1. INTRODUCTION

This glossary is directed at the members of the various task groups operating under the three pillars of the SAM Governance Structure. In utilising this glossary, the task groups must bear in mind that the terms, acronyms and definitions are drawn from various sources, and not only the official EU documentation. The terms, acronyms and definitions included in the glossary may not necessarily inform the terms, acronyms and definitions to be provided for in the South African solvency regime legislative framework and should therefore not be promoted as such. This document will be updated as and when necessary.

Please take note of the following meanings used to cross reference terms in the glossary:

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2. PURPOSE

The purpose of this glossary is to assist the various task groups to gain a better understanding of the terms, acronyms and definitions included or referred to in the EU Solvency II directive in undertaking assessments of the EU Solvency II directive and its relevance for the South African solvency regime legislative framework.
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International Association of Insurance Supervisors, Licensing
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4. GLOSSARY OF TERMS

Acceptable asset

Capital (either on- or off-balance sheet) which, under regulatory rules, may be taken into account (fully or partially) to cover insurance obligations.

Related terms: Available solvency margin, Eligible capital

Accident insurance

Generic term applying to all types of insurance indemnifying or reimbursing for losses caused by bodily accident, or for expenses of medical treatment necessitated by bodily accident.

Related term: Health insurance

Defined as ‘Accident and Health insurance’ in EU law. For more details see Annex A and B(a) of First Council Non-Life Directive 73/239/EEC and consecutive amending directives.

Accident year basis

Accounting figures – for instance, claims incurred – are based on the accidents occurring within the accounting period.

Related term: Claims incurred

Accumulation annuity

A contract that accumulates, with interest, either as a single premium or a series of premiums and which provides a maturity benefit at some point in the future or provides an option to convert to a payout annuity.

Accumulation risk

The risk that arises when a large number of individual risks are correlated in such a way that a single event will affect many or all of these risks.

Related term: Catastrophic risk

Actual solvency margin

See: Available solvency

Actuary

An actuary is a professional trained in evaluating the financial implications of contingency events. Actuaries require an understanding of the stochastic nature of insurance and other financial services, the risks inherent in assets and the use of statistical models. In the context of insurance, these skills are, for example, often used in establishing premiums, technical provisions and capital levels.

Actuary’s report

Written information provided by the actuary on the company’s calculation of premiums and/or technical provisions etc.
Adjusted Solvency Capital Requirement

Adjustment to the Solvency Capital Requirement under Pillar I based on Pillar II regulation under the Solvency II regime.

Related terms: Minimum Capital Requirement, Solvency Capital Requirement

Pillar II adjustments are expected to be made on the basis of the supervisory review process and are hence specific to the firm in question.

Admissible capital item:

See: Eligible capital element

Admitted asset

See: Acceptable asset, Eligible capital

Advanced Risk Responsive Operating Framework

Current risk-based Supervisory Review Process operated by the FSA and likely to be impacted by the introduction of Solvency II requirements.

Abbreviation: ARROW

Affiliation contracts

Contract through which a joint-stock company subjects itself to the management of another company (e.g. holding company), or commits itself to transferring its profits to that company.

Affiliated investment risk

The risk that an investment in a member company of the same conglomerate or group may be difficult to sell, lose its value or create a drain on the financial resources of the insurer

Related term: Market risk

Aggregate excess of loss reinsurance

This method provides reinsurer indemnification to the ceding company for the aggregate amount of losses during a specific time frame up to a predetermined limit or percentage. For these situations, the ceding company will be expected to furnish the reinsurer with documentation of the premiums collected and the losses sustained.

Related term: Stop-loss reinsurance

Allocated investment income

Allocated investment income is the investment income from prepaid premiums and payment of claims in arrears.

Alternative risk transfer

Any form of risk transfer other than a pure insurance contract that includes at least an element of insurance risk as opposed to pure financial risk. Possible features of ART include, but are not restricted to:

- Tailor-made solutions
• Multi-year policies
• Often the coverage of risks that the conventional market would regard as uninsurable
• Often the inclusion of some form of risk transfer of non-insurance risk

The definition of ART includes, but is not restricted to, financial reinsurance and securitisation of insurance risks.

Abbreviation: ART

Related term: Reinsurance

Annual accounts

Financial statements of a company set up according to commercial law or generally accepted accounting principles, i.e. not specifically drawn up for supervisory purposes. In some countries the annual accounts / shareholder accounts might also be used for submission to the supervisory authority.

Equivalent term: Shareholder accounts

Annuity

A contract that provides a series of regular payments (both amount and timing) by the insurer (amount payable / benefit) under specified conditions for a specified period of time.

Related term: Pension scheme

An annuity may begin at a specified time after the issuing of the contract (deferred annuity), or on a specified trigger such as death or disability, e.g. orphans’ benefits or disability annuities.

Annuity benefits under an insurance contract typically end upon the death of the insured person, or cease upon recovery of the insured from disability or after a predefined period. Coverage may relate to one or two persons, respectively single-life or joint-life. The contract can be funded by the policyholder by means of a single premium or through a series of instalments.

The amount of regular payments to the beneficiary may be fixed or not, i.e. variable or fixed annuity, certain or temporary. Annuity contracts are sold on an individual and group basis.

Ancillary Own funds

The commitments that undertakings can call upon in order to increase their financial resources, such as members’ calls or letters of credit.

Arm’s length transaction

A transaction between two related or affiliated parties that is conducted as if they were unrelated, so that there is no question of a conflict of interest.

Related terms: Control, Related party(ies).

Asset-liability management

The practice of managing a business so that decisions and actions taken with respect to assets and liabilities are coordinated. ALM can be defined as the ongoing process of formulating, implementing, monitoring and revising strategies related to assets and liabilities to achieve an organisation’s financial objectives, given the organisation’s risk tolerances and other constraints. ALM is relevant to,
and critical for, the sound management of the finances of any organisation that invests to meet its future cash flow needs and capital requirements.

Abbreviation: ALM

Related term: Asset-liability mismatch risk

*Asset-liability management forms part of the overall risk management framework of an insurer.*

**Assets-liabilities matching**

See: Asset-liability management

**Asset-liability mismatch risk**

Risk of a change in value from a deviation between asset and liability cash flows, prices, or carrying amounts, caused by:

- A change in actual cash flows (for assets and/or liabilities);
- A change in the expectations on future cash flows (for assets and/or liabilities);
- Accounting inconsistencies.

Equivalent term: Asset-liability risk

Related term: Asset-liability management

*The deviation from the expected values may relate to a difference (or different evolvement) in timing and/or the amount of cash flows. Asset-liability mismatch risk originates from changes in market risk factors.*

**Assumption reinsurance agreement**

The ceding entity is relieved of responsibility for the policies reinsured, and the contracts are accounted for by the assuming entity in the same manner as direct business. The reinsurer assumes all of the obligations formerly assumed by the ceding entity. Typically, regulatory and policyholder approval is required. When a company intends to enter into an assumption reinsurance transaction, an indemnity reinsurance agreement may be used for those policies not yet covered by the assumption agreement.

**Auditor’s report**

Written information provided by the auditor on his examination of the company’s annual accounts.

**Automatic life reinsurance**

Is similar to non-life “treaty” reinsurance. In automatic reinsurance, the ceding company is able to bind the reinsurer on a risk without submitting an application for reinsurance, provided that certain conditions are met. These conditions vary by agreement, but typically obligate the ceding company to keep retention on the life, limit the amount of insurance on a life that may be ceded, and limit the overall amount of insurance that may be in force on the life issued by all life insurers. The ceding company may be required to notify the reinsurer of automatic reinsurance arrangements through specific cessions (i.e., “cession reporting”), otherwise it is called “bordereau reporting.” This type of reinsurance will be typically offered to broad segments of an insurer’s business, such as all issues of a specified policy form.
Available economic capital

Internally defined capital measure based on the company's valuation of the market-consistent value of its assets minus the market-consistent value of its obligations.

Related term: Required economic capital

Available solvency

Surplus of assets over liabilities, both evaluated in accordance with domestic regulation (either in accordance with rules of public accounting or with special supervisory rules) and taking into account domestic requirements as regards Eligible Capital Element, i.e. the amount of capital appropriate to cover the required solvency margin in accordance with domestic law or supervisory regulations.

The “solvency formula” = Let

A: be the total amount of assets on the balance sheet,

Ad: the amount (included in A) to be deducted for prudential reasons (e.g. intangible items, percentage of market value),

TP: the total amount of technical provisions on the balance sheet evaluated in accordance with domestic regulation (either public accounting or supervisory rules),

TPd: the amount included in TP representing an eligible capital element to cover the required solvency margin (e.g. the free profit reserve),

OL: the total amount of other liabilities (provisions) not directly linked to obligations under insurance contracts,

Old: the amount included in OL representing an eligible capital element (to cover the required solvency margin (e.g. subordinated loans),

F: the total amount of free capital (i.e. balance sheet items not belonging to TP or OL),

Fd: the amount included in F to be deducted (e.g. share capital not paid up), and

I: the implicit (off–balance sheet) elements eligible to cover the required solvency margin (e.g. hidden reserves, future profits estimated in accordance with domestic law).

Then the available solvency, AS, is equal to

\[ AS = (A - Ad) - [(TP - TPd) + (OL - Old)] - Fd + I \]

As, F = A – TP – OL, by definition, the formula could be simplified to:

\[ AS = F - Ad + TPd + OLd - Fd + I. \]

This may be interpreted as available solvency on the balance sheet, adjusted for any off–balance sheet item, or as appropriate under supervisory rules.

Equivalent terms: Available solvency margin, Actual solvency margin, Statutory solvency margin, Available surplus capital, Eligible capital, Regulatory capital, Free capital, Total adjusted capital, Policyholder surplus, Statutory surplus.
Available solvency margin

The difference between the value under regulatory measurement of the eligible capital held by an insurer, and the sum of the values under regulatory measurement of the obligations.

Related term: Eligible capital

Available surplus capital

See: Available solvency

Average clause

A coinsurance clause: a clause requiring an insured to purchase insurance for a stipulated portion of the entire value of the thing insured.

Related term: Funds withheld

Back-testing

The process of comparing actual experience with statistical predictions.

For example used as a formal statistical framework to verify if actual losses are in line with projected losses in VaR models.

Basic Own funds

The economic capital available (the difference between the assets and liabilities calculated on a combination of best estimate and market consistent assumptions) plus the subordinated liabilities.

Basis risk

The risk that yields on instruments of varying credit quality, marketability, liquidity and maturity may not move in sync, thus exposing the insurer to market value variation that is independent of liability values.

Bearer policies

An insurance contract requiring the insurer to pay funds to the person(s) holding the policy document or to whom the entitlement to the benefit(s) was endorsed without the knowledge or consent of the insurer.

Beneficial owner

The natural person(s) who ultimately owns or controls a customer and/or the person on whose behalf a transaction is being conducted. The term also incorporates those persons who exercise ultimate effective control over a legal person or arrangement.

Best estimate

The probability-weighted average, also referred to the mean. The estimation process is unbiased and based on all currently available information including information of currently observable trends, but excluding effects from events not yet occurred.

Equivalent terms: Central estimate or Current estimate

Related term: Best estimate liability
The concept of best estimate applies to many circumstances, including the valuation of insurance contracts, the valuation of assets or liabilities, a cash flow stream, an individual assumption, or a valuation approach. Sometimes the term best estimate refers specifically to the current estimation of the mean value, i.e. the probability-weighted average, of cash flows. In other cases, the term best estimate refers specifically to the current estimation of the mean value of risk weighted cash flows, as e.g. IAS 39.42.

**Best estimate liability**

The expected or mean value (probability weighted average) of the present value of future cash flows for current obligations, projected over the contract’s run-off period, taking into account all up-to-date financial market and actuarial information.

Related term: Best estimate

Note that the term liability does not refer to a liability in the accounting sense, but is used in its general meaning (as a synonym for any certain or potential obligation for payment now or in the future). The use of the term best estimate liability has historically grown. When used in the context of solvency, calculations should include all current obligations, including policyholder obligations and expenses, e.g. administration cost and loss adjustments, and should explicitly value all embedded options and guarantees. Best estimate values do not include any risk margins whatsoever. The assessment of the best estimate liability refers to the valuation of future liability cash flows in aggregate, not to each individual assumption, as in practice it can be very difficult to determine whether an individual assumption is a best estimate. The best estimate refers to the total obligations under the contract, taking into account the timing for answering these obligations, hence discounting is implicitly included. Whether it is possible to split the measurement of the liability in an estimate of the mean value of the distribution function and an estimate of the risk adjustments, depends on circumstances, but it should provide the same result as directly estimating the entire liability.

**Biometric risk**

Underwriting risks covering all risks related to human life conditions, e.g. death, disability, longevity, but also birth, marital status, age, and number of children (e.g. in collective pension schemes).

Related terms: Disability risk, Longevity risk, Morbidity risk, Mortality risk

**Blind investments (or pools)**

Portfolio of investments managed by an external investment manager. The pool may consist of investments whose general characteristics are known to the pool participants, but the specific holdings are not always known. It may also consist of a pool of capital not yet invested, but with a mandate to be invested by the manager in certain investment vehicles in which the manager has specialised expertise.

**Board of directors**

Persons elected by the shareholders of an insurer, or policyholders in the case of a mutual, to manage and set policies. The board is responsible to shareholders or policyholders, appoints the officers of the insurer and sets key policy.

Related terms: Management board, Supervisory board, Two-tier board system of corporate governance, Unitary board system of corporate governance

**Book value**

See: Carrying amount
Branch

Part of a company, not being a separate legal entity, established in a jurisdiction other than the company’s home jurisdiction. In some jurisdictions there may exist other forms of permanent presence (e.g. agency).

Break-up basis

A method of considering the financial situation of an institution assuming that the company is liquidated by settling all obligations at their current value as far as the current value of available resources allows that.

Equivalent term: Wind-up basis

Related terms: Going concern basis, Run-off basis

Business risk

Unexpected changes to the legal conditions to which insurers are subject, changes in the economic and social environment, as well as changes in business profile and the general business cycle.

Related terms: Custody risk, Management risk, Operational risk, Reputational risk, Strategic risk

In practice it is often difficult to distinguish between legal changes causing business risk and those causing insurance risk. Business risk is difficult to quantify and is hence expected not to be modelled under Solvency II regulation.

Calamity risk

The risk that a single event of major magnitude leads to a significant deviation in actual claims from the total expected claims.

Related term: Catastrophe risk

The concept strongly relates to the notion of catastrophe risk, but is considered to be broader, as catastrophe risk relates to events occurring over a short period, whereas calamity risks typically include longer lasting events, e.g. a pandemic. The notion of calamity risk is per definition relative to the financial position of the individual insurer and any significance will need to be defined in mathematical terms. The exact definition of what constitutes a calamity hence varies per insurer.

Calibration test

Test of whether the Solvency Capital Requirement (SCR) computed by the (re)insurance undertaking is a fair, unbiased estimate of the risk as measured by the common SCR target criteria.

Supervisory authorities may require insurance and reinsurance undertakings to run their internal model on relevant benchmark portfolios and using assumptions based on external rather than internal data in order to verify the calibration of the internal model and to check that its specification is in line with generally accepted market practice.

Capital Add-ons

The adjustment made to a firm’s Solvency Capital Requirement (SCR) following the Supervisory Review Process.

The standard formula aims at capturing the risk profile of most (re)insurance undertakings in the Community. However, there may be some cases where the standardised approach might not entirely reflect the very specific risk profile of an undertaking. Supervisory authorities may therefore require
(re)insurance undertakings only under strictly defined exceptional circumstances to hold more capital following the Supervisory Review Process.

Capital funding risk

The risk that the insurer will not be able to obtain sufficient outside funding at the time it needs it (for example, to meet an unanticipated large claim).

Capital subscribed by members (of mutual societies)

See: Equity capital

Captive insurance undertaking

Means an insurance undertaking, owned either by a financial undertaking other than an insurance or reinsurance undertaking or a group of insurance or reinsurance undertakings within the meaning of Article 212(1)(c) [of the Solvency II Directive] or by a non-financial undertaking, the purpose of which is to provide insurance cover exclusively for the risks of the undertaking or undertakings to which it belongs or of an undertaking or undertakings of the group of which it is a member.

Related terms: Financial conglomerate, Financial group

In practice, supervisors in captive jurisdictions tend to use the following classifications:

- Pure captives: single parent companies writing only the risks of their owner and/or affiliates;
- Group and/or association captives: multi-owned insurance companies writing only the risks of their owners and/or affiliates, usually within a specific trade or activity;
- Rental captives: insurers specifically formed to provide captive facilities to unrelated bodies for a fee. They are used by entities that prefer not to form their own dedicated captive;
- Diversified captives: captives writing a limited proportion of unrelated business in addition to the risks of their owner and/or affiliates. Some jurisdictions consider that an insurance company writing any unrelated party business cannot be classified as a captive.”

This definition does not include mutual insurers, because they have no share capital so the ownership is jointly and undivided amongst its members, unlike a captive where the ownership is linked to a parent or group.

Captive reinsurance undertaking

Means a reinsurance undertaking, owned either by a financial undertaking other than an insurance or reinsurance undertaking or a group of insurance or reinsurance undertakings within the meaning of Article 212(1)(c) [of the Solvency II Directive] or by a non-financial undertaking, the purpose of which is to provide reinsurance cover exclusively for the risks of the undertaking or undertakings to which it belongs or of an undertaking or undertakings of the group of which it is a member.

Carrying amount

The amount at which an asset or liability is recognised in the balance sheet.

Equivalent term: Book value

Linked to IAS 36.6 (impairment of assets), IAS 16.6 (property, plant and equipment) and IAS 38.8 (intangible assets). This value is not necessarily the same as historic cost, e.g. because the carrying amount takes into account depreciation or could be a fair value.
Casualty insurance

A generic term used to describe all types of insurance products which are not Life, Health, or Property insurance.

