

THE EFFECT OF REGULATORY CHANGE ON THE DISTRIBUTION OF LIFE ASSURANCE IN THE UNITED KINGDOM

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Abstract

Since the 1950s favourable tax treatment of life assurance and constraints on the widespread marketing of alternative vehicles such as unit trusts have led to life assurance becoming a major home for long term savings in the United Kingdom. In turn, this has resulted in life assurance being included within the scope of the Financial Services Act 1986, which regulates the marketing and management of investments generally.

In the six years since the Act's main provisions came fully into force in 1988, there have been dramatic shifts in patterns of distribution, either as a direct consequence of the Act or as an acceleration of trends already underway.

Enforced polarisation of intermediaries between sole agencies and independents with no affiliation increased competition for access to distribution which in turn led to increased costs. Banks recognised the intrinsic net worth of their captive client base and endeavoured to maximise this firstly by sole agency agreements and then by acquiring or developing their own life assurance subsidiaries.

In the absence of significant constraints, companies continued to recover costs as rapidly as possible. Reduced persistency as a result of overselling and economic recession fuelled consumer concerns over poor early surrenders values. To encourage a reduction in costs, a more overt disclosure regime is to be introduced from 1st January 1995. Some contraction of the industry is anticipated, particularly amongst the less cost-effective participants.

Keywords : United Kingdom. Life Assurance. Distribution. Regulation. Bancassurance. Consumerism. Disclosure.

The Life Insurance Market Prior to 1988

The life insurance market in the United Kingdom between the mid 1950s and 1988 can be characterised as follows:

- (i) Many competing companies, not more than one or two with a market share exceeding 10% and none exceeding 20%.
- (ii) An environment of increasing confidence that a managed portfolio of equity shares would significantly outperform fixed interest securities or deposits over the medium and long term.
- (iii) A tax framework which encouraged investment in such assets via a life insurance shell rather than directly or via unit trusts. Although excessive exploitation of these tax advantages led to their removal, a desire to encourage personal saving - in particular for retirement and house purchase - ensured that longer term products remained advantaged.
- (iv) A market initially divided between firms which sold via unassociated agencies (e.g. insurance brokers, accountants, solicitors, banks and building societies) and those with their own "home service" sales forces. The former targeted mainly professional people and the latter the lower socio-economic groups. However, a number of direct sales forces established by market newcomers retailing primarily unit-linked business began to target the professional classes. At the same time, economic and social changes led to a blurring of class distinctions and a relative increase in wealth of the working classes.
- (v) A supervisory environment which increasingly ensured that life insurance companies, whilst retaining freedom in product design, held prudent reserves, minimising the risk of loss to policyholders. From 1975 onwards, the additional safeguard of a compensation scheme for the victims of failed insurance companies was established (under the terms of the Policyholders Protection Act).
- (vi) Commission terms to agents under which payments became increasingly concentrated at the outset of the contract. For the majority of companies, until 1982, commission payments to agents

(but not direct sales forces) did not exceed a scale agreed by the industry representative body (then the Life Offices' Association (LOA)). However, enough companies were prepared to leave the LOA in order to "buy" business with higher commission that the scale had to be dropped at the beginning of 1983.

- (vii) Nominally independent intermediaries could receive overriding commission from preferred providers, resulting in a general blurring of distinction in many cases between tied and independent advisers.
- (viii) Life Insurance companies enjoyed some marketing advantages over competitors for individuals' savings, such as unit trust managers, in that it was permissible to approach potential customers unsolicited for life assurance but not for unit trusts or direct share sales. This opportunity was exploited by the direct selling offices in particular.

Investor Protection Prior to 1988

There was little regulation of either the independent agents or employed salesmen of life insurance companies so far as their conduct with customers was concerned. The LOA had a code of conduct which member insurers were supposed to impose on their agents. Enforcing compliance on independent agents was not easy, however, and many companies with direct sales forces were not even members of the LOA. From 1977 on, those who wished to register as insurance brokers in terms of the Insurance Brokers Registration Act (necessary if they wished to use the description 'insurance broker') had to follow a code of conduct, requiring a client's interest to be put above their own, for example. There was no enforcement, however. Agents who were accountants or solicitors also had their own professional codes to follow.

