure compliance with regulatory requirements – such as those relating to sales, training, advertising and record keeping, are adhered to.

Contrast between Compliance and Audit

The roles of the Compliance and Audit functions may be contrasted in the following way. The Compliance department is a line function that positions itself within an organisation to implement systems and controls in relation to regulatory system matters to ensure the organisation adheres to regulatory requirements. The task of monitoring to assess the appropriateness and effectiveness of these systems and controls may be delegated to an Internal Audit function, in addition to the usual activities of the Audit Department.

Internal Audit, on the other hand, is not a line function and its responsibilities cover all activities of the organisation. Indeed the Internal Audit function should conduct periodic reviews of the Compliance Department since any slippage in standards here could represent a major risk to the organisation.

Some life insurers have combined Audit and Compliance under one head, there is nothing wrong with this provided that there is a clear segregation between the Internal Audit staff and the Compliance staff, they are not interchangeable.

3. General Insurance

Unlike Life Assurance, General Insurance products tend to be annual, renewable contracts. They cover the items we are all familiar with:

- Motor vehicles
- Buildings - fire, flood, earthquake, subsidence etc
- Contents
- Health
- Travel

but also provide more complex cover in such areas as:

- Public and product liability
- Fraud
- Company Directors' & Officers' activities
- Plant and machinery such as oil drilling platforms
- Marine and aircraft

Whilst not requiring all of the long term assumptions used by Actuaries to price Long Term products, general business can be equally complex in its pricing methodology.

Very skilled **Underwriters** or **Technical Risk Managers** will utilise statistical data on past events to try and establish the likelihood of such events occurring in the future and thereby establish a premium for the product or class of business. In this way the pricing is similar to the Actuary using the Mortality Table as one element in establishing the life policy premium. Indeed, in the case of Health Insurance, a similar set of tables are used, called **Morbidity Tables**.

3.1 RISK & PRODUCTS

As with the Life Assurance organisation, one major risk for a General Insurer lies in the product. This product risk is best explained in two elements:

- Short term
- Long term

Short Term

As stated earlier, the Underwriter will have used statistical data of past events to predict the likelihood of those events occurring in the future. This data is very sophisticated; for example, computer programmes can be used which take maps of the United Kingdom that show various geological features and overlay them with details of all postcodes to enable the Underwriter to predict which houses - almost down to an individual house- are likely to suffer from subsidence in the future. This information is used to prepare householder's

premium rates, which goes some way towards explaining why such rates are different - in some cases for similar houses in the same street.

It is obviously possible to work out which areas of the country are more prone to car theft and rate drivers in those areas accordingly.

Even with all of this sophistication, though, the premiums charged can only be an estimate: the past need not reflect the future. The risk is that the business written, even though it is only for the short term, will turn out to generate higher than anticipated claims and will therefore be unprofitable.

Long Term

It is important to recognise that even though General Business tends to consist of annual policies, albeit these policies can be renewed every year, there is a difference in the type of cover they provide. Essentially these policies can be viewed as:

- 'Short tail'
- 'Long tail'

Short tail business is where any liability of the insurer is known about either during the policy year - the car has either been stolen or it hasn't - or very soon afterwards.

Long tail business is where the insurer has accepted the premium in one year but the liability could arise many years into the future. For example a cigarette manufacturer who paid premiums for Product Liability cover in, say, 1960 might now be looking to claim on that policy even though his relationship with the insurer may have ceased some time ago.

It is this long tail business that gives rise to the long term product risk.

Reserving

To try and mitigate this product risk, General Insurers set up reserves in exactly the same way as their counterparts on the life side.

For short tail business there is the possibility that an insurable event will have occurred during a policy year but will not have been reported by the end of the year when the insurer closes its books. To cater for this the insurer will create a reserve called an **IBNR** reserve; standing for **I**ncurred **B**ut **N**ot **R**eported. It is possible to estimate how much this should be by looking at claim reporting patterns during the year.