Catastrophic risk

The risk that a single event of major magnitude leads to a significantly higher than usual number and/or amount of claims on an insurer.

Related terms: Accumulation risk, Calamity risk

The notion of catastrophe risk is per definition relative to the financial position of the individual insurer and any significance will need to be defined in mathematical terms. The exact definition of what constitutes a catastrophe hence varies per insurer.

Catastrophe reinsurance (life and health)

This provides for payment by the reinsurer when the ceding company’s aggregate net retained claims resulting from a single accidental event exceed the insurer’s retention under the reinsurance agreement. Commonly the reinsurer pays something less than 100% of such excess, the balance being retained by the insurer, and a limit is placed on the amount the reinsurer will pay on any one catastrophe. An annual limit may also be placed on the total amount to be paid by the reinsurer. The coverage may be purchased on the ceding company’s entire portfolio of retained risks or on any readily definable category, such as all retained individual risks, a particular group case, a category of group cases, etc. Normally, both the regular life insurance risk and the accidental death risk will be included.

Central estimate

When considering an estimate, most usually for the claims provision, the central estimate is taken to be an estimate that neither overstates nor understates the expected outcome. As a result, it can be considered the estimate that is, in a statistical sense, the mean of the distribution.

Equivalent term: Best estimate

Churning

The activity undertaken by an insurer or intermediary in which various insurance policies are sold to a single policyholder without a proper need for the insurance cover by the policyholder concerned. This practice is aimed at creating a bigger turnover – often to generate commission – and is generally illegal or at the least regarded as immoral.

Claims development triangle

The triangle shows the insurer’s estimate of the cost of claims (claims provisions and claims paid) as of the end of each accident year/underwriting year and how this estimate develops over time.

Related terms: Claims provision, Accident year basis, Underwriting year basis.

Claims fluctuation reserve

See: Equalisation provision

Claims fraud

Fraud against the insurer in the execution of an insurance product by obtaining wrongful payment.
Claims incurred

An insurer’s total liability arising from insurance events related to an accounting period either on an accident year basis or on an underwriting year basis.

Related terms: Loss ratio, Accident year basis, Underwriting year basis.

Claims provision

Amount set aside on the balance sheet to meet the total estimated ultimate cost to an insurer of settling all claims arising from events which have occurred up to the end of the reporting period, whether reported or not, less amounts already paid in respect of such claims.

Equivalent terms: Provision for outstanding claims/claims outstanding, Claims reserve, Total claim liability

Claims reserve

See: Claims provision

Claims risk

An underwriting risk. A change in value caused by ultimate costs for full contractual obligations (claims without administration costs) varying from those assumed when these obligations were estimated.

Related term: Underwriting risk

Claims risk is often split in reserve and premium risk in order to distinguish between expired and unexpired contracts. Reserve risk only relates to incurred claims, i.e. existing claims, (e.g. including IBNR and IBNER), and originates from claim sizes being greater than expected, differences in timing of claims payments from expected, and differences in claims frequency from those expected. Premium risk only relates to future claims (excluding IBNR and IBNER), and originates from claim sizes being greater than expected, differences in timing of claims payments from expected, and differences in claims frequency from those expected.

Close links

Means a situation in which two or more natural or legal persons are linked by control or participation, or a situation in which two or more natural or legal persons are permanently linked to one and the same person by a control relationship.

Coefficient of variation

The ratio of the standard deviation to the mean of a distribution

Coherent

A risk measure satisfying the following four axioms is called coherent (note that other risk measures not satisfying one or more of these axioms may have useful properties as well).

- Subadditivity: Capital for two risks is not larger than sum of capital for each risk separately.
- Positive homogeneity: Capital is invariant under scale transformations (doubling the risk doubles the capital).
- Translation invariance: Capital is invariant under location transformations (adding a certain risk increases the capital with this certain amount).
- Monotonicity: Capital is larger for larger risks.
Coinsurance basis

This type of reinsurance is considered to be the most comprehensive basis since it usually involves transfer of a portion of all the risks inherent in the original business on a quota share or excess of retention basis from the ceding company to the reinsurer. In this type of reinsurance, the insurer and the reinsurer share a portion of the risks under the original insurance policy. The reinsurer receives a portion of the gross paid policy premiums based on the amount of risk assumed and establishes a correlating reserve. In addition to fulfilling the assumed portion of the claim, the reinsurer is also required to reimburse the insurer for any other benefits provided under the policy (i.e., policy dividends, commissions, premium taxes, etc.). The reinsurer also provides the ceding insurer with a commission to cover the marketing, underwriting and distribution aspects of the policy.

Coinsurance with funds withheld

A slight variation of the coinsurance basis method may occur if assets are retained by the insurer. Under this method, the insurer withholds assets supporting the reserves on the ceded portion of the business and the insurer sets up an interest-bearing amount payable to the reinsurer. Under these circumstances, the ceding company may wish to retain control of the funds arising from its own policies either to maximise its own investment returns, or as security against the event that the reinsurer's ability to discharge its obligations to the ceding insurer becomes impaired.

Collateral

Assets held as security in support of a promise to the payment of a debt or performance of a contract.

College of supervisors

Colleges of supervisors are permanent, although flexible, structures for cooperation and coordination among the authorities responsible for and involved in the supervision of the different components of cross-border groups, specifically large groups. (Usually supported by a MOU [Memorandum of Understanding])

Combined ratio

The sum of the loss ratio (claims ratio) and the expense ratio. Gives a rough indication of the profitability of an insurer's underwriting operations. It does not, however, take into account the allocated investment return except to the extent that discounting takes into account future interest rates. Since income from invested premiums also contributes to technical performance, the business can be profitable even if the combined ratio exceeds 100%. The combined ratio is, amongst other factors, a function of the period of time premiums are invested and the return on investments. Furthermore, the characteristics of the class of business in question, that is, the uncertainties concerning a particular class of business (volatility of losses, legal framework, the time to re-establish surplus etc.) can influence the combined ratio.

Related terms: Loss ratio (claims ratio), Expense ratio

Committee of European Insurance and Occupational Pensions Supervisors

CEIOPS was established under the terms of the European Commission Decision 2004/6/EC of 5 November 2003 and is composed of high level representatives from the insurance and occupational pensions supervisory authorities of the European Union’s Member States. The authorities of the Member States of the European Economic Area also participate in CEIOPS. CEIOPS is one of the Lamfalussy ‘Level 3’ committees which develop guidance to promote consistent application of Lamfalussy directives. The other Level 3 committees are the Committee of European Banking Supervisors (CEBS) and the Committee of European Securities Regulators (CESR). As part of its duties, CEIOPS provides technical advice to the European Commission on the development of the Solvency II framework.

Abbreviation: CEIOPS
The European Insurance and Occupational Pensions Authority (EIOPA) will in future replace the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS)

Commodity risk
The risk of exposure to losses resulting from movements of market values of commodities, either physical commodities themselves or derivatives that have commodities as the underlying instruments.

Comonotonic
Two random variables, X and Y, are said to be comonotonic if there exists another variable, Z, and increasing real-valued functions, u and v, such that $X=u(Z), Y=v(Z)$. When the outcomes of insurers A and B are comonotonic; that is, they always move up or down together, then it is believed that the required capital for the combined company should be equal the sum of the required capitals for the two individual companies.

Complete risk-return profile
The establishment of a well defined risk tolerance and desired target return that the insurer may wish to achieve in its overall operations or in some specific aspect (for example, product line) of its operations.

Compliance risk
The risk of legal or regulatory sanctions resulting in a financial loss, or loss of reputation as a result of an insurer’s failure to comply with laws, regulations, rules, related self-regulatory organisation standards, and codes of conduct.

Related terms: Business risk, Legal risk, Operational risk

Composite (derivative)
A combination of two or more standard derivatives to achieve a specified objective.

Composite (insurance company)
An insurance company which deals simultaneously with both life and non-life insurance business.

Concentration risk
The exposure to increased losses associated with inadequately diversified portfolios of assets and/or obligations.

Related term: Diversification

Concentration risk for an insurer may arise with respect to investments in a geographical area, economic sector, or individual investments, or due to a concentration of business written within a geographical area, of a policy type, or of underlying risks covered.

Confidence level
Statistical measure of the level of certainty regarding an outcome, typically expressed as the probability value $(1 - \alpha)$ associated with a confidence interval.

The confidence level is often expressed as a percentage, e.g. the confidence level with $\alpha = 0.05$, is the 95% confidence level.
Conglomerate risk

Insurance companies that are participants in financial groups can be exposed to some additional sources of risk. For example:

- Intragroup exposures;
- Contagion;
- Risk concentration.

*These are but three examples. There is a great deal of work being carried through on the issue of conglomerate supervision by other parts of the IAIS as well as the Joint Forum on Financial Conglomerates.*

Related terms: Concentration risk, Intragroup exposures, Risk concentration

Consolidated supervision

Refers to a supervisory group approach that focuses on the total of individual entities (licensed or not) of a group, consolidated at the level of the top insurance or holding company. In this case the solvency requirements are applied to the overall net financial position of the group as a whole.

Related term: College of supervisors

Contagion

The propagation of the effect of a failure or financial distress of an institution in a sequential manner to other institutions, markets or systems, or to other parts of a financial group or financial conglomerate.

Related term: Systemic risk

Contingent capital

Contractually obligated instruments that trigger under a pre-defined condition.

Control

The term “control” over an insurer is defined in legislation and it addresses:

- holding of a defined number or percentage of issued shares or specified financial instruments (such as compulsory convertible debentures) above a designated threshold in an insurer or its intermediate or ultimate beneficial owner
- voting rights attached to the aforementioned shares or financial instruments
- power to appoint or remove directors to the board and other executive committees

Related terms: Arms' length, Related party(ies)

Control level

A threshold value that requires intervention of the supervisor or imposes certain restrictions on the insurer if its available solvency margin falls short of this amount. A system of solvency requirements may have more than one control level for different types of regulatory action.

Equivalent terms: Trigger amount, Trigger point, Intervention level, Impairment level, Regulatory control level
Convexity

An important measure of interest rate risk (together with duration) for fixed income securities and interest bearing liabilities. It measures the rate of change of the duration with respect to the interest rate.

*This means that it is a measure of how sensitive an instrument’s duration is to changes in the interest rate i.e., it shows the curvature of the price profile of the instrument.*

Coordination committee (Small)

Refers to a (small) group of supervisors which are responsible for the development and the implementation of a coordination arrangement for a specific group.

Correlation risk

The risk of increased exposure to losses due to the level of, or movement in, the correlation of investments in or across geographical areas, economic sectors or individual investments or with and between liabilities.

Copula

A copula is a function that associated the distribution function of one variable to the distribution function of one variable to the distribution of another random variable. Using copulas to model dependencies on a deeper level, one can for instance take into account that many insurance risks seem to be almost independent in “normal” situations but heavily dependent in the extreme.

Cost of capital approach

An approximation through which a risk margin is determined based on the present value of the cost of capital charge for all future capital requirements until run-off.

Related term: Market value margin

*The cost of capital approach is often applied to determine the market-consistent value of cash flows with non-hedgeable risks (e.g. motor claims). In this case the risk margin is referred to as the Market value margin.*

Counterparty

The other party with whom a derivatives contract is made.

Counterparty Credit rating assignment

The credit rating assigned to a particular issuer of debt instruments, or to a specific debt instrument.

Related terms: Credit rating

Counterparty credit risk

See: Credit risk

Credit Institution

A ‘credit institution’ means:

- an undertaking whose business is to receive deposits or other repayable funds from the public and to grant credits for its own account; or
Credit insurance

A form of guarantee against loss resulting from default on the part of debtors.

Equivalent term: Credit risk insurance

Credit ratings

Assessments of the abilities of debtors (e.g. bond issuers) to pay amounts owing to investors as they fall due.

Related terms: Credit rating assignment, Rating agency, Rating grade, Rating model, Rating process, Rating system

Credit risk

The risk of a change in value due to actual credit losses deviating from expected credit losses due to the failure to meet contractual debt obligations or a deterioration in the creditworthiness of counterparties. Credit risk can arise where the company has exposure to:

- issuers of securities (in the company’s investment portfolio),
- debtors (e.g. mortgagors)
- counterparties (e.g. on reinsurance contracts, derivative contracts, or deposits)
- intermediaries

The QIS4 technical specifications split credit risk into two components for the calculation of the SCR – spread risk, which is placed under the market risk module, and counterparty default risk.

Related terms: Default risk, Settlement risk, Spread risk

Critical illness insurance

An insurance policy that pays a benefit if the insured is diagnosed with a specified critical illness during the policy term.

Abbreviation: CII

Equivalent term: Dread disease insurance

Related terms: Health insurance, Life insurance

Critical illness insurance can be sold as a separate health or life insurance policy, but can also be a rider to a (group) life or health insurance contract.

Cross-border provision of services

Refers to provision of insurance or reinsurance on a services basis (without local establishment) in a jurisdiction other than the company’s home jurisdiction. This term does not always apply in the sense given here when jurisdictions within states with a federal structure are concerned. In such cases cross-border refers to crossing the borders surrounding the jurisdictions of the federal structure but not inside it.

Currency risk

The risk of a change in value caused by the fact that actual foreign currency exchange rates differ from those expected. Currency risk can arise if the assets and liabilities of an insurer are not in the
same currency, or if contracts for administrative and other services are contracted in a currency different to the currency implied in the premium determination. Also, in some jurisdictions, the sale of contracts in other than the local currency has an impact on the rates of persistency or discontinuation should the policyholders be exposed to a mismatch. For insurers it is common to distinguish between FX mismatch risk, where there are differences in currencies of assets and liabilities or supporting capital, and FX translation risk, which arises in groups where the currency of assets and liabilities/supporting capital in a local entity is different to the reporting currency of the group.

Equivalent terms: Foreign exchange risk

**Current entry value**

The amount that the insurer would charge to a policyholder today for entering into a contract with the same remaining rights and obligations as the existing contract.

Equivalent term: Entry value

Related term: Current exit value

*At inception, the measurement would be calibrated to the actual premiums incurred (and recoverable acquisition cost incurred). That calibration would act as a starting point for determining risk margins at later dates. Because there is no secondary market for most insurance liabilities, that amount would need to be estimated.*

**Current estimate**

See: Best estimate

**Current exit value**

The amount that the insurer would expect to have to pay today to another entity if it transferred all its remaining contractual rights and obligations immediately to that entity (and excluding any payment receivable or payable for other rights and obligations, such as renewal rights).

Equivalent term: Exit value

Related term: Current entry value

*Because there is no secondary market for most insurance liabilities, that amount would need to be estimated. This is a type of market-consistent value of the entire portfolio of the insurer and similar to the fair value of that portfolio.*

**Custody risk**

The risk arising from the failure to hold secure custody of assets or to incur loss in failing to obtain or release the correct secure custody when conducting purchase and sales transactions.

Related terms: Operational risk, Non-technical risks, Business Risk

**Customer**

Implies policyholder and potential policyholder.

**Customer due diligence**

The process of collecting, analysing and verifying information with respect to a current or potential customer, beneficial owner and beneficiary of an insurance contract with the purpose of understanding money laundering and other risks involved in decisions such as client acceptance and claims settlement. This includes the collection, analysis, verification and, when necessary, updating of
identification data (of the policyholder, beneficial owner and the beneficiary) and the conduct of ongoing diligence on the business relationship. Under normal circumstances the term “customer” refers to “policyholder”.

Related terms: Beneficial owner, Money laundering

Default risk

The risk that an insurer will not receive the cash flows or assets to which it is entitled due to a party with which the insurer has a bilateral contract defaulting on one or more obligations.

Related terms: Credit risk, Settlement risk, Spread risk

Default risk is a sub-type of credit risk, which also comprises settlement risk.

Deferred accumulation annuity

An annuity providing for payments to begin at some future date.

Depreciation risk

The risk associated with a depreciation of the value of investments due to various changes in the capital markets, changes in exchange rates or to the non-payment by the debtors of the insurer (e.g. the credit and market risks).

Derivative

A derivative is a financial asset or liability whose value depends on (or is derived from) other assets, liabilities or indexes (the "underlying asset"). Derivatives are financial contracts and include a wide assortment of instruments, such as forwards, futures, options, warrants, swaps and composites.

Deviation risk

The risk emerging when the actual development of claims frequencies, mortality, interest rates, inflation etc. does not correspond to the bases of premium calculations.

Related terms: Evaluation risk

Disability insurance

A health or life insurance policy, or rider to a life insurance policy, that provides a single payment or periodic payments to replace lost income when the insured is unable to work because of illness or injury.

Abbreviation: DI

Equivalent term: Disability income insurance

Related term: Health insurance

Disability risk

A change of value caused by a deviation from expected levels in the rate of insured persons that are incapable of performing one or more duties of their occupation due to a physical or mental condition (either through increased inceptions or decreased terminations). In the context of Solvency II, disability risk also covers morbidity risk.

Related terms: Biometric risk, Morbidity risk
Diversifiable risk

A risk is diversifiable when the volatility of the average claim amount declines as the block of combined insurer risks increases.

Diversification

Reduction in risks among assets and/or obligations of an institution by accumulating risks that are not fully correlated in an aggregated risk position. It follows therefore that the aggregated amount of risks within a product portfolio or at a company level is smaller compared to the simple addition of the individual risks.

Related terms: Concentration risk, Systematic risk

Diversification is based on the principle that not all risks will crystallise at the same moment - provided that the underlying sources of risk, i.e. risk drivers or triggers, are not fully interdependent. Diversification with respect to insurance obligations is typically achieved through writing a large portfolio of independent contracts, writing insurance across a number of different lines, or by geographical spread or directly in capital markets. Asset diversification is typically achieved through spreading investments in order to avoid the excessive concentration of assets or exposure to a single counterparty.