Looking more widely at general investment management and advice, the Prevention of Fraud (Investments) Act of 1958 required those who dealt in securities to be registered by the Department of Trade. No evidence of competence was required and a licence could only be refused or revoked if the dealer was convicted of fraud or dishonesty or some breach of the Conduct of Business Rules made under the Act. There was no inspection of licensed firms, so action was only taken after investors had been disadvantaged.

Of particular concern were those who were agents of licensed dealers and could undertake the provision of investment advice and client asset management without being in technical breach of the Act. This resulted in a considerable number of dealers, managers and advisers not regulated in any way as those for whom they acted as agent bore no responsibility for their actions either. There were also many others who should have had some form of authorisation to trade but were never prevented from operating.

The Act did impose a number of restrictions on the marketing of investments which were generally adhered to, but life assurance policies were specifically exempted, leading to the marketing advantages referred to in (viii) above.

The Insurance Companies Act, on the other hand, did have a few rudimentary regulations regarding fairness of sales messages, a “cooling off” period in which the new policyholder could change his mind (but not in respect of single premium policies where such a period was perhaps most needed) and some controls over the type of assets to which policies may be linked.

The Legislative Reaction

As a result of a number of cases of malpractice resulting in investor losses, in 1981 Professor L C B Gower was invited by the Government to carry out a review of investor protection. Gower’s assessment was that the current legislation was

- complicated and, particularly regarding life assurance, inconsistent
- laxly enforced and virtually impossible for those who suffered loss to gain recompense
- not ensuring competence
- in the hands of too many regulators, with insufficient reliance on self-regulation (which Gower felt was more effective).
- resulting in there being a significant number of investment advisers and managers who escaped regulation entirely.

Gower proposed a number of remedies which, after discussion with relevant industry bodies and lengthy political debate, formed the core of the Financial Services Act 1986. This Act, which came into full effect during 1988, gives the Treasury the responsibility of enforcing its provisions. Many of these factors have been delegated to a semi governmental body, the Securities and Investments Board. SIB is responsible for monitoring the effectiveness of the Self Regulatory Organisations (SROs) and other bodies recognised under the Act, for regulating those who cannot or do not wish to join an SRO and for the general enforcement and maintenance of the Act and its accompanying regulations.

The Financial Services Act has the following main provisions:

- (i) "investment business" is defined broadly to encompass:
 - dealing in investments as principal or as an agent,
 - managing investments
 - giving investment advice
 - making arrangements for the above to occur (except for introductions to authorised independent advisers).
- (ii) "investments", too, are defined broadly, encompassing not just stocks, shares and derivative instruments but also units in collective investment schemes and long term insurance policies (except most pure term assurances and permanent health insurance (PHI) without an investment element).
- (iii) only those authorised or exempted under the Act can legally carry out investment business.
- (iv) Life Insurance companies, Friendly Societies (mutual benefit societies which are authorised under specific legislation to issue life assurance) and Recognised Collective Investment Scheme Operators are automatically authorised under the Act. Other firms and individuals can become authorised in one of three ways:

- joining a recognised SRO
- certification by a recognised professional body (RPB)
- directly by SIB

Firms and individuals equivalently recognised by another EC state are also deemed to be authorised

- (v) certain firms or individuals are exempted from authorisations
 - recognised investment exchanges and clearing houses
 - Lloyds agents, so far as their activities relate to the Lloyds insurance market
 - the Bank of England and certain other institutions with regard to wholesale money market activities
 - representatives of authorised businesses for whom the business has accepted full responsibility
- (vi) SIB is given certain powers to make regulations in a number of areas, including:
 - conduct of business
 - cooling-off periods
 - compensation

Some of these rules apply to all authorised persons, whereas others only apply to those not members of SROs or RPBs.

- (vii) SIB is also given powers of intervention in the affairs of individuals and recognised bodies, culminating in disqualification or derecognition in certain circumstances. SIB can also initiate criminal prosecutions for breach of the Act.

- (viii) SIB, and the SROs, have statutory immunity from actions for damages in relation to performing their regulatory function in good faith.
- (ix) SIB's Rules and those of SROs are subject to the approval of the Treasury, which must first seek advice from the Office of Fair Trading (OFT) on the extent, if any, to which proposed rules inhibit competition within the industry to the detriment of consumers.