For long tail business the Underwriters and Risk Managers need to refer to their statistics to determine what a sensible reserving pattern should be.

Once reserves have been established it is necessary to monitor their ongoing adequacy, are they likely to be too high or too low. This is done by matching claims in subsequent years against the initial reserves established - called claims run-off.

A second risk is that of **concentration**. This can be either concentration of product - i.e. only selling one or two product types; or concentration geographically. A company with a balanced portfolio in this country might have an otherwise sound set of results undermined if its overseas activities consisted of household insurance in the North East United States which is particularly prone to ice and snow storms.

3.2 SELLING METHODS

The general insurance side is not so heavily regulated as regards Sales and Marketing as the life side. General products can be sold in a variety of ways:

- Insurance Brokers - individuals or companies specialising in one or more general insurance products; probably the most famous is Lloyds of London
- Retail organisations such as supermarkets, chemists and travel agents
- Banks and building societies - who tend to sell household cover with the mortgage
- Direct via the telephone - Direct Line being the most famous example
- Via the internet

It is fair to say that the simple, bulk standard short tail products such as motor, household, health etc. are the ones that lend themselves to the direct selling and internet marketing methods.

It is worth noting, however, that from Summer 2004 general insurance, together with mortgages, will be come under the provinces of the FSA, impacting on the level of mandatory regulation in this area.

3.3 KEY FUNCTIONS

Underwriting

In a general insurer the Underwriters and Risk Managers play a key role; they fix the premiums and establish and review the reserving levels. Their role is akin to that of the Actuary in a life assurer.

Claims department

As the name suggests, this is the area where the claims are received, reviewed and, if accepted, paid out. This area, however, has to work closely with the Underwriters since the level of claims being incurred is of importance to them, as also is the level of reserving likely to be necessary. Year end reserves can be established either in the Claims department or by the Underwriters or, probably, by a combination of the two.

4. Reinsurance

Both life and general companies will seek to cap their liabilities at a reasonable level. For example a life assurer will not want any one individual risk to exceed a certain amount, but also it would not want its death claims collectively to go above a certain amount in any one policy year.

General insurance is no different; no one individual claim, like for instance a product liability claim, should be allowed to impact on the company above a certain amount. Similarly the company should be able to limit its exposure to any one class of claim, say health claims, to a set figure.

This claim limitation is achieved through **reassurance** in the case of a life assurer and **reinsurance** in the case of a general company.

For a premium, a reinsurer will accept a level of risk from a life or general company; this premium is established by the reinsurer in the same way as it was by the life or general company, that is the reinsurer uses its skill, judgement and historical data to assess the likely risk and develops a premium accordingly.

Reinsurers pay commission to companies reinsuring with them in the same way as those companies will have paid commission to acquire the business in the first place. This is an important point in the case of life assurers. Earlier on it was pointed out that when life assurers write new business they tend to make a loss in the early months due to the commission they have had to pay out. This is referred to as the **New Business Strain**. By entering into a reassurance deal they can recover some of this commission and thus ease the New Business Strain.

Reinsurers also tend to be a source of technical advice to their client companies in respect of unusual risks thanks to their wide experience.

It is a peculiarity of the insurance industry that reinsurance transactions are largely unregulated; a standard reinsurance contract is unlikely to exist. This can sometimes test the phrase 'uberrima fides' (utmost good faith) to the limit.

The two most commonly occurring contracts are:

- Facultative
- Treaty

Facultative

This is a contract arranged for one particular exposure; for example a satellite launch. The advantage here is that the cover is tailor made and the insurer tends to get the benefit of the reinsurers' specific technical knowledge. The disadvantage is that it can take a long time to put in place and it tends to be expensive.

Treaty

Under this arrangement an insurer (referred to as the **cedant**) agrees to pass to the reinsurer all business that falls within the scope of the agreement and the reinsurer agrees to accept this business. A typical example might be all lives assured in excess of £100K are to be reassured at a set premium. The advantages here are speed and ease of operation. The cedant would provide lists detailing the categories of risk, premium etc., these lists are called **bordereaux**.