Diversification benefits

The reduction in the level of capital required by an insurer compared to the level required if all risks were assumed to be perfectly correlated.

Diversification effects

Means the reduction in the risk exposure of insurance and reinsurance undertakings and groups related to the diversification of their business, resulting from the fact that the adverse outcome from one risk can be offset by a more favourable outcome from another risk, where those risks are not fully correlated.

Domestic/foreign

Inside/outside the jurisdiction: in connection with an insurer, domestic or foreign refers to the place where the company concerned is incorporated, irrespective of the place of incorporation of its parent company. These terms do not always apply in the sense given here where jurisdictions within states with a federal structure are concerned. In such cases foreign refers to jurisdiction surrounding the federal structure but not to jurisdictions inside it.

Double-gearing

Situation in which one entity holds capital for regulatory purposes, which is issued by another entity within the same group and the issuer is also using the same capital for regulatory purposes. In that situation, externally generated capital of the group is ‘geared up’ twice; first by the parent, and then a second time by the dependant.

Double gearing (and multiple gearing) is normally associated with a parent down streaming capital to its dependant. It can also take the form of an entity holding capital for regulatory purposes issued by an entity above it in the group’s organisational chart (up streamed capital), or by a sister affiliate.

Multiple gearing occurs when the dependant in a situation of double gearing further down streams the capital for regulatory purposes to a third entity within the group, so that the parent’s externally generated capital is geared up a third time.
Downgrade or migration risk

The risk that changes in the probability of a future default by an obligor will adversely affect the present value of the contract with the obligor today.

Dread disease insurance

See: Critical illness insurance

Duration

Is an important measure of interest rate risk (together with convexity) and for the sensitivity of the value of an asset to changes in interest rates.

Dynamic financial analysis

See: Stress testing

Economic balance sheet

Balance sheet statement based on one of those accounting approaches using market-consistent values for all current assets and current obligations relating to in-force business, including off-balance sheet items.

Related term: In-force business, Total balance sheet approach

Depending on the reporting approach, different items can be recognized or not recognized in the balance sheet. Likewise the definition of a current resource or obligation can vary from approach to approach. The economic balance sheet provides the market-consistent value of the shareholder equity.

Economic capital

Economic capital is what the firm judges it requires for ongoing operations and, for an insurance company, what it must hold in order to gain the necessary confidence of the marketplace, its policyholders, its investors and its supervisors.

See: Available economic capital, Required economic capital

Economic group

Refers to a cohering complex of companies under (almost) common governance.

Economic value

See: Market-consistent valuation

Effective duration

Is defined as the approximation

\[ D \approx (-1/P) \left( (P + - P -)/(r + - r -) \right) \]

where P is the price of the instrument before any parametric shift. In the case of interest rates this represents the unshifted yield curve. \( r+ \) represents a parallel up shift whereas \( r- \) represents a parallel down shift. \( P+ \) represents the value for the positive shifted scenario \( r+ \) and \( P- \) the value for the negative shifted \( r- \). This concept is very sensitive to the size of the shift of the yield curve.
Eligible capital

Capital (either on- or off-balance sheet) which, under regulatory rules, may be taken into account (fully or partially) in determining the insurer’s available capital for solvency purposes.

Related term: Available solvency margin

Also referred to also as admitted assets, acceptable assets, and unrestricted assets, but eligible capital is the preferred term for Solvency II purposes. More formally referred to in European Commission publications as ‘Eligible Elements to cover Capital Requirements’.

Eligible capital element

On- or off–balance sheet element which, in accordance with domestic regulations, is suitable to cover the required solvency margin (i.e. eligible for inclusion in the available solvency or regulatory capital, i.e. allowable for solvency purposes). As a general rule, these elements are either assets free of all foreseeable liabilities, or, if they represent liabilities, the latter should be subordinated to any other liabilities. In other words, in the event of a winding-up or bankruptcy, they are to be paid only after the claims of all other creditors have been satisfied. The eligible capital elements correspond to items in TPd, OLd or I in the solvency formula.

Equivalent terms: Regulatory capital element, Admissible capital item, Available solvency element

Embedded guarantee

See: Guaranteed benefit, Guaranteed element

Embedded option

See: Option

Embedded value

An estimate of the value to shareholders of a book of insurance business at a given date, consisting of the following components:

- Free surplus allocated to the covered business;
- Required capital, less the cost of holding required capital;
- Value of future shareholder cash flows from in-force covered business.

Abbreviation: EV

Related terms: European embedded value, Value of in-force business

The embedded value concept is applicable to general insurance, although it is more commonly encountered in the life context. The value of renewals of existing contracts is included, but the value of future new contracts is excluded.

Endowment insurance

Insurance payable to the beneficiary if the insured survives the maturity date of the contract, or to a beneficiary if the insured dies prior to the maturity date.

Related terms: Life insurance, Pure endowment insurance

The minimum benefits are defined at the point of sale.
Enterprise Risk Management (ERM)

Some insurers use ERM as part of their strategic decision-making framework to exploit opportunities to create value and optimise their risk/reward profile. ERM considers all sources of risk to an insurer.

Entry value

See: Current entry value

Equalisation provision

Amount set aside on the balance sheet in compliance with legal or administrative requirements to equalise fluctuations in loss ratios in future years or to provide for special risks. The choice of term ‘reserve’ or ‘provision’ depends on the purpose of this amount. Amounts set aside for specified types of business (e.g. hail, pollution liability or credit insurance) may be referred to as “provisions”, whereas amounts set aside to cover fluctuations of the entire portfolio may be referred to as “reserve”. This item may include catastrophe provisions.

Equivalent terms: Fluctuation provision, (claims) Fluctuation reserve, Stabilisation reserve

Equity capital

Potential surplus resulting from an evaluation based on the principle of lower-of-cost-or-market value as long as the market values exceed the purchase prices of the assets. This item may correspond to the revaluation reserve if assets are valued on the basis of the current market price.

Equivalent terms: Share capital, Subscribed capital, Paid-in capital, Capital subscribed by members (of mutual societies), Hidden reserves

Equity risk

The risk of a change in value caused by deviations of the actual market values of equities and/or income from equities from their expected values.

Related terms: Market risk, Real-estate risk

Establishment

Of an undertaking means its head office or any of its branches;

European Commission

The European Commission acts as the EU's executive arm and is responsible for initiating legislation and the day-to-day running of the EU. They draft and publish proposals for new European legislation. The European Commission is directly accountable to the European Parliament/Council.

European Council

The EU receives its political leadership from the European Council, which usually meets four times a year. It comprises one representative per member state — either its head of state or head of government — plus its President as well as the President of the Commission. The European Council uses its leadership role and sets the direction of travel of European policy but does not have legislative powers.

European embedded value

A method for calculating the embedded value according the principles and guidelines set by the CFO Forum.*
Abbreviation: EEV

Related term: Embedded value

* Chief Financial Officer Forum, forum of major European insurance companies.

**European Insurance and Occupational Pensions Authority**

EIOPA is the new European authority expected to replace CEIOPS. The proposals over EIOPA’s powers are being debated, but in general EIOPA will be given more power to enforce prudential standards through the development of Binding Technical Standards (BTS). They will also play a more active role over the co-ordination of group supervision activities. The new authority is likely to be formed during 2011.

Abbreviation: EIOPA

**European Insurance and Occupational Pensions Committee**

The Level 2 “Lamfalussy” committee of Member States chaired by the EU Commission. EIOPC will develop the Level 2 implementing measures within the scope of the Solvency II framework directive (Level 1). It also advises the Commission on insurance matters more generally.

Abbreviation: EIOPC

**European Parliament**

The European Parliament is made up of Members of the European Parliament (MEPs) directly elected by EU citizens every five years. The Parliament and the Council of Ministers pass legislation jointly in nearly all areas. The Commission is directly accountable to Parliament. The Parliament adopted the Solvency II framework directive and will formally adopt the implementing measures for Solvency II.

**Evaluation risk**

The risk of invalid evaluation of balance sheet items. In the context of assets / investment risk this indicates that investments are being evaluated at a disproportionally high price. In the context of technical risks then it would denote the risk of technical provisions being insufficient to meet the liabilities of the insurer.

**Excess capital**

See: Surplus capital

**Excess per risk reinsurance**

This reinsurance method provides indemnification to the ceding company for each covered risk up to a predetermined limit. The ceding company is required to meet the obligations of the claim up to a preset dollar amount before the reinsurer becomes liable.

**Exit value**

See: Current exit value

**Exotic contract**

An investment contract with a new or complex structure.
**Expected loss**

See: Credit risk

**Expected policyholder deficit**

Risk-measure used to determine the risk-based capital of an insurer. It refers to the expected cost of insolvency.

Abbreviation: EPD

Related terms: Probability of ruin, Value-at-Risk

*The expected cost is obtained by multiplying the probability of the occurrence of insolvency with the average cost of that insolvency. There are different definitions available for this term.*

**Expected shortfall**

See: Tail-Value-at-Risk

**Expense ratio**

The ratio of expenses to earned premiums. Expenses are the sum of commissions, administrative expenses and other technical charges. This ratio could vary depending on the way an insurer allocates its general costs. It can be used to assess how well premiums cover expenses incurred.

**Expense risk**

The risk of a change in value caused by the fact that the timing and/or the amount of expenses incurred varies from that projected, e.g. assumed for pricing basis.

Equivalent term: Operating expense risk

**Extreme value model**

Mathematical and probabilistic models that provide methods to assign probabilities to the tails of the distribution curve of a particular kind of risk factor. Extreme value theory covers the following two main types of models:

- The distribution of the maximum value of a sequence of random observations, as a reference distribution for more general cases;
- The distribution of the excesses over a high threshold.

**Facultative obligatory reinsurance**

Or “open cover” is an arrangement pursuant to which the cedant may, at its option, cede certain defined risks to the reinsurer, which the reinsurer must assume, subject to the cedant’s retention. This arrangement has both treaty and facultative elements. It is normally used to provide cover for risks that are irregular in incidence or to supplement a treaty that has limited capacity.

**Fair value**

The price at which transactions would occur at arms’ length between willing parties. This is a similar concept to market value, but the fair value may be a mark-to-model price if no actual market price for asset/liability exists. It needs to be considered that concepts of market price vary, especially with respect to prices observed in markets which are not deep, active or liquid, or where different markets exist.

Related terms: Arm’s length transaction, Market value, Market consistent valuation
Facultative reinsurance (life)

Is similar to non-life facultative reinsurance or to “special acceptances” reinsurance under treaty reinsurance. However, facultative obligatory reinsurance and “semi-automatic” reinsurance will rarely be encountered in the life and health market.

Facultative reinsurance (non-life)

Is not obligatory for either the cedant or the reinsurer. Facultative reinsurance involves the reinsurance of the exposures covered by a single policy, or sometimes only specific portions of a policy. The nature of the underwriting process and the kind and quantum of data usually required by the facultative underwriter, make this approach far less efficient and much more expensive to handle than treaty reinsurance. Nevertheless, facultative reinsurance often plays a significant role in a insurer’s overall reinsurance program. It is commonly used to enable the insurer to write risks that may be excluded under its reinsurance treaties, to generate additional capacity needed that is not fully accommodated under its treaties, or to accept risks requiring technical underwriting expertise beyond that which may be available in-house. It is also possible to arrange reinsurance protection on a “hybrid” basis that contains obligatory and non-obligatory elements. Two commonly encountered facultative arrangements are Facultative obligatory insurance and Semi-automatic facultative reinsurance.

Financial conglomerate

Refers to any group of companies under common control whose exclusive or predominant activities consist of providing significant services in at least two different financial sectors (e.g. banking, securities, insurance).

Abbreviation: FC

Related term: Financial group

Financial derivatives (risk related to)

That part of the investment risk that relates in particular to the credit risk, market risk and liquidity risks associated with these instruments.

Financial group

Refers to an economic group structure of which the constituent entities are predominantly involved in (licensed) financial activities.

Related term: Financial conglomerate

Financial health

See: Solvency

Financial institution

A ‘financial institution’ means an undertaking other than a credit institution, the principal activity of which is to acquire holdings or to carry on one or more of the activities listed in the points below:

1. Lending including, inter alia: consumer credit, mortgage credit, factoring, with or without recourse, financing of commercial transactions (including forfaiting);

2. Financial leasing;

3. Money transmission services;
4. Issuing and administering means of payment (e.g. credit cards, travellers' cheques and bankers' drafts);

5. Guarantees and commitments;

6. Trading for own account or for account of customers in:
   (a) money market instruments (cheques, bills, certificates of deposit, etc.);
   (b) foreign exchange;
   (c) financial futures and options;
   (d) exchange and interest-rate instruments; or
   (e) transferable securities.

7. Participation in securities issues and the provision of services related to such issues;

8. Advice to undertakings on capital structure, industrial strategy and related questions and advice as well as services relating to mergers and the purchase of undertakings;

9. Money broking;

10. Portfolio management and advice; and

11. Safekeeping and administration of securities.

**Financial instrument**

A contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.

**Financial intelligence unit**

Centre for the receiving, analysis and dissemination of suspicious transaction reports and other information regarding potential money laundering or terrorist financing.

Related term: Law enforcement agency

**Financial reports**

Refers to accounting statements, financial returns, and statutory reports, including the balance sheet, the income statement and any other numerical reports prepared for disclosure to policyholders, investors, or insurance supervisors. It does not refer to reports prepared for other purposes.

**Financial undertaking**

Means any of the following entities:

- a credit institution, a financial institution or an ancillary banking services undertaking within the meaning of Article 4(1), (5) and (21) of Directive 2006/48/EC respectively;
- an insurance undertaking, or a reinsurance undertaking or an insurance holding company within the meaning of Article 212(1)(f);
- an investment firm or a financial institution within the meaning of Article 4(1)(1) of Directive 2004/39/EC; or
- a mixed financial holding company within the meaning of Article 2(15) of Directive 2002/87/EC.
Finite reinsurance

A generic term that will be used to describe an entire spectrum of reinsurance arrangements that share limited risk for a limited amount of premium. In some jurisdictions finite reinsurance is a specialised form of limited liability reinsurance whereby the financial and strategic motivations of the reinsured to effect the transaction, take precedence over the insurance risk transfer motivation. Although there is no accepted global definition of “finite reinsurance,” a typical transaction may include, but not be limited to provisions for aggregating risk, for aggregating limits of liability, for aligning the interests of the insurer and reinsurer, and for explicitly recognising the time value of money. A detailed review of the entire reinsurance contract and any side agreements is necessary to determine if contracts containing such clauses do transfer risk and are in fact reinsurance contracts when considered in their totality. Usually, one (or a number) of the following characteristics will be present within finite reinsurance contracts although some of them may be present in traditional reinsurance as well:

- insurance risk transfer and financing are combined and the time horizon of money is emphasised in the contract;
- assumption of limited risk by the reinsurer (aggregate limit of liability, blended cover);
- transfer of volatility (e.g., multiple lines of business, multiple years of account and multiple year contract terms);
- inclusion of future investment income in price of contract (recognition of time value of money with funds withheld);
- potential profit sharing between parties;
- pricing determined by ceding entities’ results and not reinsurance pricing cycle terms and pricing are typically determined in advance; or
- bulk reinsurance (i.e. administration of reinsurance is done on a bulk basis rather than on a traditional seriatim policy-by-policy basis, for a block of in-force business).

Equivalent terms: Financial reinsurance, Structured reinsurance, Non-traditional reinsurance, Loss mitigation reinsurance

Financial returns

Report prepared for the supervisory authority giving detailed information on the company’s financial situation.

Equivalent terms: Supervisory returns

Financial Services Action Plan

The EU’s legislative framework for developing the Single Market in financial services.

Abbreviation: FSAP

Fit and proper requirements

See: Fitness and propriety (fit and proper)

Fitness and propriety (fit and proper)

Necessary qualities that must be exhibited by a person performing the duties and carrying out the responsibilities of his/her position with an insurer. Depending on his or her position or legal form these qualities could relate to a proper degree of integrity in attitude, personal behaviour and business conduct, soundness of judgement, degree of knowledge, experience and professional qualifications and financial soundness.

Fluctuation provision / fluctuation reserve

See: Equalisation provision
**Foreign company**

A legal entity whose head office is outside the jurisdiction concerned.

**Foreign exchange risk**

The risk of a change in value caused by the fact that actual foreign currency exchange rates differ from those expected.

Abbreviation: FX risk

Equivalent term: Currency risk

**Forward (or Forward contract)**

A contract for the delivery of a particular commodity or financial product in the future in exchange for a contract-specified price. A commitment to buy (sell) an asset at a future date for a price determined at the time of commitment, usually reflecting the net cost of carry.

**Four eyes principle**

The principle describing the involvement of more than one person in decision-making or other material activities for reasons of e.g. validation, proper governance, transparency and control.

**Framework Directive**

Regulations that need to be agreed and adopted by the European Commission under Level 1 of the Lamfalussy process.

**Fraud**

An act or omission intended to gain dishonest or unlawful advantage for a party committing the fraud (the fraudster) or for other parties. This may, for example, be achieved by means of:

- misappropriation of assets and/or insider trading;
- deliberate misrepresentation, concealment, suppression or non-disclosure of one or more material facts relevant to a financial decision, transaction or perception of the insurer’s status; or
- abuse of responsibility, a position of trust or a fiduciary relationship.

**Free capital**

See: Available solvency

**Fronting arrangements**

Fronting is a term that describes a particular form of reinsurance frequently employed by captive insurers. Commonly, a commercial insurer licensed in the jurisdiction from which the risk emanates issues a policy to the insured. Subsequently, the risk is transferred to a captive insurance company by way of a reinsurance contract also known as a fronting agreement. The insured receives a policy written by the licensed commercial insurer, but the economic risk of that policy resides in the captive insurance company, although the ultimate liability remains with the fronting insurer. In some jurisdictions, it is a legal requirement for either all, or certain classes’ of business, to be written by a local insurer. Hence, if the captive is established in a domicile other than that where the risk resides, then fronting arrangements are mandatory.
**Function**

Within a system of governance, means an internal capacity to undertake practical tasks; a system of governance includes the risk-management function, the compliance function, the internal audit function and the actuarial function.