SIB will only continue to grant recognition to SROs, RPBs and exchanges if their rules have generally the same effect as SIB's own.

Although directly authorised under the Act, most life insurance companies friendly societies and unit trust operators marketing to the public chose to form an SRO and to be subject to that SRO's rules and discipline rather than to those of SIB. This was primarily to ensure that they could have the maximum input to the development and enforcement of their own regulation.

As at 30th June 1994 there were:

- 219 Life Insurance Companies
- 171 Friendly Societies
- 173 Unit Trust Management Companies

authorised by the PIA's predecessor SRO (*source PIA*)

A fully annotated text of the Act and SIB's regulations can be found in Lomnicka and Powell⁽¹⁾.

SROs and RPBs

Initially 5 SROs were formed, however these have since reduced to 3:

- SFA - The Securities and Futures Authority (for stockbrokers, derivative dealers etc)
- IMRO - The Investment Management Regulatory Organisation (for institutional fund managers)

PIA - The Personal Investment Authority (for those marketing investments, especially life assurance and unit trusts, directly to the public)

It is interesting to note that one of the requirements for the recognition by SIB of PIA in 1994 was that its controlling Board should only have a minority of members from firms regulated by PIA. The majority expressly represent the public interest.

A more detailed study of the early days of the Act and the SROs can be found in Kipling⁽²⁾.

Four professions have so far sought recognised status for one or more of their professional bodies. These are actuaries, accountants, solicitors and insurance brokers. At first sight, the latter might be a little strange. However, as mentioned above, the Insurance Brokers Registration Act already provided for some regulation of the conduct in general of insurance brokers. The Council established by that Act can now also authorise brokers to transact investment business, provided that carrying out such business is not their main activity.

One major insurance company, at 31st December 1994, remains directly regulated by SIB, having refused to join PIA on principle.

Regulation by PIA

In the process of giving substance to SIB's broad principles and regulatory intent in a specific market context, the PIA and its predecessors introduced or emphasised three significant principles:

- (i) polarisation - an agent tied to any one insurance company may not advise on or sell the investment products of any other company. The only alternative for a person or firm wishing to sell investment products is to be a PIA member in their own right - and of necessity independent of any product company.
- (ii) best advice - all types of intermediary must only recommend/sell investment products which are suitable (i.e. which

meet a genuine need of the investor, which the investor can afford and which have only the degree of risk to which it is appropriate for the investor to be exposed). Tied agents must recommend the most appropriate product from their company's range. Independent intermediaries must recommend the most appropriate product from the entire market.

- (iii) competency - intermediaries of either type must be adequately trained before advising and selling.

Polarisation, Competency and other rules all aim to create an environment in which best advice can be delivered. For example, commission scales must not be such as to unduly influence the choice of products (although term-dependency is permitted). Initially, a maximum scale was introduced for independent intermediaries, to reduce the possibility of bias in their selection of companies. However, the OFT advised that this restricted competition (it had rapidly become a norm) and should be withdrawn in favour of overt disclosure of commission.

Intermediaries must also formally identify investors' financial circumstances and investment objectives and must provide reasoned justification for the products which they are recommending. For example, clients' existing long-term investment arrangements should normally be left intact unless *bona fide* in the investor's best interest. Similarly, priority should normally be given to basic life assurance protection and provision for retirement over more speculative investment products.

PIA members are required to deal promptly and fairly with complaints from the public about bad advice or other rule breaches by themselves or their tied agents. If the complaint is not dealt with satisfactorily, the complainant may present his case to the PIA Ombudsman (adjudicator) who will investigate and award compensation if appropriate. The Ombudsman's decision is binding on the PIA member.

PIA rules also ensure disclosure of the status of an intermediary (i.e. whether 'tied' or not), fair advertising, disclosure of product details before a sale is made and a consistent basis of illustration of the future proceeds of a

policy (on standard interest rates, and until 31st December 1994, standard mortality and expense assumptions, too).