Facultative and treaty business can be classified as **proportional** or **non-proportional** business. Proportional business is where the reinsurer accepts a percentage of a risk without any limit in relation to the size of the risk. Non-proportional business is where the reinsurer accepts a risk but payment of any claim relating to that risk is dependent on the occurrence of a specific event.

Typically reinsurance arrangements distribute either the insurance or the loss. Some typical distribution methods are:

- **Quota Share.** Here the insurance and the loss are shared according to some prearranged percentage; e.g. it is agreed to split a £100K policy 50/50, the reinsurer would accept half the liability and pay half of any loss.
- **Surplus Share.** Here the reinsurer accepts a portion - perhaps 100% - of the insurance in excess of a stated amount and any losses are pro-rated according to the amount of insurance assumed. So if the reinsurer had accepted 100% of the insurance in excess of £100k on a £200K policy the reinsurer's liability would be $(200,000 - 100,000)/200,000$ or half.
- **Excess Loss.** Here the reinsurer agrees to pay the portion of any loss under an individual contract in excess of some specified amount.
- **Catastrophe.** This is similar to Excess Loss but the losses covered are those incurred by the insurer as a result of a single event under all contracts covered. So, for example, the reinsurer might have to reimburse the insurer the amount by which total losses sustained by the insurer following, say, a hurricane exceeded an agreed amount.

As with general insurers, one of the key functions in a reinsurer is the Underwriting function. This is where the mass of historical statistical data is used to assess the various risks being underwritten.

5. Functions common across the industry

As well as the functions common to all companies such as Human Resources, Facilities Management and Legal & Secretarial, insurance organisations, in both life and general, have some specific requirements:

5.1 New Business

This area receives the initial request for insurance cover - the proposal - and processes it in accordance with the individual company's procedures.

In a life assurer this area will probably contain the Underwriters who will check to see that the proposed life assured conforms to the criteria set down by the Actuaries.

This department will accept or decline the proposal, ensure that, for accepted proposals suitable premium payment arrangements have been made and capture the customer data onto the organisation's computer systems.

Where a proposal for life cover is outside of the standard acceptance criteria it may be necessary to obtain medical details before a decision as to whether or not to proceed can be made. This medical information is obtained in one of two ways:

- Medical Attendant's Report (MAR)
- Medical Examiner's Report (MER)

An MAR is a report obtained from the proposer's GP. It usually takes the form of a completed questionnaire.

An MER involves the proposer visiting either his own GP or the insurer's doctor for a full medical examination. The insurer pays the fees in this case.

Once a proposal is considered acceptable to the company a policy document is issued. This activity is usually carried out by New Business although the policy schedules are invariably computer generated. In the case of life assurance the policyholder must be notified of their statutory right to cancel the policy within a set time period if they so desire; this is referred to as the statutory 'cooling off' period.

5.2 Finance

This area will deal with all of the usual financial activities associated with large companies such as budgets, management accounts, financial accounts and the like. However, in addition there are some specific considerations that need to be borne in mind in the case of insurance activities.

Insurers must keep policyholder funds and shareholder funds strictly segregated. In addition, if a company writes both long term and general business these funds must also be segregated.

In the case of life assurers, this segregation usually results in the accountants managing the asset side of the balance sheet whilst the actuaries take care of the liabilities in the form of the Actuarial Valuation.

In the case of general insurers, the Underwriters or Risk Managers will need to supply the liability figures for Outstanding Claims Reserves, IBNR and the like.

It is quite usual to find a number of suspense accounts present in insurance companies. The most common are:

- New Business Suspense - initial premiums held by the company until the Underwriters have determined whether or not to accept the risk
- Claims Suspense - the proceeds of policies which have been surrendered or part surrendered and are awaiting despatch to the client
- Policy Suspense - money received by way of regular premium that cannot, for one reason or another, be credited to the policyholder's record

If not managed strictly these suspense accounts can quickly get out of hand. This can result in policyholders on the general business side getting notification that their policies have not been renewed and policyholders on the life side being notified that their policies have been cancelled or lapsed.