**Funds withheld**

Assets that would normally be paid over to a reinsurer but are withheld by the cedant to permit regulatory credit for non-admitted reinsurance, to reduce a potential credit risk, to retain control over investments or to assist in realising the time value of money in jurisdictions that do not allow discounting or equalisation reserves.

**Funeral insurance**

A life policy with a low sum assured intended to pay for the burial costs on the death of the insured.

Equivalent term: *Funeral cost insurance*

Related term: *Life insurance*

*Also referred to as an assistance policy.*

**Fungible capital**

That part of the capital of a group which can be transferred between different legal entities of the group.

*Capital flow from a legal entity may be restricted due to regulatory capital requirements. However a group has always the option to sell a legal entity and thereby free capital.*

**Future**

A standardised forward contract offered by a central trading exchange (such as the New York Mercantile Exchange, or NYMEX)

**General business risk**

Unexpected changes to the legal conditions to which insurers are subject, changes in the economic and social environment, as well as changes in business profile and the general business cycle.

Related term: *Non-technical risks*

**General insurance**

Generic term mostly used in Anglo-Saxon countries to refer to all risks others than life.

Equivalent term: *Non-Life insurance*

**Going-concern basis**

A method of considering the financial situation assuming that an entity will continue to operate.

Related terms: *Break-up basis, Run-off basis*

*Going concern means that the entity (which can be a holding entity) continues its operations. It does not impose requirements on the type of operations, only that the total business volume should not be reduced too much. Hence, the selling of part, or even the entire insurance business, while starting another insurance business does not per definition violate the going concern assumption. The*
purpose is mainly to refer to a situation where the entity is able to proceed all its activities in the foreseeable future unfor
ced by liquidation procedures.

Granularity

The level of detail that investment policy includes in setting market exposure limits. At a high level, limits may be set with respect to asset class exposure. At a more detailed level, limits regarding specific industries, geographic areas, or even specific issuers may be considered.

Group insurance

Contracts in which insurance cover is provided to a number of insured people (normally a workforce) or a number of other individual risks of one party, usually the counter-party, or many affected parties, which are not necessarily parties under the contract, under a single master contract.

The group plan is typically arranged by the employer of the insured individual or another group, e.g. sport clubs for all their members or automobile clubs for third-party liability of all their members. Group contracts and policy conditions are usually issued on a yearly renewable term, but permanent plans also exist. The premium may be shared between contract holder and those insured.

Group supervision

For each group, a single authority may be appointed as a lead supervisor with concrete coordination and decision powers. Groups will be required to calculate a group-level SCR.

Related term: College of Supervisors

Group support

The framework directive proposal introduces the concept of group support as a way for firms within a group to cover their SCR over and above their own funds. However, at the very least the MCR must be covered locally. The group support might take the form of a declaration to the group supervisor, expressed in a legally binding document and constituting a commitment to transfer funds from the group (or possibly from other subsidiaries) when necessary. The group supervisor may need to verify that it has sufficient funds to cover its group SCR, and that there is no practical or legal restriction on the prompt transfer of funds. The group supervisor may also review, at least annually, any significant risk concentration at group level and any significant intra-group transactions.

Group-wide supervision

See: Group supervision

Guarantee

See: Guaranteed benefit, Guaranteed element

Guaranteed benefit

Payments or other benefits to which a particular policyholder or investor has an unconditional right that is not subject to the contractual discretion of the issuer.

Related term: Guaranteed element, Embedded guarantee

The unconditional right of the policyholder implies that no condition is subject to the insurer’s discretion, nor to insurer’s performance. Hence, a guaranteed benefit, or its determination, is contractually stipulated without any ability of the insurer to influence that benefit, neither by discretion nor by its performance. Accordingly, a guarantee is a risk-bearing feature, since the amount to be paid might deviate from the earnings of the insurer, without the ability of the insurer to avoid that.
Guaranteed element

An obligation to pay guaranteed benefits, included in a contract that may also contain other benefits, which may be subject to insurer’s discretion or subject to the performance of the insurer.

Related term: Guaranteed benefit

Health insurance

Generic term applying to all types of insurance indemnifying or reimbursing for losses (e.g. loss of income) caused by illness or disability, or for expenses of medical treatment necessitated by illness or disability.

Related terms: Accident insurance, Disability insurance

Defined as ‘Accident and Health insurance’ in EU law. For more details see Annex A and B(a) of First Council Non-Life Directive 73/239/EEC and consecutive amending directives.

Hedgeable risk

A risk associated with an asset or an obligation that can be effectively neutralised by buying or selling a market instrument (or engaging in a contract with a third-party in an arm’s length transaction under normal business conditions), the value of which is expected to change and offset the change in value of the asset or liability caused by the presence of the risk.

Related terms: Arm’s length transaction, Diversification, Systematic risk

The term hedgeable risk depends on market conditions. It is not a characteristic of the risk itself. Further it may be that the risk can be mitigated cheaper and more easily through other means, e.g. some storm risks can be mitigated at lower cost in a world-wide pool than through storm bonds.

Non-hedgeable risks are risks that cannot be hedged or easily transferred to a third-party due to the lack of a deep and liquid market.

Hedging

To invest in a manner that reduces the risk attached to the underlying assets or liabilities. A hedging strategy will take into account the risks, return required and the projected cash flow of the assets or liabilities, including the existence of policyholder options which may be exercised. Risks to be considered will include market and credit risk.

Heterogeneous financial group

Refers to an economic group with a mixed character, consisting of different financial entities, such as banks, insurance companies, securities houses, investment firms, pension funds, etc.

Hidden reserves

See: Equity capital

Historic cost

Assets are recorded at the amount of cash or cash equivalents paid or the fair value of the consideration given to acquire them at the time of their acquisition. Liabilities are recorded as the amount of proceeds received in exchange for the obligation, or in some circumstances (for example, income taxes), at the amounts of cash or cash equivalents expected to be paid to satisfy the liability in the normal course of business.

Related term: Carrying amount
Home jurisdiction

A home jurisdiction is one in which the parent insurer is incorporated, or in which the head office of a branch is incorporated. Host jurisdictions / supervisors must be aware of the distinctions between immediate and higher level home jurisdictions / supervisors, taking account of the hierarchical corporate structures of many international insurers and insurance groups. Except where specified, the terms home jurisdiction / supervisor where they appear cover both immediate and higher levels.

Home/host supervisor

Supervisor of the home/host jurisdiction.

Related terms: Home jurisdiction, Home supervisor, Host jurisdiction, Host supervisor

Home Member State

Means any of the following:

- for non-life insurance, the Member State in which the head office of the insurance undertaking covering the risk is situated;
- for life insurance, the Member State in which the head office of the insurance undertaking covering the commitment is situated; or
- for reinsurance, the Member State in which the head office of the reinsurance undertaking is situated

Home supervisor

The supervisory authority which is responsible for the prudential supervision in the EU Member State in which the insurer has obtained its license to perform its EU insurance activities (home country), and which is also responsible for the prudential supervision of business underwritten in other EU Member States via branches or freedom of services.

Related terms: Host supervisor, Lead supervisor

In EU legislation, home Member State is defined as the Member State where the undertaking has its based office, see Article 2(f) 2005/68/EC.

Homogeneous financial group

Refers to an economic group, consisting of (predominantly) financial licensed entities which essentially have the same sectoral character, e.g. a group consisting of life and/or non-life insurance companies. An economic group is defined as a cohering complex of companies under (almost) common governance.

Host jurisdiction

Is one in which a branch of a foreign insurer is located; or in which a subsidiary or joint venture of a foreign parent insurer is incorporated; or, in the case of the cross-border provision of insurance on a services basis, the jurisdiction in which the service is provided.

Host Member State

Means the Member State, other than the home Member State, in which an insurance or a reinsurance undertaking has a branch or provides services. For life and non-life insurance, the Member State of the provisions of services means, respectively, the Member State of the commitment or the Member State in which the risk is situated, where that commitment or risk is covered by an insurance undertaking or a branch situated in another Member State.
Host supervisor

The supervisory authority responsible for the prudential supervision in the EU Member State in which an insurance undertaking has a subsidiary, other than the home Member State which has licensed the insurer to perform its EU insurance activities.

Related terms: Home supervisor, Lead supervisor

In EU legislation, host Member State is defined as the Member State where the undertaking provides services or has a branch, see Article 2(n) 2005/68/EC, whereas home Member State is defined as the Member State where the undertaking has its based office, see Article 2(f) 2005/68/EC.

Hybrid capital

Capital that has the form of a combination of two or more different financial structures or instruments.

Examples are subordinated and deeply subordinated debt. Hybrid capital is used to provide cheaper funding than share capital.

IBNR provision

Provision for claims incurred but not reported by the balance sheet date. That is, it is anticipated that there would be a number of policies that have, but for the advice of the claim to the insurer, occurred and therefore are likely to result in a liability on the insurer. The magnitude of this provision can be expected to reduce as the time since the insurance risk on the contract expired extends. The magnitude is also likely to vary depending on the type of insurance risk covered by any particular class of insurance contract.

IBNER provisions

Additional provisions for claims incurred but for which not enough has been reserved.

Immediate payout annuity

An annuity contract that provides an income on an immediate basis, as distinct from a deferred annuity.

Impairment level

See: Control level

Implementing measures

Implementing powers given to the Commission, decided in consultation with Member States in the Lamfalussy Level 2 committees. They will be developed on the basis of mandates given by the Commission to CEIOPS (the Lamfalussy Level 3 supervisors’ committee) and will be subject to consultation with stakeholders and to an impact assessment.

Indemnity reinsurance agreement

The ceding entity remains legally responsible for all policyholder obligations of the reinsured policies. The assuming entity indemnifies, or protects, the ceding entity against one or more of the risks in the reinsured policies.

Indirect credit or spread risk

The risk due to movements in market perception or appetite for risk on either a macro or micro basis.
Individual Capital Adequacy Standards

The current capital adequacy requirements regime applicable to UK insurance firms that will be replaced upon adoption of Solvency II on 1 November 2012.

Abbreviation: ICAS

Inflation risk

The risk of a change in value caused by a deviation of the actual market-consistent value of assets and/or liabilities from their expected value, due to inflation, e.g. price inflation, wage inflation, etc., and leading to an unanticipated change in insurance cost and/or impact of an insurance contract, e.g. with respect to contract limits.

In-force business

The portfolio of insurance contracts which give raise to current obligations or current rights.

Initial capital requirement

Minimum capital required to set up an insurance company.

Equivalent terms: Initial solvency requirement

Initial solvency requirement

See: Initial capital requirement

Insolvency

The point at which under national bankruptcy procedures the owner loses ownership rights and/or the policyholders are no longer entitled to the orderly settlement of contracts.

Insurance company

See: Insurer

Insurance contract

A contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder or its beneficiary if a specified uncertain future event (the insured event) affects the policyholder.

IFRS4, Appendix B provides detailed guidance on the definition of ‘insurance contract’.

Insurance group

A group structure which contains two or more insurers.

Related terms: Captive insurer, Financial conglomerate, Financial conglomerate, Insurance entity

The structure of insurance groups may derive from an ultimate holding company which is not an insurer. Such a holding company can be an industrial or commercial company, another financial institution (for example a bank), or a company holding most of its assets as shares in insurance companies (and/or other regulated financial institutions).
Insurance Groups Directive

The EU Directive which applies Solvency I regulatory capital requirements to insurance groups and makes provisions for group supervision (98/78/EC). This will be replaced by the Solvency II Directive.

Abbreviation: IGD

Insurance guarantee scheme

Arrangements which should ensure that policyholders and beneficiaries are not left without compensation in the event of the insolvency of an insurance entity.

Abbreviation: IGS

This can either be achieved by providing reimbursement to policyholders/beneficiaries or by securing the continuation of the insurance contracts. In the field of third-party motor liability insurance, the EU legislation requires Member States to set up a compensation body with the task of providing compensation, at least up to the limits of the insurance obligation for damage to property or personal injuries caused by an unidentified vehicle or a vehicle (for which the legal insurance obligation has not already been satisfied). Insurance guarantee schemes also exist for worker’s compensation. IGS can be focused on one or on multiple lines; the financing of these schemes can be either private or public and can be very diverse.

Insurance intermediary

Any natural person or legal entity that engages in insurance intermediation (in any medium). Intermediaries are generally divided into separate classes. (The most common types are “independent intermediaries” who represent the buyer in dealings with the insurer (also known as “independent brokers”) and “agents” (which generally include multiple agents and sub-agents) who represent the insurer.)

Related term: Insurance intermediation

Insurance intermediation

The business activity to promote or facilitate an insurance contract between an insurer and a purchaser; selling or attempting to sell insurance on behalf of an insurer, asking or urging potential purchaser to apply for a particular insurance product, conferring with or giving advice to a potential purchaser concerning particular insurance product by a person or entity who sell or arrange the insurance contract. Activities by an insurer are not included.

Related term: Insurance intermediary

Insurance obligation

An insurer’s contractual obligations/rights under an insurance contract.

Related term: Best estimate liability

Total net obligations associated with an insurance company can be split into various parts such as policyholder obligations, obligations arising from business and management cost of the portfolio, tax liabilities, and debts to creditors and others, and in total rights to policyholders (e.g. regarding premiums due or recoveries). Liabilities can be measured net or gross of risk mitigation and transfer contracts including reinsurance and hedging. Amount recognized on the balance sheet to meet as liabilities to reflect obligations arising out of insurance contracts, include:

- Claims liabilities (whether reported or not);
- Liabilities for unearned premiums;
Liabilities for unexpired risks; Life insurance liabilities, and; Other liabilities related to life insurance contracts (e.g. premium deposits, accumulated savings for unit-linked contracts, accumulated guaranteed bonus for participating contracts, liabilities for future bonuses for participating contracts).

Insurance product

An insurance product is defined as a product that is provided by an insurance company.

Insurance risk

See: Technical risks

Insurance Standing Group

Regular pre-consultation forum for discussing a number of issues relating to Solvency II and any ad-hoc domestic prudential policy issues between the Industry and the FSA.

Abbreviation: ISG

Insurance supervisor

Refers, as appropriate, to either the insurance and reinsurance regulator or the insurance and reinsurance supervisor in a jurisdiction.

Equivalent term: Supervisory authority

Insurance undertaking

Means a direct life or non-life insurance undertaking which has received authorisation in accordance with Article 14, as per the Solvency II Directive.

Insurer

A licensed legal entity, which underwrites insurance, including a mutual insurance company.

Interest rate risk

The risk of a change in value caused by a deviation of the actual interest rates from the expected interest rates.

Related terms: Market risk, Asset-liability mismatch risk

Intermediary fraud

Fraud by intermediaries against the insurer or policyholders.

Internal controls

The means by which compliance with the insurer’s risk management policies is maintained. Regular reporting, including the use of measurements and metrics required to be within limits specified by the risk management policies, may be used to verify compliance.

Internal fraud

Fraud against the insurer by a director of the board, a manager or member of staff (regardless if the member of staff is employed on a permanent or temporary basis) on his/her own or in collusion with others who are either internal or external to the insurer.
Internal Model

Risk management system of an insurer for the analysis of the overall risk situation of the insurance undertaking, to quantify risks and/or to determine the capital requirement on the basis of the company specific risk profile.

Related term: Standard formula

Within the Solvency II framework an internal model is intended to fully or partially replace the standard formula for the calculation of the Solvency Capital Requirement. Both quantitative and qualitative requirements will be set by the regulator and explicit approval has to be granted by the supervisor.

International Accounting Standards Board


Abbreviation: IASB

International Association of Insurance Supervisors

Issues global insurance principles, standards and guidance papers, provides training and support on issues related to insurance supervision, and organises meetings and seminars for insurance supervisors. The IAIS was established in 1994 and now represents insurance regulators and supervisors of some 190 jurisdictions.

Abbreviation: IAIS

International financial conglomerate

Refers to a financial conglomerate with regulated entities located in different countries

International Financial Reporting Standards

Accounting standards set by the IASB; listed EU companies have been required to produce their accounts using IFRS since 2005.

Abbreviation: IFRS

International Monetary Fund

An international organization established to promote international monetary cooperation; to foster economic growth and high levels of employment; and to provide temporary financial assistance to countries to help ease balance of payments adjustment.

Abbreviation: IMF

Intervention level

See: Control Level

Intragroup exposures

Exposures to risk that result from transactions conducted between members of the one corporate group, e.g. the risk that the company guarantees another part of the group implicitly or explicitly.

Related terms: Conglomerate risk, Contagion
**Intra-group transaction**

Means any transaction by which an insurance or reinsurance undertaking relies, either directly or indirectly, on other undertakings within the same group or on any natural or legal person linked to the undertakings within that group by close links, for the fulfilment of an obligation, whether or not contractual, and whether or not for payment;

**Investment management**

The activity of making and controlling investment decisions

Related terms: Investment policy, Investment risks, Investment risk management, Investment risk management framework, Investment risk management function, Investment risk management policy, Investments risk exposures, Investments risk limits

**Investment policy**

The insurer's policy with respect to the overall characteristics for an investment portfolio or for the investments of the insurer as a whole. A statement of a portfolio's investment policy will normally include the objectives of the portfolio, its risk tolerance, constraints to be obeyed in the management of the portfolio, such as minimum liquidity requirements, and a list of eligible assets or asset classes in which the portfolio may be invested, along with a target asset mix and limits on how much the portfolio may diverge from the target.

**Investment risk management**

The process an insurer uses to identify investment risk exposures, and to monitor, measure, report, and mitigate this risk.