The Effects of Polarisation

As the framework of the Act and the associated SRO rules emerged during 1987, it became clear that the majority of intermediaries who were nominally independent faced a choice under the new philosophy of polarisation:

- (i) tie to one product company, with the following advantages:
 - no maximum commission scale
 - no restriction on product company support
 - only one range of products with which to become familiar
 - product company responsible for regulatory compliance
- (ii) remain independent and be able to offer a wider product range, both in terms of different companies' insurance products and, if competent, other types of investment.

Not surprisingly, a significant proportion of advisers chose option (i), using their access to customers as a bargaining tool to negotiate commission higher than the maximum initially allowed to independent intermediaries. Many product Companies actively competed to tie intermediaries. Other initially chose instead to deal only with independent advisers, although very few now retain this stance.

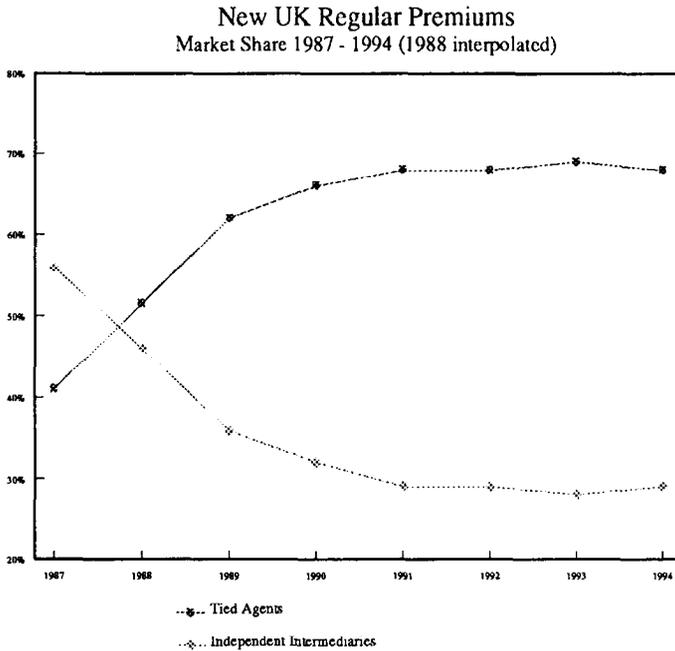


Fig. 1: Source: Association of British Insurers

As can be seen from Figure 1, the proportion of regular premium business written by tied agents as opposed to independent intermediaries rose from 40% in 1987 to 70% in 1993, most of this change taking place within the first two years but with further widening subsequently. The removal of the maximum commission limit for independent intermediaries took place in May 1989 and, although in the absence of full disclosure this led to an increase in commissions payable to independent intermediaries, there was no reversal of the continuing drift to tied status. However, many smaller independent intermediaries have banded together into 'networks' (or joined existing networks), sharing central facilities and increasing their negotiating power on commissions with product providers.

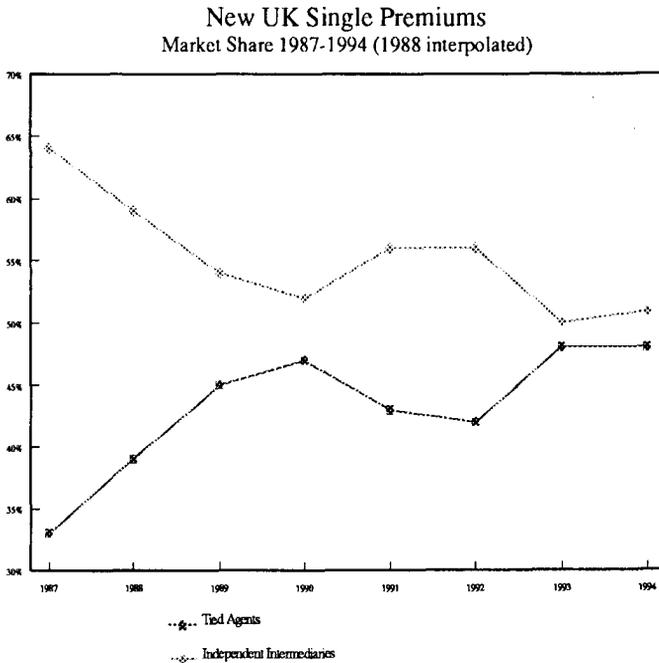


Fig. 2: Source: Association of British Insurers

The proportion of single premium business written by tied agents (Figure 2) has also risen since 1987, but only from 35% to 50%. This business, paying relatively less commission per case and generally being of more relevance to the more sophisticated investor, has traditionally been purveyed by the type of adviser more likely to wish - and to be able to afford to maintain - independent status.