Another key activity performed in Finance is Cashflow reporting. This is discussed further in the Investment Department section below.

The Finance function will also handle the financial reporting for the organisation. As well as the usual published financial statements, insurers have to lodge with the DTI very detailed annual reports, including a section compiled by the Appointed Actuary certifying the policyholder liabilities. These returns go into very considerable detail about every type (or class) of business written by the company.

5.3 Systems

There are certain key systems that need to be present in all insurance operations:

General Ledger

Like any other financial organisation the insurer will run a general ledger; the point to bear in mind is the segregation of the policyholder and shareholder funds referred to earlier.

The general ledger needs some form of link to the next system to be discussed, the Policy Masterfile. This is because premiums received and claims paid need to be reflected on individual policies whilst being recorded, probably in bulk, in the General Ledger. Often this link is not robust and serious mismatching occurs.

Policy Masterfile

All insurers need to maintain records of individual policyholders. For general insurers the details can be fairly brief depending upon the type of cover:

- Name
- Address
- Type of cover

- Inception date
- Premium, including payment type if not single premium

For life assurance the Policy Masterfile adopts much greater significance. As well as the basic details referred to above the record needs to show:

- Sex
- Age
- Smoking habits
- Marital status
- Employer details (in the case of pensions)
- Unit holdings and specified fund(s) (in the case of unit linked products)
- Policy value

There are several package systems on the market that can handle this business but many of the older established life companies will have their own, old, bespoke systems and these will have needed to have been amended over the years to cater for the more modern products. This is another area of significant risk for many companies.

In a life assurer the Policy Masterfile needs a link to the next system to be discussed, the Valuation System.

Valuation System

This is used by the Actuaries to 'value' all in-force policies at various points during the year, and specifically at the year end. This valuation process, as has already been pointed out, is where the Actuary determines the reserves that need to be established for each in-force policy by calculating the present value of the benefits the policyholder has been promised and deducting the present value of the premiums the policyholder has promised to pay. For this calculation to be made on thousands of policies of differing types requires bespoke software. Whilst certain consulting actuarial firms will supply this software, it is quite usual to find that the Actuarial department have written their own.

The key point to bear in mind here is that the interface between the Policy Masterfile and the Valuation System needs to ensure that all in-force policies are transferred by the former to the latter.

Unit Pricing

Another system specific to life assurers is the system used to calculate the price of units to be published in the press in respect of any unit linked business the organisation might sell. This system needs to have robust interfaces to both the Policy Masterfile (to get regular, accurate details of all units on policies) and the General Ledger (to obtain up to date details of investment assets). The system will also require some method of obtaining current values for investment assets, either Reuters or Bloomberg.

Treasury and Investment Management Systems

All insurers need to invest premiums, pay claims, manage their investment portfolios and pay staff and suppliers. For this they need Treasury and Investment Management systems.

5.4 Investment Department

In any insurer, surplus funds are invested. A general insurer, in the ideal world, would collect sufficient premium income to settle all claims and therefore run its 'book' on a no profit/no loss basis; its profits would be solely derived from its investment income on the premiums collected before they are used to pay the claims.

For a life assurer the picture is very different. Here the policyholders have certain long term expectations and their premiums need to be invested to ensure that investment returns at least meet these expectations; anything over and above that and the organisation makes money, anything below that and the organisation loses money.

The Investment Department then is a key function and will be staffed by senior personnel with investment management skills. To perform their role to the highest standard they need up to date information about premiums and claims as well as major corporate expenditure. This is where the Cashflow reporting mentioned in the Finance section comes in to play.