**Investment risk management framework**

The strategies, policies, procedures, methodology and the organisational structure that an insurer uses to perform its investment risk management function. The investment risk management function is normally separate and distinct from the investment management function, to the extent that this is practical for the insurer.

**Investment risk management function**

The committees, departments, or persons charged with the responsibility to ensure that the insurer complies with its investment risk management policy and the activities that they carry out, including the oversight of timely corrective action when investment policy constraints are breached and other mitigating action.

**Investment risk management policy**

The insurer's policy with respect to investment risk management including definition of the investment risk exposures that are present in an insurer's operations, a description of the investment risk management process, and assignment of the investment risk management function within the insurer’s structure.

**Investment risks**

The various kinds of risk which are directly or indirectly associated with the insurers' investment management. They concern the performance, returns, liquidity and structure of an insurer's investments. Such risks can have a substantial impact on the asset side of the balance sheet and the company's overall liquidity, and potentially can lead to the company being over indebted or insolvent. The investment risks include: market risk, credit risk, liquidity risk, operational risk.
Investment strategy

The overall direction by the insurer’s investment management governing the insurer’s investment policy and investment risk management policy.

Investments risk exposures

Measures of the amounts by which an insurer’s financial position may vary adversely.

Investments risk limits

The maximum amount of risk exposure that an insurer is prepared to accept. Limits are normally included in the insurer’s risk management policy, and monitoring of compliance with these limits is part of the risk management function

Jurisdiction

A country, state, province, or other territory with legally enforceable local insurance laws that relate to the incorporation or operation of insurance companies.

Key coordinator

Is the supervisor who is responsible for the coordination of the group comprehensive supervisory arrangement for a specific group.

Related term: College of Supervisors, Home supervisor, Host supervisor, Lead Supervisor

Key functionary (ies)

Individuals defined by legislation, such as board members, directors and senior management of an insurer, who must meet fit and proper requirements. The key functionaries identified may differ depending on the legal form and governance structure of the insurer.

Related terms: Fit and proper requirements, Fitness and propriety

Lamfalussy arrangements

The arrangements designed to enable the EU to develop and update financial services legislation more quickly and easily. Under this approach, directives set out high-level principles and define the scope for implementing measures. The latter are decided by the Commission in consultation with Member States in the Level 2 committees and taking into account technical advice from the Level 3 supervisors’ committee.

Lapse

The expiration of all rights and obligations under an insurance contract if the policyholder fails to comply with certain obligations required to uphold those, e.g. premium payment.

Related terms: Lapse risk, Surrender

Typically, the insurer must receive the premium payment within a specified period after the due date.

Lapse risk

The risks of a change in value caused by deviations from the actual rate of policy lapses from their expected rates.

Equivalent term: Persistency risk
Related terms: Lapse, Surrender risk, Underwriting risk

**Large risks**

Means:

(a) risks classified under classes 4, 5, 6, 7, 11 and 12 in Part A of Annex I of the Solvency II Directive;
(b) risks classified under classes 14 and 15 in Part A of Annex I of the Solvency II Directive, where the policy holder is engaged professionally in an industrial or commercial activity or in one of the liberal professions and the risks relate to such activity;
(c) risks classified under classes 3, 8, 9, 10, 13 and 16 in Part A of Annex I of the Solvency II Directive in so far as the policy holder exceeds the limits of at least two of the following criteria:
   (i) a balance-sheet total of EUR 6.2 million;
   (iii) an average number of 250 employees during the financial year.


**Law enforcement agency**

Public authority charged with the investigation and/or prosecution of criminal conduct.

Related term: Financial intelligence unit

**Lead supervisor**

The supervisory authority responsible for the supervision of a financial group or conglomerate.

Related terms: Home supervisor, Host supervisor, Key Coordinator

**Legal risk**

The possibility that lawsuits, adverse judgements or contracts that turn out to be unenforceable, may disrupt or adversely affect the operations or condition of an insurer.

Related terms: Business risk, Operational risk

The result may lead to unplanned additional payments to policyholders or that contracts are settled on an unfavourable basis, e.g. unrecoverable reinsurance.

**Liability insurance**

Type of non-life insurance that provides insurance to meet legal obligations to third parties arising from non-intentional acts or wrongs, e.g. negligence by the insured.

Related term: Casualty insurance

Reasons for legal obligations include bodily injury, property damage, and professional errors. Defined as ‘Third-party liability insurance’ in EU law.

**Licensed financial institution**

Refers to a financial institution which has received a permit from a regulator or a supervisor to do specific financial business as defined by that particular licence (e.g. life assurance, non-life insurance, banking, etc.).
Licensing

The incorporation of an insurer in the jurisdiction or the approval given to a company to underwrite insurance in the jurisdiction. These are recognised to be separate approvals and may be made in separate jurisdictions.

Life assurance provisions

Amount on the balance sheet which comprises the actuarially estimated value of an insurer’s liabilities for future benefit payments, including bonuses already declared and after deduction of the actuarial value of that component of future premiums attributable to meeting those liabilities.

Equivalent terms: Mathematical provisions, Policy liabilities, Policy reserves

Life insurance

Category of insurance contracts for which the benefit payment is based on the occurrence of death, disability, or critical illness of the insured within the specified coverage term, or on the life status of the insured at maturity.

Related term: Health insurance

Life insurance offers life and/or death coverage of the insured in the form of a single or multiple (as well as regular in case of an annuity) lump sum payments to a beneficiary. Health insurance products are often sold as a rider to a (group) life contract. In sensu stricto these are not life insurance, because they do not relate to the occurrence of death. The classes of life insurance that EU insurers can write on a license are defined in Annex I of Life Directive 2002/83/EC.

Lifetime annuity

A contract that provides income for the life of the annuitant

Liquidity risk

Liquidity risk is exposure to loss in the event that insufficient liquid assets will be available from among the assets supporting the policy obligations, to meet the cash flow requirements of the policyholder obligations when they are due - or that assets may be available, but only at excessive cost.

Related term: Market risk

Liquidity risk may arise due to illiquidity of the assets held to meet the cash flow requirements (commonly referred to as asset, market, or trading liquidity risk), but also due to insufficient funds being available to meet cash flow requirements (funding liquidity risk). From a more theoretical point of view liquidity risk on a day-to-day basis could also be understood as a change in value due to a deviation of the actual cash flow requirements from the expected cash flow requirements, being the cost of being over- or under capitalised.

Longevity risk

Type of biometric risk. A change in value caused by the actual mortality rate being lower than the one expected.

Related term: Biometric risk

Longevity risk affects contracts where benefits are based upon the likelihood of survival, i.e. annuities, pensions, pure endowments, and specific types of health contracts.
Long-tailed business

Insurance business whose uncertainty about the amount and timing of claims payments typically takes more than one year to resolve.

Related term: Short-tailed business

Loss given default

Means the ratio of the loss on an exposure due to the default of a counterparty to the amount outstanding at default.

Abbreviation: LGD

Equivalent terms: Loss in the event of default, Loss severity

Related term: Probability of default

Loss ratio

Refers to the ratio of claims incurred to earned premiums. Gives an indication of how well the pricing of an insurer matches the risks taken in the insurance contracts.

Equivalent term: Claims ratio

Related term: Claims incurred

Macaulay duration

The duration for any bond with cash flow payments of $C_1\ldots C_n$ at times $t_1\ldots t_n$ and interest rate $r$ is defined as:

$$D = \frac{\sum_{i=1}^{n} C_i (1 + r)^{-t_i} t_i}{\sum_{i=1}^{n} C_i (1 + r)^{-t_i}}$$

Management board

The board of directors in a two-tier board system of corporate governance

Related terms: Board of directors, Supervisory board, Supervisory body, Two-tier board system of corporate governance, Unitary board system of corporate governance

Management body

A term given referring to the Board Members that are responsible for the management or oversight of the insurer’s operations/business as per the Solvency II Directive adopted in December 2009.

Other terminology used to refer to Board Members under the Solvency II Directive: Administrative body, Supervisory body.

Management risk

The risk associated with an incompetent management or a management with criminal intentions. As such they would include, for example, matters wilfully caused by management.

Related term: Non-technical risks
**Marine, aviation, and transport insurance**

Category of insurance products defined in EU law providing coverage for:

- Accidental injury of passengers,
- All damage to or loss of railway rolling stock, sea, river and canal vessels, goods in transit and baggage, and
- All liability arising out of the use of ships, vessels or boats on the sea, lakes, rivers or canals, including carrier's liability.

Abbreviation: MAT

*Defined as ‘Marine, Aviation, and Transport insurance’ in EU law. For more details see Annex A and B(a) of First Council Non-Life Directive 73/239/EEC and consecutive amending directives.*

**Market Capitalisation**

Market capitalization representing the aggregate value of a company or stock. It is obtained by multiplying the number of shares outstanding by their current price per share.

**Market-Consistent Embedded Value (MCEV)**

MCEV is the present value of the contribution of the covered business to shareholder distributable earnings. This is defined as the sum of the following three components:

- The free surplus allocated to the covered business
- The value of the required capital allocated to support the in-force covered business, allowing for the costs associated with holding that capital
- The value of future shareholder cash flows emerging from assets backing the in-force covered business, allowing for both the intrinsic and time value of any inherent financial options and guarantees.

**Market-consistent valuation**

The practice of valuing assets and liabilities on market values where observable with a given quality (mark-to-market), and where not, on market-consistent valuation techniques (mark-to-model).

Related terms: Market value, Mark-to-market valuation, Mark-to-model valuation

**Market discipline**

The creation of disciplining pressure through the publication of financial information and other information about the insurer's activities to the public, sometimes only to policyholders, and the providing of transparency, hence allowing market participants and policyholders to assess key organisational and product information.

*Disclosure requirements and recommendations may either be imposed by the responsible supervisory authority or based on the insurer's own initiatives. Market discipline serves to ensure that insurers display a fair attitude towards policyholders and provide financial transparency toward market participants.*

**Market risk**

The risk to an insurer's financial condition arising from movements in the level or volatility of market prices. Market risk involves the exposure to movements of financial variables such as equity prices, interest rates, exchange rates or commodity prices. It also includes the exposure of derivatives to movements in the price of the underlying instrument or risk factor. Market risk also involves the exposure to other unanticipated movements in financial variables or to movements in the actual or
implied volatility of asset prices and options. Market risk incorporates general market risk (on all investments) and specific market risk (on each investment).

Abbreviation: MV

Related term: Matching risk

*Fair value is a similar concept to market value, but the fair value may be a mark-to-model price if no actual market price for asset/liability exists.*

**Market value**

Market value is the basis of settling claims under insurance policies, taking into account the best price reasonably obtainable for an item/property in the market. For example, some motor insurance policies are market value policies. If a vehicle is destroyed, then the amount paid is the market value of the vehicle at time of loss.

**Market value of liabilities (MVL)**

The market-consistent cost to the insurer to meet its obligations to policyholders over time in the ordinary course of business. The MVL, therefore, represents the present value of the financial costs to the insurer that is obliged to meet those liability cash flows. The costs are comprised, *inter alia*, policyholder benefits, expenses, tax payments and capital costs, as well as the net of expected future premiums and fees from the existing contracts. Whenever such obligations, or some component thereof, can be hedged through the financial markets, a valuation approach that is consistent with those markets should be applied. For risks that cannot be hedged, a risk margin should be included.

**Market value margin**

The measurement attribute for determining the risk margin in a market-consistent measurement of an insurance obligation or asset reflecting the price charged by market participants for accepting the deviation risk inherent to a cash flow.

Abbreviation: MVM

Related terms: Best estimate liability, Fair value, Market consistent valuation, Market value

*Under the cost of capital approach the MVM is to be approximated as the present value of the cost of capital for all future Solvency Capital Requirements (or economic capital requirements which will have to be put up during the entire run-off of the portfolio of assets and liabilities) for the risks of the in-force book of business.*

**Mark-to-market valuation**

The practice of valuing insurance rights and obligations, or more broadly, security and financial instruments, using current market prices.

Related terms: Mark-to-model valuation, Market-consistent valuation

**Mark-to-model valuation**

The practice of valuing insurance rights and obligations, or more broadly, security and financial instruments based on modelling.

Related term: Market-consistent valuation

*Mark-to-model valuing is often based on benchmarking, extrapolation or other forms of calculation based on current and market-consistent parameters, any such form of modelling can be applied.*
Matching risk

The risk emerging when the future cash flows generated by assets do not coincide with (or do not suitably cover) the cash flow demands of the corresponding liabilities. This would include Currency Risk, as well as the risk that the timing of cash flows may not match, and therefore leads to a risk associated with movements in interest rates (Interest Rate Risk and Reinvestment Risk).

Mathematical provisions

See: Life assurance provisions

Maximum Event Retention (MER)

The maximum amount that is retained by an insurer in respect of accumulations of losses arising out of one event.

Member State in which the risk is situated

Means any of the following:

- the Member State in which the property is situated, where the insurance relates either to buildings or to buildings and their contents, insofar as the contents are covered by the same insurance policy;
- the Member State of registration, where the insurance relates to vehicles of any type;
- the Member State where the policy holder took out the policy in the case of policies of a duration of four months or less covering travel or holiday risks, whatever the class concerned;
- in all cases not explicitly covered by the above points the Member State in which either of the following is situated:
  - the habitual residence of the policy holder; or
  - if the policy holder is a legal person, that policy holder’s establishment to which the contract relates.

Member State of the commitment

Means the Member State in which either of the following is situated:

- the habitual residence of the policy holder;
- if the policy holder is a legal person, that policy holder’s establishment, to which the contract relates.

Migration risk

The risk of a change in value caused by a deviation of the actual probability of a future default by an obligor from the expected probability of future default, adversely affecting the present value of the contract with the obligor today.

Related term: Credit risk

Minimum Capital Requirement

The MCR under Solvency II represents the minimum level of capital below which ultimate supervisory action will be triggered requiring the firm to restore rapidly the level of solvency. It is expected to be calculated in a simpler and possibly more transparent manner than the SCR.

Abbreviation: MCR

Related term: Solvency Capital Requirement
**Mispricing risk**

The risk that miscalculations have led to premiums that are too low to cover the insurer’s expenses related to claims, claims handling and administration.

Equivalent terms: Risk of insufficient tariffs, Product design risk, Pricing risk

Related term: Underwriting risk

**Model risk**

The risk that a model is not giving correct output due to a misspecification or a misuse of the model.

Related term: Parameter uncertainty risk

Possible sources of model risk include, but are not restricted to:

- The use of an inappropriate model;
- The inappropriate use and implementation of models;
- The selection of inappropriate models;
- Errors within the models or the estimated parameters; or
- Insufficient or incorrect data.

**Modified coinsurance basis**

Modified coinsurance, or ‘modco’, differs from coinsurance and coinsurance with funds-withheld agreements, in that the portion of policy assets and reserves normally entitled to the reinsurer are actually retained by the ceding company. In addition to the transactions required in a coinsurance arrangement, a “reserve adjustment” must be calculated. For each accounting period, the change in reserves is first determined. If these have increased, the amount of the increase, less interest on the reserve for the period, if positive, will be payable to the ceding company. If negative, the amount of the decrease, plus interest on the reserve, will be payable by the cedant to the reinsurer. The rationale for this procedure is that the ceding company holds the policy reserves and the corresponding assets on the reinsured business and, is therefore responsible for the portion of the reserve increase derived from interest on the policy assets. Any other fluctuations in the reserve would be the responsibility of the reinsurer. Establishing the reserve adjustment interest rate is a complex part of the treaty negotiations. The formula for calculating the interest rate is typically set forth in the reinsurance agreement.

**Modified duration**

Is expressed as:

\[
\mathcal{MD} = \frac{1}{1 + r} \frac{\sum_{i=1}^{n} C_i (1 + r)^{-t_i} t_i}{\sum_{i=1}^{n} C_i (1 + r)^{-t_i}}
\]

**Money duration**

Measures the absolute sensitivity of an investment’s position in the local currency. For fixed income instruments it can be expressed as:

Duration = Delta x Market Value,
where delta is the change in interest rates. This measure can be useful when the economic values of assets and liabilities differ.

**Money laundering**

The processing of the proceeds of crime to disguise their illegal origin.

**Monte Carlo simulation**

A method that estimates possible outcomes from a set of random variables by simulating a process a large number of times and observing the outcomes.

**Morbidity risk**

Type of biometric risk. A change of value caused by the actual disability and illness rates of the persons insured deviating from the ones expected.

Related terms: Biometric risk, Disability risk

*Morbidity risk is generally considered as to only relate to insurance cover for losses other than loss of income, i.e. medical expenses, contrary to disability risk. An increase in the frequency of an insured becoming disabled or ill may for example result in higher claim patterns than charged for in the premiums. It affects health insurance contracts where payments are paid for insured types of disability and/or illness.*

**Mortality risk**

Type of biometric risk. A change in value caused by the actual mortality rate being higher than the one expected.

Related terms: Biometric risk, Longevity risk

*An increase in the frequency of the death of insured persons may, for example, result in higher claim patterns than charged for in the premiums. Mortality risk affects all life insurance contracts and those health insurance contracts where claims depend upon the death of the insured.*

**Motor insurance**

A generic term referring to all types of insurance indemnifying for third-party liability, legal liability for bodily injury, and damage to property of others, arising out of ownership or operation of a motorised vehicle (compulsory cover as in EU Directives), and/or other losses arising out of the ownership, or operation of a motorised vehicle by the insured (comprehensive cover).

Related term: Liability insurance

**National bureau**

Means a national insurers’ bureau as defined in Article 1(3) of Directive 72/166/EEC.

“National insurers' bureau" means a professional organization which is constituted in accordance with Recommendation No 5 adopted on 25 January 1949 by the Road Transport Sub-committee of the Inland Transport Committee of the United Nations Economic Commission for Europe and which groups together insurance undertakings which, in a State, are authorized to conduct the business of motor vehicle insurance against civil liability.