The Changing Mix of Business

Figures 3 and 4 show new life insurance premiums for the years 1987 to 1994 inclusive (1994 estimated from 9 months' data). Regular premiums rose rapidly until 1990 and have then been in steady decline. Single premiums fell in 1988 but then rose rapidly, peaking in 1993.

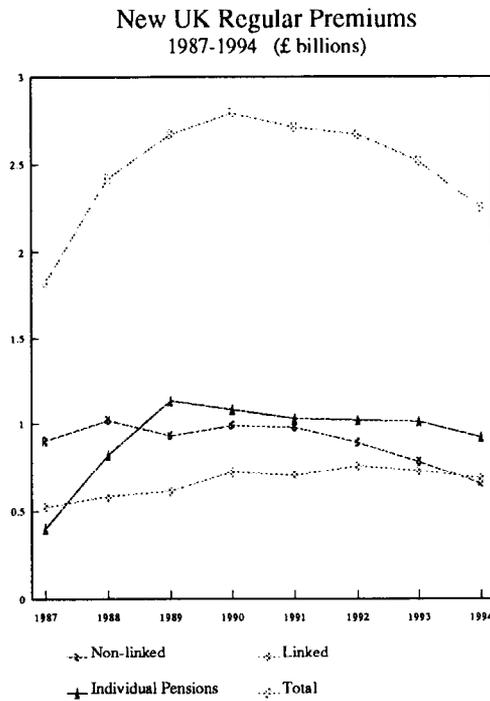


Fig. 3: Source: Association of British Insurers

The overall trends can actually be analysed into a number of different underlying changes for different classes of business. Many of these changes can be attributable to the Financial Services Act and its implementation, at least in part, and I have attempted to bring out the reasons below:

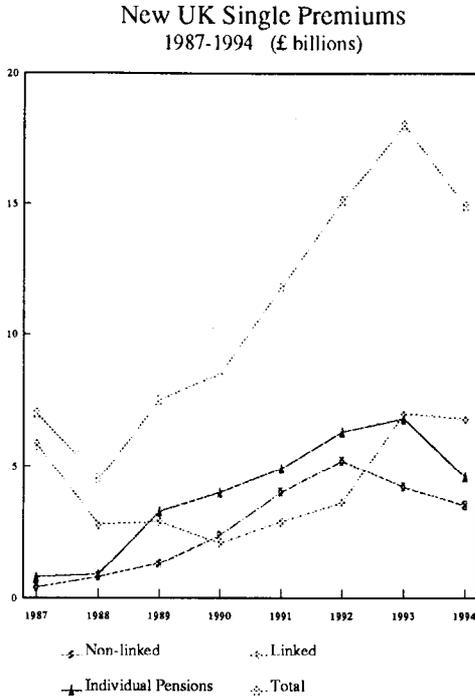


Fig. 4: Source: Association of British Insurers

(i) **Regular Premiums**

(a) **Non-linked Life**

This class is made up largely of ‘with-profits’ endowment assurance. In 1987, endowments were sold in considerable quantities as a vehicle for repaying interest-only mortgages, usually over a 25 year term.

A number of factors have contributed to the decline in this mortgage endowment business, much of which was obtained through the agency of building societies:

- the decline in house prices and in the number of house purchases since 1990

- reductions in bonus rates which resulted in some consumer concerns, not necessarily justified, that some policies will fail to repay the loan
- 'best advice' considerations that other products might be more efficient vehicles for repaying the loan and that existing endowment policies should not (as was often previously the practice) be surrendered and replaced when the lender was changed
- the formation of in-house insurance companies by building societies, usually offering only unit-linked policies
- reduction in the rate of tax relief on mortgage interest
- market saturation.