The Investment Managers also need to liaise closely with the Actuary to ensure that their investment strategy matches the product strategy formulated by the Actuary. A simple example would be if the Actuary has a significant tranche of Endowment policies issued with a 10 year lifespan but the Investment Managers invest the funds in 15 year gilts; the assets and liabilities match but the timeframes do not.

The Investment Department will also handle the funds relating to the unit linked business of the organisation. The investment management strategy here could be markedly different from that required for non-linked business.

Because life business is long term and the product tends to be sold on the benefits to be derived by the policyholder in the future, companies with a good investment performance, that can show significant growth in their long term products will obviously have a marketing edge. For this reason the Investment Department is a key function in the overall marketing strategy. In the search for superior performance many companies have outsourced this activity.

6. Main audit issues in a composite insurer

Obviously all companies are different, every company has its own particular area of concern, its own current control issues. There are, however, certain areas of composite insurers that seem to always present the auditor with potential problems.

Generally it has to be remembered that the major insurers are old, well established, companies and this has resulted in their having a collection of systems to process different aspects of their work. These systems tended to have been added as they were needed; many do not integrate with the systems already in place; many are used by specialist functions such as the Actuaries who have built the systems themselves and so have not necessarily followed established system design methodologies.

This is the background to the potential audit issues discussed below.

6.1 Mixing shareholder and policyholder funds

It was stated earlier in this guide that there is a legal requirement to keep policyholder and shareholder funds separate. As a general rule funds are only transferred to the shareholder 'pot' after the Actuary has performed his valuation and agreed a surplus that can be allotted to the shareholders. So the picture to imagine is that all the funds received by the company from its policyholders go into one bank account, they may then be allotted to different funds depending on the policyholder's type of policy. The Actuary performs a valuation - present value of future benefits less present value of future premiums - and establishes a surplus, some of which can be transferred to the shareholder's account. This is all very well but how is the company to pay for its running expenses in the meantime? If these expenses are paid out of the same account as the premium receipts then shareholder and policyholder transactions have become mixed up. Companies must keep these transactions entirely separate and for some it proves to be very difficult.

6.2 Suspense Accounts

This is an area that most insurance companies have had problems with at some time or another.

Suspense accounts will be used to hold money received with insurance proposals whilst those proposals are being underwritten; there may be suspense accounts to hold the proceeds of policy surrenders that have come out of a particular fund and are awaiting final documentation before being sent to the customer. There will also be cases in suspense where the premium received is not that expected by the company's systems - this is particularly the case with pensions. All of this money will be in separate accounts in the General Ledger but may or may not be in separate bank accounts - but since it is all policyholder money it should all be in a bank account that is part of the policyholder funds.

What tends to happen is that large volumes of transactions go through these accounts and if they are not strictly managed items do not get cleared. Provided that the policyholder receives a policy or a claim cheque, or does not receive a notice stating that their policy is in arrears, they do not complain. Insurance, particularly life business, is something where it is very difficult for the policyholder to know at any point in time what premiums have been applied to their policies and therefore companies do not get feedback about 'missing' premiums in the same way as a bank or building society.

Having a number of Suspense Accounts with, in some cases, many thousands of transactions in each, also provides an ideal opportunity for teeming and lading, depending on which areas of the company have access to the accounts to clear items.

6.3 Reconciliations

Problems here can fall into two categories.

Firstly, the problem of different systems within the company which require the use of elements of the same data. For example, the policyholder database records details of all customers to whom the company has a potential liability. The Actuaries have a database that they use for valuing the company's future liabilities. If these two systems are not reconciled, at a minimum prior to every valuation run, there is the possibility that records might be present on one system but not on the other. It is quite possible that a company's policyholder database will in fact not be on one system at all. Both new products and new systems will be developed over time and a well established company could have several different systems making up its policyholder database. A client who has several different policies could appear on any or all of them. Unless there are strict reconciliation rules in place it is easy to see how such a situation could lead to problems.