**Non-diversifiable risk**

A risk is non-diversifiable when it cannot be (relatively) reduced by increasing portfolio size.
See: Systematic risk

Non-life insurance

Generic term used to refer to all types of insurance business other than Life insurance, including for example Property insurance, Liability insurance, Motor insurance, Accident insurance, and Health insurance.

Equivalent term: General insurance

Related terms: Life insurance, Health insurance

In Anglo-Saxon countries the term General insurance is commonly used. Official term used in EU law to refer to specified classes of insurance defined in First Council Directive 73/239/EEC and amended in consecutive Non-life Directives.

Non-proportional reinsurance

Non–proportional reinsurance occurs when the reinsurer indemnifies the ceding entity against the amount of loss in excess of the cedant company’s specified retention. Non–proportional reinsurance, as the name implies, does not contemplate the sort of sharing of premium, losses, and loss expenses that occurs under proportional structures. Instead, the reinsurer assumes liability for only such loss as exceeds the insurer’s stipulated net retention (or, in the case of a layered excess structure, loss which exceeds the combined limit of liability of all underlying layers of reinsurance plus the insurer’s retention). Typically, these reinsurance policies are written annually to protect from excessive losses. The three types of non-proportional reinsurance in non-life business include excess per risk, aggregate excess of loss and per occurrence excess of loss. In life business, they may be written as catastrophe reinsurance and stop-loss reinsurance.

Related terms: Reinsurance, Proportional reinsurance, Excess of loss

Non-technical risks

Non technical risks represent the various kinds of risk which cannot in any suitable manner be classified as either technical risks or investment risks. Insurance supervisors will also be concerned about these risks, (although the list should not be seen as exhaustive):

- management risk;
- risks connected with guarantees in favour of third parties; or
- general business risk.

There can be debate about the inclusion of what some define as operational risk in this category. Depending on the definition assumed, operational risk can be added or can be included in this list.

Operating expenses risk

The risk of actual or future expenses exceeding – to a considerable degree – the corresponding amount as estimated by using the bases of calculation.

Operating ratio

The operating ratio is the combined ratio adjusted by the addition of allocated investment return to earned premiums. This ratio enables the assessment of business performance after the inclusion of allocated investment return.

Related terms: Combined ratio, Allocated investment income
Operational risk

Operational risk is defined as the risk of loss resulting from inadequate or failed internal processes, people, systems or from external events.

Related terms: Business risk, Compliance risk, Expense risk, Legal risk, Management risk, Model risk, Reputational risk, Strategic risk

Operational risks relate to operational loss events caused by internal or external reasons, excluding all ‘financial’ risks that a company has taken on in the expectation of a financial return.

Option

The contractual right, but not the obligation, to buy or sell a specified amount of a given financial instrument at a fixed price before or at a designated future date. A call option involves the right to buy the financial instrument. A put option involves the right to sell the financial instrument.

Outsourcing contracts

Outsourcing means to transfer certain functions of material importance, (e.g. investment management, distribution, informatics, accounting etc.) from an insurance company to another company which need not necessarily also be an insurance company.

Own funds

Refers to a (re)insurance undertaking's available financial resources which can serve as a buffer against risks and absorb financial losses, where necessary. Own funds can be split into “basic own funds” and “ancillary own funds”, which is further split between Tiers 1, 2 and 3. Limits are likely to be applied to the levels of loss absorption in Tiers 2 and 3.

Own Risk and Solvency Assessment (ORSA)

The ORSA is intended to outline the entirety of the processes and procedures employed to identify, assess, monitor, manage, and report the short-and long-term risks a (re)insurer faces or may face and include a determination of the own funds necessary to ensure that a firm can cover its liabilities, including technical provisions, the regulatory capital requirements – SCR and MCR – as well as the internal capital needs. The ORSA will be an important source of information for the supervisory authorities, and firms are obliged to describe the process they have undertaken to satisfy the ORSA requirements through the regulatory reporting requirements. Firms should highlight areas where they believe the assessment deviates significantly from the assumptions underlying the SCR calculation. The submission must also include details of the methods used and, where an internal model has been used, a recalibration that transforms the internal results so that they are consistent with the SCR calibration.

Paid-in capital

See: Equity capital

Parameter uncertainty risk

A change of value caused by the uncertainty in the estimation of the parameter values applied in a model.

Related terms: Model risk, Operational risk

Possible sources of parameter uncertainty risk include, but are not restricted to:

- The number of observations on which best estimates are based is limited because the observation period is too short;
The volatility of the observations makes estimation less certain;
The period over which the observations were made may not include certain calamitous events that, in fact, should be reflected in the parameters of the distribution;
The observations contain contaminated data;
The observed population differs from the one being underwritten;
There is an uncertainty for long-term insurance in projection of the parameters (diagnosis versus forecasting).

Parent company

A company that controls subsidiaries through partial or full stock ownership or some other financial or legal connection, or that in the opinion of the competent authorities, effectively exercises a dominant influence over another undertaking.

Equivalent term: Parent undertaking


Parent undertaking

See: Parent company

Partial model

A partial internal model only covers certain sub-modules of a specific risk module, or some of the business units of an insurance or reinsurance undertaking with respect to a specific risk module, or parts of both.

Participation

Means the ownership, direct or by way of control, of 20% or more of the voting rights or capital of an undertaking.

Participation risk

The risk related to the holding of an ownership or a financial interest in other companies and the possibilities of being affected by financial difficulties within the latter companies.

Payout annuity

A contract that provides income to a policyholder for a specified period of time, such as a number of years or for life.

Pension scheme

A contract, an agreement, a trust deed, or rules stipulating which retirement benefits are granted and under which conditions.

Related terms: Annuity, Life insurance

Percentile approach

See: Quantile approach
Performance-linked benefit

A contractual benefit sharing the policyholder in the performance of the insurer, i.e. the surplus under a group of contracts or the surplus of the entire entity; achieved after providing the guaranteed benefits, after making the related internal expenses as a result of received guaranteed premiums, and taking into account the investment income.

Contracts can limit the surplus in which policyholders share, can determine to which extent they share in those surplus, and when and by which means the policyholders’ share in surplus is benefited to individual policyholders. Contracts often grant insurers a certain discretion in that process. There are various methods for deciding how profits are shared.

Permanent capital

Instruments that have no end date and are available indefinitely to absorb losses in defined circumstances.

Related term: Available solvency margin

Per occurrence (catastrophe) excess of loss

This reinsurance method is identical to the ‘Excess per Risk of Reinsurance’, except that the policies are designed to account for an accumulation of losses from a single catastrophic event. As catastrophic events can result in significant losses, the insurer may find it necessary to cede parts of the risk to different reinsurers, or the assuming reinsurer may cede some of the assumed risk to others (retrocession). In non-proportional reinsurance the reinsurer does not assume responsibility for a proportional share of all losses. Therefore the distribution of premium will not be on a proportional basis. Non–proportional reinsurance is commonly arranged in a series of layers, the first of which attaches immediately to the excess of the insurer’s retention, followed by as many additional layers as are necessary to generate the required total amount of capacity (per risk), or to afford such catastrophe (per occurrence) or aggregate (net retained loss) protection as deemed prudent and sufficient, given the size, geographic distribution and nature of the insurer’s portfolio of business.

Persistency risk

See: Lapse risk

Pillar 1

Pillar 1 under the new proposed Solvency II regime sets out the rules and guidelines for calculation of the technical provisions and capital requirements. The capital requirements consist of a minimum level of capital called the ‘minimum capital requirement’ (MCR) and the ‘solvency capital requirement’ (SCR).

Pillar 2

Pillar 2 under the new proposed Solvency II regime is often referred to as the supervisory review process (SRP). It deals with internal and external supervisory methods and development of standards for sound internal risk management. It is also concerned with the remaining risk classes whose effects cannot easily be quantified (for example liquidity risk). The risks are to be assessed and managed using more qualitative approaches.

Pillar 3

Pillar 3 under the new proposed Solvency II regime represents ‘market discipline’ and usually describes the disclosure requirements imposed on firms. Increased disclosure requirements are generally thought to incentivise better risk management practices by increasing transparency.
Pillar 5

CEIOPS created a number of expert groups to complete its tasks. The Internal Governance, Supervisory Review and Reporting (IGSRR) Expert Group are tasked with developing Pillars 2 and 3 of the Solvency II regime. Adding the two pillars together has created what is commonly referred to as Pillar 5.

Policy liabilities

See: Life assurance provisions

Policy reserves

The amounts that a life insurance company allocates specifically for the fulfilment of its policy obligations: reserves are so calculated that, together with future premiums and interest earnings, they will enable the company to pay all future claims.

Related terms: Life assurance provisions, Mathematical provisions, Policy liabilities

Policyholder

The party to whom the contract of insurance is issued by the insurance company.

Policyholder fraud

Fraud against the insurer in the purchase or in the execution of an insurance product by obtaining wrongful coverage or payment.

Policyholder surplus

See: Available solvency

Politically exposed persons

Individuals who are or have been entrusted with prominent public functions in a foreign country, for example Heads of State or of government, senior politicians, senior government, judicial or military officials, senior executives of state owned corporations, important political party officials. Business relationships with family members or close associates of PEPs involve reputational risks similar to those with PEPs themselves. The definition is not intended to cover middle ranking or more junior individuals in the foregoing categories.

Abbreviation: PEP(s)

Premium deficiency reserve

See: Provision for unexpired risks

Premium risk

See: Claims risk

Pricing risk

See: Mispricing risk

Probability distribution forecast

Means a mathematical function that assigns a probability of realisation to an exhaustive set of mutually exclusive future events.
Probability of default

Risk measure. The likelihood that a counterparty will not repay contractual obligations according to the agreement.

Abbreviation: PD

Related term: Loss given default

The probability of default is typically specified in terms of a one year period, but may also relate to a longer or shorter period.

Probability of ruin

Risk measure. The likelihood that total net cash outflows may at any time exceed the available resources starting with a given amount of resources, within a specified time horizon.

Equivalent term: Ruin probability

Procyclicality

The cumulative pressure on a larger number of institutions to sell assets or raise capital at the same time, due to the ‘Solvency Capital Requirements’ and thereby potentially amplifying market movements.

In addition, this causes sales to occur at inopportune times, i.e. when the achieved returns are such that, in a cascade reaction even more assets need to be sold, with the consequence that a major impact on the entire industry is possible.

Producer owned reinsurance companies

Are captives, or cells of protected cell companies, that are beneficially owned by the producers of the business that is ultimately reinsured into the company through an independent fronting insurer. There are additional risks associated with these companies, since the producer could be in a position to influence the placing of business with its own captive and could control the level of premiums or commissions that apply.

Abbreviation: PORCs

Product design risk

Generic term used to describe the fact that an insurer may face a risk exposure under its insurance contracts that had not been anticipated when the insurance contract was originally designed and priced.

Related term: Underwriting risk, Mispricing risk

Product proofing

Development of an insurance product in such a way that fraud risk and other relevant risks are recognised and dealt with using adequate control measures.

Profit reserve

Amounts, i.e. bonuses and rebates, that are intended for policyholders or contract beneficiaries if such amounts have not been credited to policyholders or contract beneficiaries or included in a fund for future appropriations.

Equivalent terms: Provision for bonuses and rebates
Property and casualty insurance

See: Casualty insurance, Property insurance

Property insurance

A generic term used to describe all non-life insurance products that can protect an insured against loss of, or damage to, property for specified peril(s).

Related term: Casualty insurance

Defined as ‘Insurance against Fire and other Damage to Property’ in EU law. For more details see Annex A and B(a) of First Council Non-Life Directive 73/239/EEC and consecutive amending directives.

Proportional reinsurance

A type of reinsurance arrangement whereby the ceding insurer and assuming reinsurer share an agreed portion or percentage of the original premiums and subsequent losses from the reinsured business.

Related terms: Reinsurance, Non-proportional reinsurance

Prospective cover

Reinsurance cover that serves to reduce volatility in current and future premiums and claims patterns.

Protected Cell Company

Is a single company consisting of a core and an indefinite number of cells, which are kept legally separate from each other. Each cell has assets and liabilities attributed to it, and its assets cannot be used to meet the liabilities of any other cell. The company will also have non-cellular (core) assets, which may be available to meet liabilities that cannot be attributed to a single cell. A PCC can create and issue shares (‘cell shares’) in respect of any of its cells but the company is managed by a single Board.

Abbreviation: PCC

Equivalent terms: Segregated Account Company (SAC), Segregated Portfolio Company (SPC)

Provision

The amount needed under a certain measurement of a present obligation to meet that obligation adequately.

The term ‘technical provision’ is a part of the provision separated for presentation purposes, referring to parts subject to uncertainty.

Provision for bonuses and rebates

See: Profit reserve

Provision for claims outstanding/outstanding claims

See: Claims provision
Provision for unearned premiums

Amount on the balance sheet representing that part of premiums written which is to be allocated to the following financial year or to subsequent financial years.

Equivalent terms: Unearned premium reserve (UPR)

Related term: Provision for unexpired risks

Provision for unexpired risks

Amount set aside on the balance sheet in addition to unearned premiums with respect to risks to be borne by the insurer after the end of the reporting period, in order to provide for all claims and expenses in connection with insurance contracts in force in excess of the related unearned premiums and any premiums receivable on those contracts.

Equivalent terms: Premium deficiency reserve

Related terms: Provision for unearned premiums

Prudent person approach

The ‘prudent person’ approach requires the insurer to act in the way that a prudent person would, e.g. by considering the risks involved, obtaining and acting upon appropriate professional advice and suitably diversifying the investments.

Equivalent term: Prudent man approach

Prudent person principle

A principle which guides asset management by requiring the manager to invest as a prudent person would do.

Prudential filter

Regulatory requirements applied to the measurement of rights and obligations under insurance contracts and capital obligations of the insurer which result in differences to the values shown in public financial reporting.

They are applied for prudential reporting purposes to ensure that the capital is suitably quantified to meet the specific aims of prudential supervision.

Prudential margin

A margin added to the best estimate of an insurance liability which to reflect the uncertainties in the underlying liability.

Pure endowment insurance

Insurance payable to the beneficiary if the policyholder is alive at the maturity date stated in the policy.

Related terms: Endowment insurance, Life insurance

Qualifying holding

Means a direct or indirect holding in an undertaking which represents 10 % or more of the capital or of the voting rights or which makes it possible to exercise a significant influence over the management of that undertaking.
Qualifying participation

A participation held directly, or indirectly through one or several subsidiaries, by a natural person, of at least X % in the company, or – also in the case of a lower percentage – a participation enabling the shareholder to substantially influence the company’s management. X is defined in accordance with domestic law (10% or 20% are common threshold values).

Quantile approach

Approach to define a risk margin above best estimate liabilities in terms of a confidence level. It defines a risk margin as the difference between the stated quantile of the applicable probability distribution (value at risk) and the mean of that distribution.

Equivalent term: Percentile approach

Related terms: Confidence level, Cost of capital approach, Risk margin, Value-at-Risk

As this can, for low quantiles and/or skewed distributions, lead to negative risk margins, a supplementary rule is needed if the resulting risk margin is always to be positive.

Quantitative Impact Study (or Survey)

Quantitative Impact Studies (QIS) are data collection exercises conducted for the purposes of testing or calibrating new solvency requirements. CEIOPS is undertaking these exercises to quantify the impact of the proposed Solvency II reforms on firms’ regulatory capital requirements.

Abbreviation: QIS

Quota share reinsurance

This type of reinsurance was the earliest form of proportional reinsurance and is still widely used wherever appropriate. Quota share reinsurance arrangements agreement represent a sharing of all business in a fixed ratio, or proportion. A 50% quota share agreement is one in which premiums, losses, and loss expenses are shared equally, half being retained by the insurer and half being ceded to the reinsurer. A 70% quota share would involve a 70% share ceded to the reinsurer, with the remaining 30% retained by the insurer. The insurer’s needs and objectives, and the amount of proportional capacity available in the reinsurance marketplace at the time of placement, will determine the percentage share it will retain for its own account. Quota share treaties are invariably obligatory contracts. The contract will contain a stipulated limit of liability with respect to any single original policy. There will ordinarily be certain forms of coverage or classes of business that are excluded under the terms of the contract. These may not be ceded to the reinsurer without prior review and approval (usually referred to as a special acceptance) by the reinsurer. The reinsurance premium is simply the reinsurer’s proportional share of the insurer’s original premium for all business ceded. The reinsurer’s share of the insurer’s acquisition costs and general operating expenses associated with the ceded business is recovered by the insurer via a ceding commission allowance, i.e. a deduction from the reinsurer’s share of the gross original premium.

Rating agency

Entity that specialises in assigning credit ratings to borrowers.

Rating agency driven capital

Amount of capital the rating agencies expect the company to hold for a given rating.

It is designed to test and communicate capital adequacy warranting the target debt rating based on the rating agency metrics and models.
Rating grade

An assessment of credit risk satisfying a specified and distinct set of rating criteria. The grade definition should include both a description of the degree of credit risk typical for credits that have been assigned the grade and the criteria used to distinguish that level of credit risk.

Rating model

A systematic approach to determining one or more of the risk characteristics of a potential, or an existing, investment in a consistent manner with other investments to facilitate comparison.

Rating process

The steps used to determine an appropriate rating for a potential or existing investment.

Rating system

Comprises all of the principles, methods, processes, controls, data collection and information systems that support the insurer’s or credit rating agencies assessment of credit risk, the assignment of risk ratings, and the quantification of default and loss estimates.

Real-estate risk

The risk of a change in value caused by a deviation of the actual values of real-estate securities and/or income from real-estate securities, from their expected values.

Related term: Equity risk

Red flag

An indicator that suggests the need for more detailed investigation of a fact, event, statement or claim. It may – especially in combination with the occurrence of other red flags – indicate potential fraud.