(b) Linked Life

Apart from the formation of new bancassurance companies selling predominantly unit-linked business (discussed later), the growth in such business is also attributable to the 'best advice' need to provide protection products. To avoid taking on onerous and possibly ill-understood guarantees and because no established with-profits fund was available, many offices choose to write protection business (including PHI and critical illness covers) on a unit-linked whole life basis, with the discretion to increase the risk charges if experience dictates.

(c) Individual Pensions

In 1988, new Tax and Social Security legislation was enacted with considerable publicity, introducing a new regime of Personal Pensions, available to all of those not in a pension scheme run by an employer. This widened the scope of the old 'self-employed' pension regime, particularly with regard to the ability to 'contract-out' of the State Earnings-Related Pension Scheme (and receive contributions from the State into private pension policies).

This development coincided with the establishment and expansion of direct sales forces by a number of insurers previously reliant on business from independent intermediaries (especially banks and building societies). Pensions

business was relatively easy to sell, particularly before the recession took hold, and direct sales forces tripled their production between 1987 and 1989.

Subsequently, new business has declined marginally, although still remaining the largest single class.

As will be seen later, many of the participants subsequently lived to regret this rapid salesforce expansion fed on personal pensions.

(ii) Single Premiums

Single premium business saw an increase of over 150% between 1987 and 1993, although it is expected to fall back a little in 1994.

Increased incidences of inherited wealth as a by-product of increased home ownership has fed the growth in these classes of business, which are now a more significant contributor to most companies' profits than was previously the case.

A number of developments can be attributed to market innovations which would probably have happened even in the absence of regulatory change. Nevertheless, regulatory requirements have tempered what might otherwise have been excessive and inappropriate marketing of certain products.

(a) Non-Linked Life

Single premium unitised with-profits whole life policies with minimum life cover, commonly called 'with-profits bonds', were promoted heavily when short term bank deposit rates reduced significantly.

Considerations of solvency and also regulatory concerns over whether all purchasers recognised that these product were not direct substitutes for deposit accounts, particularly with regard to access, has tempered sales recently.

(b) Linked Life

Increasing acceptance of derivative instruments as part of insurers' investment portfolios have led to a significant increase in so-called

Guaranteed Equity Bonds, unit-linked bonds which guarantee to provide a minimum return after a fixed period. Again, there has been some regulatory concern expressed about the extent to which investors are aware that, for example, income is commonly diverted to pay for the guarantee.

Other products promise a guaranteed level of income for a fixed period but only undertake to return the capital invested if a certain minimum returns, sometimes quite substantial, is earned. Regulatory disquiet has been expressed at the extent to which customers understand the risk of only partial return of capital.

(c) Individual Pensions

Pensions legislation in the UK permits those leaving employment to apply the cash equivalent of the accrued benefit in a company pension scheme as a single premium to an insured personal pension policy. Policies to receive such transfers were easy to sell, although they were not always best advice. However see below for the unfortunate consequences for the industry which have resulted from misselling. Adverse publicity in this area has led to the decline seen in 1994.

This adverse publicity may also have impacted upon growth in the normal single premium personal pension contributions. Regulatory concern over the advisability of regular contribution policies for those with uncertain future earnings or employment prospects had previously led to growth in the recurrent single premium alternatives.

Bancassurance

Prior to 1988, banks and building societies (mutual savings and loan companies) had generally been content to act as agents for insurers, receiving commission on business sold. Some banks had established their own relatively small scale life insurance subsidiaries to absorb some particularly profitable and simple lines, such as mortgage endowments. However, until fairly recently, building societies were legally unable to own a life assurance company.

The reaction to polarisation differed between banks and building societies. Those banks with life insurance subsidiaries chose to tie to them,

although most, as they were allowed to, also maintained independent intermediary operations for those clients who required them. One major bank remained independent until the beginning of 1993, when it, too, established its own in-house life insurer.

In contrast, most building societies immediately tied to an existing major insurer. From 1990 onwards, however, virtually all the larger societies began to establish or acquire life insurance subsidiaries, often in partnership with the insurer to whom they were tied (the partner typically being a minority shareholder and the provider of administration and investment management services). Only one major building society has remained staunchly independent throughout.