Secondly, the problem of key accounts within the business not being reconciled. The obvious example is the bank accounts. Non reconciliation of bank accounts would be an audit issue in any company, in an insurance operation it is a significant issue because there are usually many bank accounts requiring reconciliation and because, as stated earlier, the company does not have the safety net of a customer complaining about premiums not being credited - the policyholder will assume everything is alright until told otherwise.

Another example, specific to Life Assurance, is unit reconciliations. Earlier in this guide the concept of unit linking was explained; policyholders buy units with their premiums and can check the progress of their policy by looking up the unit price in the financial press. From the company's point of view it needs unit data for two purposes. Firstly, it records the number of units against each policyholder record; secondly, it needs the aggregate total of all units in issue to calculate its unit prices on a regular basis. Although these two records are derived from the same data they are usually held on separate files. If these two files are not regularly reconciled there is the danger of incorrect unit prices being calculated.

6.4 Misselling

Strictly speaking this is an issue for the company's Compliance department but due to its seriousness it is usual for the Internal Auditors to also become involved - particularly if Internal Audit and Compliance are under the same management.

The problem has been well publicised as far as pensions are concerned; people being encouraged by salesmen to leave their current pension schemes and take out policies with the salesman's company which, in many cases, had poorer benefits than the schemes they left. This was all prompted by the vast commissions to be earned on these types of policy.

What has been less well publicised is the potential misselling of endowments, again prompted by the commissions to be earned.

A regular review of customer complaints and early surrenders is a fruitful area for the auditor to detect potential problems in this area. If a complaint, including those relating to mis-selling, is not addressed by the organisation to the satisfaction of the complainant, it can be referred to the Financial Ombudsman Service (FOS).

6.5 Claims Fraud

This can affect both life and general business, although it tends to be more of an issue on the general side.

The problem is one of claims being submitted when an insurable event has not occurred - fraudulent death claim, fraudulent accident claim - or of inflated claims being submitted for genuine events.

On the general side the company will usually have specialists attached to the Claims department who will have indicators to highlight potential fraud and will then arrange investigation. The auditor needs to ensure this is the case and that the system is working efficiently since this type of fraud can cost a company a substantial sum.

On the life side it is not usual to have specialists in the claims area, the company will simply rely on the experience of the claims staff. Whilst fraudulent claims, usually death claims, will not be as big a problem as on the general side they can still cost a lot of money and are more difficult to detect - after all who knows what a Death Certificate issued in, say, Brazil is supposed to look like!

6.6 Long Term Guarantees

Whilst strictly the province of the Actuary, this is an area where a good Internal Auditor will take an interest.

Earlier in this guide it was explained how life assurance was a long term product where the eventual benefits were set out at the start, with, perhaps, bonuses being added throughout the life of the policy, until at maturity, or death if earlier, the benefits are paid out. This eventual pay-out could be 25-30 years into the future.

The diagram of a box with a diagonal line showing the increasing policy value was used.

These products were designed, and subsequent bonuses declared, based on the Actuary's best guess of likely future economic and demographic conditions. But the Actuary is looking well into the future, what if the predictions are wrong to any great extent? Usually this is catered for by additional reserves - not distributing all available surpluses. If, however, the future guarantees are so generous that the current projections are that the company will not be able to meet them this has a very significant impact on the company.

The Internal Auditor needs to have a constant dialogue with the Actuary to ensure that all reasonable steps are being taken to avoid this situation.

7. Legislation

The table below provides a summary of all statutory legislation relevant to financial services. Recently repealed legislation has also been included for reference.