Regulated market

Means either of the following:

- in the case of a market situated in a Member State, a regulated market as defined in Article 4(1)(14) of Directive 2004/39/EC; or
- in the case of a market situated in a third country, a financial market which fulfils the following conditions:
  - it is recognised by the home Member State of the insurance undertaking and fulfils requirements comparable to those laid down in Directive 2004/39/EC; and
  - the financial instruments dealt in on that market are of a quality comparable to that of the instruments dealt in on the regulated market or markets of the home Member State.

Regulatory arbitrage

The exploitation of differences between regulatory regimes across sectors or countries.

Regulatory capital

See: Available solvency, Eligible capital element

Regulatory control level

See: Control level
Regulatory surplus

See: Surplus capital

Reinsurance

Means either of the following:

- the activity consisting in accepting risks ceded by an insurance undertaking or third-country insurance undertaking, or by another reinsurance undertaking or third-country reinsurance undertaking; or
- in the case of the association of underwriters known as Lloyd’s, the activity consisting in accepting risks, ceded by any member of Lloyd’s, by an insurance or reinsurance undertaking other than the association of underwriters known as Lloyd’s

Reinsurance basis risk

The reinsurance cover might prove insufficient to adequately handle the risk in question because of reinsurance needs not having been precisely identified. This might result in relevant clauses of the reinsurance contract being inappropriate.

Reinsurance counterparty risk

See: Credit risk, Reinsurance credit risk

Reinsurance credit risk

A reinsurer might prove to be unable or unwilling to pay its part of the liabilities or the claims incurred which can put the insurer’s liquidity at risk and even cause its bankruptcy.

Reinsurance risk

The risk of insufficient reinsurance covers or a failure of reinsurers to pay their part of the overall liabilities (or incurred claims) evaluated on a gross basis. This risk can be further separated between: Reinsurance basis risk, and Reinsurance credit risk.

Related terms: Reinsurance basis risk, Reinsurance credit risk

Reinsurance undertaking

Means an undertaking which has received authorisation in accordance with Article 14 [of the Solvency II Directive] to pursue reinsurance activities.

Reinsurer

A reinsurer is an insurer that offers protection through the sale of a reinsurance contract to a risk-transferring policyholder who is also an insurer. If the risk-transferring policyholder a (re)insurer itself, the risk-assuming insurer is called the reinsurer, and the risk transfer is known as (retro)cession.

Reinvestment risk

Risk of a change in value caused by a deviation of the actual return on investment for funds to be reinvested, from the expected return on investment of these funds.

Related term: Market risk

Related party(ies)
Parties are considered to be related if one party has the ability (e.g. on the basis of a joint venture) to control the other party or exercise significant influence over the other party’s financial and operating decisions. It also includes corporations that are members of the same group and are controlled by a holding company.

Related terms: Arm’s length, Control

**Report to Supervisors (RSR)**

A report submitted solely to the supervisor and containing the information considered necessary for the purposes of supervision.

**Reputational risk**

Type of business risk. The risk that adverse publicity regarding an insurer’s business practices and associations, whether accurate or not, will cause a loss of confidence in the integrity of the institution.

Related term: Operational risk

*Reputational risk could arise from other risks inherent in an organisation’s activities. The risk of loss of confidence relates to stakeholders, which include, inter alia, existing and potential customers, investors, suppliers, and supervisors.*

**Required economic capital**

The total of assets measured at market-consistent value, internally required by an insurer above the market-consistent value of obligations, in order to reduce the risk of not meeting the obligations to a defined risk measure (e.g. VaR, TVaR, EPD), and within a defined time period (e.g. one year).

Related term: Available economic capital

**Required solvency margin**

The minimum amount of solvency margin stipulated by domestic law. If we denote the required solvency margin as RS and refer to the solvency formula, this would mean that AS = RS. The required solvency margin should have a level that ensures with a high probability the insurer’s ability to meet its obligations over a certain period of time or sets the expected policyholder deficit to an acceptable low level. However, the views as to which level is acceptable may differ from jurisdiction to jurisdiction.

Equivalent terms: Required minimum margin, Statutory minimum solvency margin, Minimum capital requirement, Required surplus, Regulatory capital requirement

**Reserve**

Amounts set aside to meet unforeseeable liabilities (i.e. an obligation that has not yet materialised) or statutory requirements, and stemming either from shareholders' capital or, in the case of mutuals, members’ contributions and from accumulated surplus. Reserves are part of the own funds (in contrast to provisions that support liabilities to parties other than shareholders or other owners).

Equivalent terms: Appropriated surplus, Segregated surplus, Contingency reserve

**Reserve risk**

See: Claims risk
**Resilience reserve**

A reserve for adverse movements in the capital markets to the extent that these movements will not be matched by a corresponding movement in the liabilities.

Equivalent terms: Mismatch reserve, Additional reserve for cash flow testing

**Retakafu**

The equivalent of conventional reinsurance

Related term: Takaful

**Retrospective cover**

Reinsurance cover that provides protection against a more rapid deterioration of old-year reserves than expected.

**Revaluation reserve**

Amount set aside in the balance sheet representing the difference (or a portion thereof) between purchase price and current market price if assets (investments) are valued on the basis of the current market price (market value).

**Risk**

Risk is the chance of something happening that will have an impact upon objectives. It is measured in terms of consequences and likelihood.

**Risk concentration**

A risk concentration refers to an exposure with the potential to produce losses large enough to threaten an insurer’s health or ability to maintain core operations.

Related terms: Concentration risk, Conglomerate risk, Contagion

**Risk-free (interest) rate**

The rate of return available on an asset which has no or negligible credit risk and where the pay-off is certain. Debates continue over whether government bond yields or interest swap rates are more appropriate benchmark risk free interest rates and whether illiquid risk free rates exist and should be used to value illiquid insurance liabilities.

**Risk gap**

A key measure of the adequacy of a captive’s capital and reserves is the risk gap. This is defined as the projected total of a captive’s net retained liability less year one premiums net of expenses, capital, profit and loss account balance and any other free reserves. Captive owners and managers are required to demonstrate how the captive manages the risk gap. Protection strategies may include guarantees of additional capital or premiums, LOCs, or other alternatives in a form acceptable to the supervisor.

**Risk management**

Risk management is the process whereby the insurer’s management takes action to assess and control the impact of past and potential future events that could be detrimental to the insurer. These events can impact both the asset and liability sides of the insurer’s balance sheet, and the insurer’s cash flow.
Risk margins

A generic term, representing the value of the deviation risk of the actual outcome compared with the best estimate, expressed in terms of a defined risk measure.

Related terms: Market value margin, Quantile approach

The term ‘risk margin’ in the context of Solvency II refers to the amount above the best estimate liability.

Risk measure

Means a mathematical function assigning a monetary amount to a given probability distribution forecast and increasing monotonically with the level of risk exposure underlying that probability distribution forecast.

Risk mitigation

Techniques methods of transferring risk including reinsurance but also through derivatives and other financial instruments.

Risk of error

The risk depending on the quality of the basis of computation and arising due to the lack of knowledge about the development of the expected insured risk.

Risk of excessive or uncoordinated growth

The risk that the growth of the company will lead to pressure of undercapitalisation or inadequacy of other infrastructure.

Risk of insufficient tariffs

See: Mispricing risk

Risks connected with guarantees in favour of third parties

The potential strain on the economic capacity of an insurer caused by a call on a guarantee furnished for the purpose of the financial commitments of a third-party.

Related term: Non-technical risks

Risk tolerance

An insurer's risk tolerance is a statement of the nature and amount of risk exposure that the insurer is willing to accept. The risk tolerance will dictate the risk limits that are established as part of the insurer's risk management policy.

Run-off basis

A method of considering the financial situation assuming that no new business will be written, but that the company will continue to operate with in-force business until the end of the term set by the policy conditions (e.g. the renewal date, the end of a fixed term, death of the insured person), including the settling of claims eventually arising during this period.

Related terms: Break-up basis, Going concern basis
Run-off result

The run-off result is the difference between:

- a provision made at the beginning of the financial year and
- the sum of the payments made during the year on account of that provision and the provision for the same claims shown at the end of the year

Related terms: Claims provision, Claims incurred

Scenario analysis

Simulation of an alternative set of parameters within a model in order to establish the impact on the outcome. The following types of scenarios analysis can be distinguished:

- Historical scenarios;
- Hypothetical scenarios;
- One-off events (e.g. simulation of strategic decisions).

Equivalent term: Scenario testing

Related terms: Sensitivity test, Stress test

Scenario test

A scenario test is a complicated type of test, which contains simultaneous moves in a number of risk factors and is often linked to explicit changes in the view of the world. Scenario tests often examine the impact of catastrophic events on an insurer’s financial condition, particularly in a defined geographical area, or simultaneous movements in a number of risk categories affecting all of the insurer’s business lines or trading operations, e.g., underwriting volumes, equity prices and interest rate movements. There are two basic types of scenarios: historical and hypothetical. Historical scenarios reflect changes in risk factors that occurred in specific historical episodes. Hypothetical scenarios use a structure of shocks that is thought to be plausible, but has not yet occurred. Each type of scenario has its benefits. Depending on the risks, both approaches could be of value and should thus be used.

Securitisation

Involves a simple financial concept: the future cash flows that can be expected from a particular source (e.g., receivables or loan repayments) serve to back up a financial instrument for sale to an investor. When a business entity (originator) engages a securitisation, it first transforms the cash flows into a tradable instrument and then transfers the attendant risk from the entity to capital market investors who, in turn, expect a return commensurate with the risks.

Semi-automatic facultative reinsurance

Requires the reinsurer to accept certain defined risks of the reinsured, subject to the right of the reinsurer to reject liability for any of such risks within a stated period after submission. Like facultative obligatory reinsurance, semiautomatic facultative reinsurance is a hybrid of both treaty and facultative reinsurance.

Sensitivity test

A simulation designed to test the robustness of a relationship or projection, given various changes in the underlying assumptions.

Related terms: Scenario analysis, Stress test
A sensitivity test estimates the impact of one or more small moves in a particular risk factor, or a small number of closely linked risk factors.

**Settlement risk**

The risk that the completion or settlement of a financial transaction will fail to take place as expected. It includes elements of market, credit, liquidity and operational risks. The level of risk is determined by the particular arrangements for settlement. Factors in such arrangements that have a bearing on credit risk include the timing of the exchange of value, payment and settlement finality, and the role of intermediaries.

Related term: Credit risk

**Share capital**

See: Equity capital

**Short-tailed business**

Insurance business where uncertainty about the amount and timing of claims payments is typically resolved within one year.

Related term: Long-tailed business

**Side agreements**

Formal or informal agreements (oral or written) that are not part of the reinsurance contract that essentially modify a reinsurance arrangement or alter the risk transfer inherent in the contract.

**Significant owner**

A significant owner is defined as a person (legal or natural) that directly or indirectly, alone or with an associate, exercises control over the insurer.

**Special purpose vehicle**

Means any undertaking, whether incorporated or not, other than an existing insurance or reinsurance undertaking, which assumes risks from insurance or reinsurance undertakings and which fully funds its exposure to such risks through the proceeds of a debt issuance or any other financing mechanism where the repayment rights of the providers of such debt or financing mechanism are subordinated to the reinsurance obligations of such an undertaking.

**Solo supervision**

Refers to the supervision of a licensed financial entity by the supervisor in the jurisdiction where the licensed financial entity is incorporated, whereby the supervised entity is treated as a ‘stand-alone’ entity. The solvency requirements are applied on a stand-alone basis. Under solo supervision there can be no automatic assumption that the entity in question will receive additional financial support from a parent institution, or that it - in turn - will have moral or commercial obligations to support other insurers in which it has invested beyond the extent of those investments, or other contractual obligations (e.g. guarantees). The concept of solo supervision is not in any way intended to exclude the possibility of supervision of a branch by a host jurisdiction.

**Solo-plus supervision**

Refers to a supervisory group approach that combines the solo supervision applied to all licensed financial entities with a, in general, mainly qualitative, assessment of the group as a whole, by considering all the group relations that could have an impact on the financial position of the individual licensed entities, with special attention to capital adequacy (ensuring that there is no double-gearing
or double leverage), risk concentrations, intragroup transactions and risk transfers (ensuring that they are conducted as if they were on an arm’s length basis), and co-operation among supervisors. In this case the solvency requirements are applied to all relevant entities, taking into account group-induced corrections, and - as a general check – also on an aggregated basis to the group as a whole. Consolidated supervision of a sub-group may of course be an element of solo-plus supervision of the whole group.

**Solvency**

Ability of an insurer to meet its obligations (liabilities) under all contracts at any time. Due to the very nature of insurance business, it is impossible to guarantee solvency with certainty. In order to come to a practicable definition, it is necessary to make clear under which circumstances the appropriateness of the assets to cover claims is to be considered, e.g. is only written business (run-off basis, break-up basis) to be considered, or is future new business (going-concern basis) also to be considered. In addition, questions regarding the volume and the nature of an insurance company’s business, which time horizon is to be adopted, and the setting of an acceptable degree of probability of becoming insolvent, should all be considered.

Equivalent terms: Capital adequacy, Financial health

*In the Australian life insurance context these terms “solvency” and “capital adequacy” are not used like synonyms: Solvency is used assessing financial health on a runoff basis while capital adequacy is used assessing financial health on a going-concern basis.*

**Solvency and Financial Condition Report (SFCR)**

This is the public disclosure report which is required to be published annually by all undertakings and will contain detailed quantitative and qualitative elements.

**Solvency I**

The term used for the 2002 directive updating the minimum capital requirements for EU insurers. Since the introduction of the first Solvency framework in the early 1970s, sophisticated risk management systems have been developed. Solvency II introduces a comprehensive framework for risk management for defining required capital levels and implementing procedures to identify, measure, and manage risk levels.

**Solvency II**

The European Commission’s Solvency II project is devoted to revising and extending the current rules for insurers and reinsurers. It covers a broader spectrum than existing directives: in particular it aims to take account of present developments in the fields of risk management and investment management. Solvency II is based on three Pillars (Pillar 1, 2 and 3) and in this way resembles the Basel II regulatory framework applicable to banks. The main objectives of Solvency II are to:

- assess solvency,
- build a more risk sensitive approach,
- increase the harmonisation of quantitative and qualitative supervisory methods,
- seek more efficient supervision of insurance groups and financial conglomerates,
- evolve in parallel with international trends, in particular with outcome of IASB work

**Solvency Capital Requirement (SCR)**

The solvency capital requirement is the ‘target’ level of capital defined under Pillar 1 of Solvency II calculated in accordance with predefined guidelines set out by the regulator. The SCR represents the
level of capital that an insurer is required to hold such that, in adverse circumstances resulting in losses, it would still be able to meet its liabilities when they fall due. If companies do not meet this target level of capital, then the regulator will undertake certain predefined steps which may include requiring the company to produce a recapitalisation plan and/or implement a plan to reduce its risks. Insurers will be able to choose between using the standard model or their own internal models to calculate the SCR. The SCR may be adjusted to reflect the Pillar 2 supervisory review process including, for example, the results of stress and scenario testing.

Abbreviation: SCR

Related terms: Adjusted Solvency Capital Requirement, Minimum Capital Requirement

It is expected that the SCR may be derived using either an approved internal model or the standard formula.

Solvency margin

This term is used in the current Directives but will no longer be used under Solvency II and will be replaced by ‘Solvency Capital Requirement and Minimum Capital Requirement’.

Spread risk

The risk of a change in value due to a deviation of the actual market price of credit risk from the expected price of credit risk.

Related term: Market risk

Stabilisation reserve

See: Equalisation provision

Standard formula

A set of calculations prescribed by the regulator for generating the Solvency Capital Requirement (SCR). This is likely to be through the use of standardised factors or stress tests. The standard formula is intended to be able to be used by a very wide range of undertakings and so will necessarily be relatively unsophisticated.

Related term: Internal model

The standard formula is intended to be able to be used by a very wide range of undertakings.

Statutory solvency margin

See: Available solvency

Statutory surplus

See: Available solvency

Stop loss

An arrangement where the company accepting the reinsurance risk indemnifies the ceding company for an aggregate or cumulative amount of losses in excess of a contractually specified aggregate. Such aggregate can be defined as an amount or as a loss ratio.
Strategic risk

Type of business risk. The risk of a change in value due to the inability to implement appropriate business plans and strategies, make decisions, allocate resources, or adapt to changes in the business environment.

Related terms: Business risk, Management risk, Operational risk

Statistical quality test

Quality standards that need to be adhered to, ensuring that the data and methodology underlying both internal and regulatory applications are sufficiently reliable.

Straw men

People used as a front to hide the identity of their principal on whose instructions they act.

Stress test

The method of solvency assessment that provides for the consideration of the impact (current and prospective) of a particular defined set of alternative assumptions or outcomes that is adverse. Consideration is given to the effect on the insurance company assets, liabilities and operations of a defined adverse scenario.

Abbreviation: ST

Equivalent terms: Dynamic financial analysis, Pessimistic scenario test, Adverse scenario test

Related terms: Scenario analysis, Sensitivity test

Subordinated loans

Loans (liabilities) that rank after the claims of all other creditors and to be paid, in the event of liquidation or bankruptcy, only after all other debts have been met. These items may be part of OLd in the solvency formula.

Equivalent terms: Subordinated liabilities, Subordinated debt, Subordinated debenture

Subscribed capital

See: Equity capital

Subsidiary undertaking

Means any subsidiary undertaking within the meaning of Article 1 of Directive 83/349/EEC, including subsidiaries thereof.

Sum at risk

The sum that the insurer must add to the technical provisions in case of death, a base for the exposure to adverse deviations in the mortality assumptions.

Supervisor

See: Supervisory body
Supervisory authority

Means the national authority or the national authorities empowered by law or regulation to supervise insurance or reinsurance undertakings.