The need to diversify profits sources, the need to consolidate client loyalty, the increased profits available from life insurance (industry norm expense loadings rising faster than costs) and the desire to decrease dependency on external parties were all reasons driving this trend. A much fuller account of the development of bancassurance in the UK can be found in Papisavvas and Parmee⁽³⁾.

The result has been a maintenance of market share of regular premium of around 13% and an increase in single premium share from 8% to 18%, the latter contributing significantly to the swing from independent to tied in that market. An additional 5% to 6% share of both markets is held by life assurance subsidiaries of banks which function independently of the banking operations.

No bancassurer genuinely able to exploit low operating costs has yet done so to increase market share in an aggressive manner. Neither have any so far seriously attempted to expand beyond their banking customer base. Senior management attention may also have on occasion been diverted to other markets - or to corporate mergers - and opportunities may have been missed.

The same senior management may also be more wary of the true profit potential of life assurance post the Financial Services Act. No longer can every counter clerk sell insurance products. Significant initial and continued training and supervision is now required. Moreover, in common with many non-bank insurers, insufficient attention to compliance with SIB or SRO rules

period has left (and may still be creating) a considerable number of customers who have not been given best advice, and the potential legacy of significant potential compensation costs.

Reaction to 'Best Advice' Requirement

Simultaneously with the introduction of the requirement only to sell a life assurance investment product if it was suitable, the UK life assurance industry regrettably introduced and allowed to be promoted several products or methods of use of products which were likely in many circumstances not to be 'best advice'. These included:

- Home Income Plans - elderly property owners were advised to mortgage their home and to invest the proceeds in unit-linked bonds. In theory, the income and growth of the bonds would pay the interest on the loan and provide additional income. In practice it fell considerably short, putting the property at risk of forfeit.

- Missold Personal Pensions- individuals were badly advised to leave a company scheme and contribute instead to a personal pension plan (hence forfeiting employers' contributions to their pension). Former employees were wrongly encouraged to take a transfer value from a company pension scheme and invest it in a personal pension plan. Prospective retirement benefits were reduced, not increased as the advisers had suggested.

How were these sales allowed to take place? In the case of Home Income Plans, it was largely lack of competence amongst both advisers and companies promoting the plans. In the case of missold Personal Pensions, it was largely lack of supervision of tied agents caused in turn by insufficient senior management attention to the much stricter requirements of the relatively new regulatory regime or the communication/discipline problems within their own organisations. Cultures and agent remuneration practices which focused on the quantity and not the quality of sales were also to blame.

As Bernard Levin ⁽⁴⁾, a prominent non-financial journalist, wrote (with an element of journalistic exaggeration). "... from one end of the market to the other there was nothing but a huge, a vast, a colossal line of telescopes carefully clapped to blind eyes".

The SROs were in their infancy and were neither adequately nor sufficiently competently staffed in the first few years of the regime to detect such cases of poor advice, particularly given the initial, generally poor industry achievement at even more basic matter such as adequate record keeping (for example, of what advice had been given). For example, the number of staff employed by one of PIA's predecessor SROs grew from 50 to 130 between 1990 and its amalgamation into PIA in mid 1994.

Eventually, the regulators became aware of the problem and preventative measures were enforced. However, Home Income Plans compensation amounts of around £50m may be payable by the industry as a result of investor losses incurred. Missold Personal Pensions are estimated to be likely to cost the industry somewhere between £1bn and £4bn in compensation and administration costs and could well lead to the insolvency of a number of independent advisers and possibly several small insurance companies.

There are several other possible situations already identified where, particularly with the benefit of hindsight, best advice may well not have been given. Further compensation costs may yet be incurred.

The industry, spurred on by SIB and the SROs, has now invested heavily and generally successfully in better recruitment, training and supervisory practices, particularly as far as the generally previously less compliant tied distribution is concerned. This development has been one of the contributors to the decline in new business in 1994 - and to the decline in regular premium business over a longer time span. Not only are intermediaries more wary of recommending unsuitable products but, as a result of the considerably increased costs of putting and keeping a trained agent "in the field", there has been a recent sharp decline in the number of tied agents, too.