Statutory Instrument	Comments
Financial Services and Markets Act 2000	Received royal assent June 2000. Came into effect December 1 2001. Act in force.
Financial Services Act 1986	Act repealed under FSMA.
Money Laundering Regulations 1993	Regulations in force.
Banking Act 1987	Act repealed under FSMA.
Building Societies Act 1986	Part of Act repealed under FSMA.
Friendly Societies Act 1974	Part of Act repealed under FSMA.
Friendly Societies Act 1992	Part of Act repealed under FSMA.
Insurance Companies Act 1982	Act repealed under FSMA.
Consumer Credit Act 1974	Act in force.
Investment Services Directive 1993	Council Directive 93/22/EEC 10 May 1993.
Insurance Brokers (Registration) Act 1977	Act repealed under FSMA.
Non-Life Establishment Directive 1973	Council Directive 73/239/EEC.
Life Establishment Directive 1979	Council Directive 79/267/EEC.
Capital Adequacy Directive 1993	Council Directive 93/6/EEC 15 March 1993
Electronic Commerce Directive 2000	Council Directive 2000/31/EC.
Insurance Mediation Directive 2002	Council Directive 2002/92/EC.
Data Protection Act 1998	Act in force. Widens the definition of data in the 1984 Data Protection Act to include some manual records as well as computer-based records.
Policyholders Protection Act 1975	Substantially repealed under FSMA. Terms now only apply to claims against insurance companies that failed before 1 December 2001.

Provisions are currently being made to introduce statutory regulation for selling and advising on mortgage and general insurance products. This was announced in December 2001 by the government, to comply with the Insurance Mediation Directive. This directive must be implemented within two years and therefore it is anticipated that these changes will be effective from mid-2004. The GISC, ABI and MCCB are actively involved in the development of transitional arrangements for the transfer of oversight responsibilities to the FSA.

Glossary of terms

Actuary	A qualified person employed by a life assurer to price products and perform valuations
Appointed Actuary	A qualified Actuary, usually employed by a life assurer, who has been approved by the DTI to sign Actuarial Reports about the company, particularly its valuations
Bordereaux	A list detailing categories of risk, premiums etc
Claim	A request for payment under the terms of a policy
Compliance Function	A function in financial services organisations that has responsibility for ensuring the activities of the organisation conform to regulatory requirements
Composite	A company or mutual that deals in both life and general business
General Business	Non life and pensions business such as motor, fire, theft, accident, illness etc
IBNR	Incurred But Not Reported. A form of reserve set up by a general insurer to cover events which have occurred but have not yet been reported by policyholders
Loading	An amount included in the pricing of an insurance premium to cover such things as expenses, commissions, profit etc
Long Term Business	Life, pension and annuity business
Mortality Tables	Statistical tables showing the probability of males and females dying at particular ages
Morbidity Tables	The same as Mortality Tables except that the probability being measured is that of becoming ill rather than dying
Mutual	An insurance operation that is owned by the policyholders as opposed to shareholders
New Business Strain	The deficit arising in the early years of a life insurance contract due to the payment of initial expenses, particularly commission
Policy	The formal schedule agreeing the terms of business between the insurer and the policyholder (customer)
Premium	An amount paid by the policyholder to the insurer in respect of the provision of insurance cover
Proprietary company	An insurance company owned by shareholders
Reinsurer	A company which acts as an insurer to an insurer in as much as they accept the excess risk that the insurer is not willing to bear
Reserves	Amounts of money set aside out of current insurance premiums to fund the likely future benefits payable to policyholders. The figure is established by the Actuary
Regular Premium	A premium paid to an insurer on a regular basis, i.e. annually or monthly
Reversionary Bonus	An amount added to the value of a long term policy, during the policy's lifetime, by the insurer representing a portion of the insurers surplus
Single Premium	A premium that is paid to an insurer once only
Solvency Margin	The amount by which an insurers assets exceed its liabilities
Terminal Bonus	An amount added to the value of a long term policy, at the end of the policy's lifetime, by the insurer representing a portion of the insurer's surpluses during the policy's lifetime
Underwriter	Professional individual who scrutinises an insurance application from a customer to ensure that it conforms to the risk patterns acceptable to the insurer
Unit linking	A form of long term investment in which the policyholder chooses a fund run by the insurer in which to place their investment; any increase or decrease in the value of this fund is attributable to the policyholder not the insurer
Valuation	An activity usually performed by an Actuary to determine the amount of an insurer's liability to its policyholders