Supervisory board

In a two-tier board system of corporate governance, the body whose function is to supervise, on behalf of the shareholders, or policyholders in the case of a mutual, the activities of the management board.

Related terms: Board of directors, Management board, Two-tier board system of corporate governance, Unitary board system of corporate governance

Supervisory body

Body responsible for supervision of the management of an insurer or intermediary.

Related terms: Supervisor, Supervisory authority

Supervisory co-operation

Processes designed to achieve effective the regulation of cross-border groups and the consistent application of the relevant directives to insurers across the EU.

Supervisory ladder

In the context of Solvency II, describes the scale of control levels and accompanying supervisory measures for capital levels between the Solvency Capital Requirement and the Minimum Capital Requirement.

Supervisory law

Rules and regulations being applied by the insurance supervisor / insurance supervisory authority to insurance companies and/or reinsurance companies.

Equivalent terms: Supervisory legislation, Supervisory regulation

Supervisory powers

The powers given to supervisory authorities to carry out their tasks. Member States must ensure that supervisory authorities have the power to take any measure necessary to ensure that undertakings comply with the regulatory requirements set out by the Directive as well as to prevent and remedy any irregularities.

Supervisory regulation

See: Supervisory board

Supervisory returns

See: Financial returns

Supervisory Review Process

Under Solvency II, Pillar 2 is often referred to as the Supervisory Review Process and can be seen as a qualitative approach to supervising insurers. It describes the process that enables the supervisory authority to evaluate, on an ongoing basis, whether the undertaking fulfils all relevant regulatory requirements. The supervisory review process is designed to encourage insurers to continuously
improve their internal procedures for assessing risk and the adequacy of their capital. It aims to identify insurers with financial, organisational or other features susceptible to producing a higher risk profile. The SCR for such organisations may be adjusted upwards.

Abbreviation: SRP

**Surety business**

An obligation undertaken (a surety bond or guarantee) by one party (the surety) to another party (the beneficiary), to ensure the fulfilment of contractual, legal, or regulatory obligations by a third-party (the principal) up to the bond limit.

Related term: Credit insurance

**Surplus capital**

Term commonly used to refer to that part of the available solvency margin that is held by an insurer in excess of the Solvency Capital Requirement.

Equivalent terms: Excess capital, Regulatory surplus

Related terms: Available solvency margin, Solvency Capital Requirement

**Surplus relief**

A method of deferring losses or accelerating future profits on a block of in-force or new insurance business. This can be done in three ways:

- reinsurer pays an amount equal to its best estimate value of all future margins and takes all future income, however there is no experience refund. This is a traditional risk transfer in that the reinsurer is taking a risk that the profit may not emerge as projected.
- reinsurer pays initial expenses, has a charge over all emerging surplus and returns excess surplus through the experience account. In this situation the reinsurer will suffer a loss if the profits do not emerge as projected. The reinsurance agreement does not limit the loss exposure to the reinsurer. If the profits are over a certain level, these are returned to the cedant via the experience account, which caps the reinsurer’s potential for profit. This is a finite reinsurance transaction.
- reinsurer pays an upfront amount, takes a charge over future margins, however if the margins do not emerge the cedant has an obligation to make payments from sources outside the reinsured business. This should be treated as a loan.

**Surplus share reinsurance**

This type of proportional reinsurance is a variation on the quota share concept. Instead of sharing every policy on the basis of a never-changing fixed ratio, a surplus agreement permits the insurer to cede varying amounts or percentage shares of each original policy to the reinsurer. The amounts ceded are still subject to a stipulated minimum retention and maximum cession. Once a cession has been made to the surplus treaty, premiums, expenses and losses will be shared proportionally between the insurer and the reinsurer.

**Surrender**

The termination of an insurance contract by the policyholder.

Related terms: Lapse, Surrender risk

The insurer pays the policyholder or its beneficiary the cash value which is contractually agreed or legally prescribed.
Surrender risk

The risk of a change in the value of an insurance policy caused by a deviation of the actual surrenders (premature terminations) from the expected surrenders, i.e. those assumed in the valuation, due to full repurchase, partial repurchase, premium reduction, conversion to paid-up policy status or transfer.

Related terms: Lapse risk, Surrender

Though driven by the same risk driver, i.e. the potential premature termination of an insurance contract, surrender risk is different from lapse risk because it relates to the change in value that is caused by the premature termination of contracts with a surrender value, while lapse only relates to the premature termination of contracts without a surrender value.

Swap

A financial transaction in which two counterparties agree to exchange streams of payments over time according to a predetermined rule. The most common form of swap is a “vanilla” interest rate swap. With that structure, one party pays interest at a fixed rate while the other pays according to a floating rate such as LIBOR.

Swaption

An option on a swap

Systematic risk

Any risk inherent to the entire market or entire market segment which cannot be mitigated through diversification.

Equivalent term: Non-diversifiable risk

Related term: Hedgeable risk

Also known as non-diversifiable risks (as measured by an assets’ beta), contrary to idiosyncratic risks.

Systemic risk

The risk of experiencing systemic events which may lead to the failure of institutions, markets or financial systems.

Related term: Contagion

The spectrum of systemic risk ranges from the second-round effect on a single institution or market to the risk of having a systemic crisis affecting most of the (or even the whole) financial system. The geographical reach of systemic risk can be regional, national or international.

Tail-Value-at-Risk

A coherent risk measure. For a given confidence Level 1-α it measures the average losses over the defined threshold (typically set as the VaR for a given quantile), i.e. the conditioned mean value, given that the loss exceeds the 1-α percentile.

Abbreviations: TVaR, TailVaR

Equivalent term: Expected shortfall, Contingent Tail Expectation (CTE)

Related term: Value-at-Risk
**Takaful**

Is the Islamic counterpart of conventional insurance, and exists in both life (or “family”) and general forms. It is based on concepts of mutual solidarity, and a typical Takaful undertaking will consist of a two-tier structure that is a hybrid of a mutual and a commercial form of company. In addition, all the functions of a Takaful undertaking should conform fully to Islamic law.

Related term: Retakaful

**Target capital**

Term formerly used in the initial papers of the Commission Services, but no longer used and changed into Solvency Capital Requirement.

**Technical liabilities**

See: Technical provision

**Technical provisions**

Technical Provisions are the amount that an insurer needs to hold in order to meet its expected future obligations on insurance contracts.

Abbreviations: TP

Related terms: Insurance obligation, Provision

**Technical risks**

Technical risks (liability risks) represent the various kinds of risk that are directly or indirectly associated with the technical or actuarial bases of calculation for premiums and technical provisions in both life and non–life insurance, as well as risks associated with operating expenses and excessive or uncoordinated growth. Technical risks result directly from the type of insurance business transacted. They differ depending on the class of insurance. Technical risks exist partly due to factors outside the company’s area of business activities, and the company often may have little influence over these factors. The effect of such risks – if they materialise – is that the company may no longer be able to fully meet the guaranteed obligations using the funds established for this purpose, because either the claims frequency, the claims amounts, or the expenses for administration and settlement are higher than expected. When considering the technical risks, the issues paper proposes distinguishing between “current risks” and “special risks”. Current risks consist of the following elements:

- risk of insufficient tariffs,
- deviation risk,
- risk of error,
- evaluation risk,
- reinsurance risk,
- operating expenses risk, and
- risks associated with major or catastrophic losses or accumulation of losses caused by a single event.

As to the special risks, they can be considered to consist of the following:

- risk of excessive or uncoordinated growth, leading to a rapidly increasing claims ratio or an aggravated expenses ratio, and
- liquidation risk.

Equivalent terms: Insurance risk
Term insurance

Insurance payable to a beneficiary upon the death of the insured, provided death occurs within the term of the contract.

Equivalent term: Term life insurance

Related term: Life insurance

Term products are often sold as a rider or linked to another product, e.g. a mortgage or investment product.

Terrorist financing

The wilful provision or collection, by any means, directly or indirectly, of funds with the intention that the funds would be used, or in the knowledge that they are to be used, to facilitate or carry out terrorist acts.

Third-country insurance undertaking

Means an undertaking which would require authorisation as an insurance undertaking in accordance with Article 14 (of the Solvency II Directive) if its head office were situated in the Community;

Tier 1 and Tier 2 capital

References types of capital quality reflecting the permanency and loss-absorbency of the capital. Tier 1 includes share capital; it represents a higher quality of capital than Tier 2 which includes certain forms of subordinated debt.

Tier 3

Any basic and ancillary own fund items not covered under Tier 1 and Tier 2.

Time horizon

Time horizon is a period over which a risk is measured. Assuming a certain fixed acceptable level of insolvency risk per year, extending the time horizon should always result in a higher capital need.

The time horizon for the SCR is set at one year and the confidence level will be set accordingly.

Top-5-(reinsurance) concentration ratio

Refers to the reinsurance premium paid to the five largest reinsurers of the insurer as a ratio of the total reinsurance premium paid to reinsurers.

Total adjusted capital

See: Available solvency

Total balance sheet

Total balance sheet requirement is the sum of both the liabilities and solvency capital requirement upon realistic values. Using the total balance sheet requirement allows solvency assessment to be relatively independent of the accounting system.

Total claim liability

See: Claims provision
Total balance sheet approach

Principle which states that the determination of an insurer’s capital that is available and needed for solvency purposes should be based upon all assets and liabilities, as measured in the regulatory balance sheet of the insurer, and the way they interact.

Treaty reinsurance (non-life)

Are usually automatic arrangements in that the insurer does not have to make specific cessions in order to activate reinsurance protection. Exceptions to this general rule are special acceptances, a procedure by which risks that do not qualify for coverage under the terms and conditions of the treaty may be submitted to the reinsurer for specific underwriting evaluation and determination of any additional premium charge. Treaties are also usually obligatory, in that the cedant is obligated to cede all business defined by the reinsurance agreement, and the reinsurer is obligated to accept all such business, subject to the terms and conditions of the contract. Surplus treaties are sometimes non-obligatory from the insurer’s standpoint as the insurer may elect not to cede a specific risk, or to cede something less than the maximum cession permitted under the contract provisions. Treaty reinsurance usually applies to a broad segment of the insurer’s overall book of business (e.g., all Workers’ Compensation business, all Commercial Property business, all Accident & Health business, all Aviation business, etc.). All sorts of segregations are possible, but the idea is to group together entire lines or classes of business. As long as the business to be reinsured is reasonably homogeneous in nature or exposed to loss arising from a common cause and written in sufficient volume it can be considered for treaty reinsurance. A sufficient volume of reinsurance is necessary in order to satisfy the reinsurers’ need to collect reinsurance premiums that bear a reasonable relationship to the assumed liabilities. Treaty reinsurance is considered to be the most efficient and least expensive way of arranging for such transfers.

Trigger amount

See Control level

Trigger point

See: Control level

Two-tier board system of corporate governance

When the corporate governance of an insurer is divided into two boards and executed separately; where a supervisory board supervises a management board. This system exists in jurisdictions in which, for reasons of conflict of interest, a member of the management board (business operational function) cannot be a member of the supervisory board (monitoring function) of the same legal entity at the same time.

Other related terms: Board of directors, Management board, Supervisory board, Supervisory body, Unitary board system of corporate governance

Type A risk

Type A credit risk is the credit risk relating to actual assets held.

Type A market risk is the market risk relating to the volatility of the market value of the actual assets held and the market value of the replicating portfolio of assets.

Type B risk

Type B risk is the credit risk involved with future reinvested assets.

Type B market risk is the market risk involved with future reinvestment assets and long-term options and/or guarantees.
Unbiased valuation (of an insurance liability)

The best estimate plus a margin which reflects the true uncertainty in the insurance liability.

Unbundling (Bifurcation)

For accounting purposes unbundling is the separation of a contract into financing and risk transfer components.

Underwriting risk

Means the risk of loss or of adverse change in the value of insurance liabilities, due to inadequate pricing and provisioning assumptions.

Underwriting year basis

Accounting figures – for instance, claims incurred – are based on the contracts underwritten in the accounting period.

Related term: Claims incurred

Unearned premium reserve

See: Provision for unearned premiums

Unexpected loss

See term: Credit risk

Unitary board system of corporate governance

When there is only one high level of corporate governance, being the board of directors with all corporate powers, as opposed to a two-tier board system where a supervisory board supervises a management board.

Related terms: Board of directors, Management board, Supervisory board, Supervisory body, Two-tier board system of corporate governance

Unit-linked contract

A contract in terms of which benefits are determined based on the fair value of units of a mutual fund. The benefit reflects the fair value of a specific number of units, which is either contractually determined as a fixed number, or derived from other events under the contract, e.g. premium payments associated with a specific additional number of units based on the fair value of the units at the time of premium payment.

In some cases additional guarantees can be given, e.g. minimum guaranteed maturity benefits, term insurance, etc. The investment risk is borne by the policyholder. Other forms are index linkage, where the linked items are of such a kind, that the insurer is able to match entirely, or investment linkage, where the contract does not refer to the fair value of units but to the fair value of assets in a portfolio. Performance-linked contracts refer to the returns recognized under a specific measurement approach from that portfolio or other performance of the insurer as actually occurred or recognized.

Unit-linked policy

Is a life insurance contract which guarantees a link between policyholder funds and external equity or bond indices or market values.
Universal life insurance

A flexible premium life insurance policy, resembling a savings account combined with a term insurance funded from the savings account, under which the policyholder may change the death benefit from time to time (with satisfactory evidence of insurability for increases) and vary the premium payments.

Related term: Life insurance

Unrealised gains

The increased market value of an asset that is still being held compared with its cost of acquisition. Unrealized gains are not usually taxable.

Unrealised losses

The reduction in value of an asset that is being held compared with its original cost. An unrealized loss usually must be realized by closing out the position before it can be recognized for tax purposes. Also called paper loss. Compare realized loss. See also wash sale.

Use Test

A test to ensure that an internal model used to calculate the Solvency Capital Requirements is genuinely relevant to and widely used within risk management as well as economic and solvency capital assessment and allocation processes. Undertakings will be subject to the “use test” in gaining internal model approval.

Value at risk

Value at Risk is defined as the loss a company can suffer, over a specific period for a given level of probability.

Abbreviation: VaR

Related term: Tail-Value-at-Risk

Value at risk models

Systems which use statistical approaches to determine the value at risk of all or part of an insurer’s operations.

Value of in-force business

The value of future distributable post-tax profits, expected to emerge on business already written (including renewals), i.e. the in-force business. VIF excludes any value associated with future new contracts that have not yet been written.

Abbreviation: VIF

Related terms: Embedded value, European embedded value, In-force business

VIF is calculated using current actuarial, economic and operational assumptions and is part of the embedded value.

Volatility risk

Volatility is the risk of random fluctuations in either the frequency or severity of a contingent event.
Whistle blowing

The exposure and reporting of fraud by a member of the public or within an insurer by a director of the board, a manager or a member of staff.

Whole-life insurance

Insurance payable to a beneficiary upon death of the insured whenever that occurs: premiums may be payable for a specified number of years (limited payment life) or for life (straight life).

*Whole-life products typically provide level death benefits and vary mainly with respect to the period over which premiums are paid, varying from single premium to full-lifetime premium payments.*

Withdrawal (of a license)

Removal of a license by the insurance supervisory authority.

With-profit product

See: Performance linked benefit

Workers compensation insurance

Insurance cover for the cost of medical care and rehabilitation for workers injured on the job, during the way to and from the job, or to work-related diseases.

Related terms: Disability insurance, Health insurance, Life insurance

*Workers compensation insurance also compensates for wage loss and provides disability or death benefits for beneficiaries if the insured person is killed or injured in work-related accidents.*

Yearly renewable term

Reinsurance arrangements written on this basis transfer the mortality risk to the reinsurer. For every age, plan, and policy year, there is a certain reserve per $1,000 of insurance. In calculating the insurer’s available surplus capital, this is the liability that is deducted from assets to arrive at the insurer’s available surplus capital. Since this reserve amount is already in the insurer’s liabilities, it is clear that if the insurer is called upon to pay more than this amount, only the excess over the reserve needs to be taken from the insurer’s available surplus capital. In the event of a death claim, assets are reduced by the face amount paid, liabilities are reduced by the reserve amount, and the excess of the face amount over the reserve comes from its available surplus capital. This excess is called the “policy net amount at risk.” In the reinsurance agreement the ceding company and the reinsurer agree upon how the policy net amount at risk will be apportioned between them. The ceding company would prepare a schedule of the net amounts at risk for each policy year. The reinsurer would develop a schedule of yearly renewable term premium rates for reinsurance on the ceding company’s schedule. The ceding insurer would pay the reinsurer the established premiums for the appropriate net amounts at risk each year. In the occurrence of a claim, the reinsurer would remit payment for the assumed portion of the policy’s net amount at risk. Although the policy net amount at risk will decline over time as the policy reserves increase, it is common for the parties to agree to make adjustments only at agreed intervals to ease administration and lower processing costs. This reinsurance method is widely used because it reduces reinsurance to its fundamentals and provides a very flexible mechanism for satisfying the insurer’s reinsurance needs.

Abbreviation: YRT

Equivalent term: Risk premium reinsurance basis
2. ACKNOWLEDGEMENT

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- CEA website – Insurers of Europe - Solvency II Glossary
- Watson Wyatt website – Glossary of terms
- FSA (Financial Services Authority)
- EU Solvency II Directive
- IAIS (International Association of Insurance Supervisors) website
- Source: CEIOPS issues paper
- Source: CRO forum on Market Value of Liabilities for Insurance Firms
- Adapted from CEIOPS CP 37 CEIOPS-CP-37/09 (26 March 2009)
- Source: http://www.acted.co.uk/forums/showthread.php?t=3312
- Source 4(1) directive 2006/48/EC
- Source 4(5) directive 2006/48/EC
- Source: Article 1(3) of Directive 72/166/EEC
- http://www.emb.com/uk/news/is-your-board-fit-for-Solvency-II.php