<u>Year</u>	<u>Number of Tied Agents</u>
1990	186,000
1991	193,000
1992	179,000
1993	147,000
1994	93,000

Source: PIA

Increased and better quality sales per individual should be the welcome result of reduced numbers and better training.

Persistency

One effect of the rapid expansion of direct sales forces and the resultant high turnover in tied agents was a worsening in the rates of persistency of regular premium business (as a result of uncontrolled overselling and lack of subsequent customer maintenance).

In order to pay for the costs of recruitment and training and of increased commissions, regular premium products were typically loaded for initial expenses equivalent to 100% and 200% (more in some cases) of the annual premium and most if not all of this was recovered on early termination by means of nil or very low surrender values.

Poor persistency experience was exacerbated by economic effects. In the late 1980s significant unemployment was experienced for the first time in the service industries as well as manufacturing, leading to the inability of many individuals likely to be policyholders and of many owners of small business to maintain premiums on personal pension or mortgage endowment policies, many only taken out within the previous 12 or 24 months when the economy was not yet in recession.

The result was an increasing number of consumers dissatisfied as a result of having contributed to a policy and having only a fraction of their premiums returned following early termination.

Little explicit data is currently available about companies' relative persistency. However, in 1991 SIB commissioned a study using data supplied by insurers in their annual returns to the Department of Trade and Industry.

The following termination rates were derived:

	Non-linked <u>Life</u>	Non-Linked <u>Pensions</u>	Linked <u>Life</u>	Linked <u>Pensions</u>
Year 1	13.8%	17.9%	22.3%	21.8%
Year 2	9.2%	11.9%	14.8%	14.6%
Subsequently	4.9%	6.3%	7.9%	7.8%

Those compiling the study pointed out that the data was not ideal for the purpose and that a considerable number of assumptions had had to be made. Some industry commentators were considerably more critical.

Underlying the overall picture were rates from individual offices which varied in some cases from under half of the aggregate figures to more than twice the aggregate. There was also a correlation between low persistency and firms against whom regulators had already taken action to correct poor selling practices.

The study also attempted to identify any difference between the persistency of independent intermediaries and tied agents. In general, the analysis pointed towards higher persistency rates from independent intermediaries although there was evidence that the market in which the intermediary operated was sometimes equally influential.

Subsequent studies have revealed slight deteriorations in persistency, followed by improvement from 1992 onwards.

Further evidence of the impact of poor persistency in the industry can be seen from the table below, which shows the numbers and premiums of regular premium individual policies in force between 1986 and 1993.

<u>Year</u>	<u>Number of Policies (millions)</u>	<u>Yearly Premiums (£bn)</u>
1986	100	8
1987	101	9
1988	101	11
1989	103	13
1990	105	14
1991	105	16
1992	106	17
1993	105	18

Source: Association of British Insurers

It can be seen that the total number of policies, in force has hardly changed over the period. Yearly premiums increased by £10bn. Yet over 60 million new policies were sold with new yearly premiums of approximately £20bn in the intervening years. Although accurate statistics are not readily available, maturities and deaths would probably have accounted only for 10-15 million policies and about £1bn in yearly premiums.

Low persistency has always been identified as a potential indicator of poor selling practices and the PIA and its predecessor SRO for life insurers has always insisted that companies monitor the persistency of business introduced by each tied agent and investigate and where necessary take corrective action when unusually poor results emerge. However, no standard method for measuring persistency was decreed and there has been no requirement to make any figures publicly available.

As a result of consumer pressure, PIA have now made rules which will require insurers to submit aggregate persistency rates, split by distribution channel, on a yearly basis, starting in mid 1995 based on policies terminating in 1994. PIA will also consult on the most appropriate ways for companies to make this data available to the public, although no timescale for this process has yet been set.

The threat of publicity alone should compel insurers to turn even more attention to correcting the underlying causes of poor persistency or to designing products which do not penalise early terminations in the first place

(even though such products are likely to provide lower benefits on final maturity).

Disclosure

In 1988, the OFT found two features of the SIB rule book which particularly suppressed competition in the market:

- (i) commissions paid to IFAs was not automatically disclosed (rather, as mentioned earlier, it was restricted).
- (ii) the total expenses incurred in selling and administering policies were undisclosed.

The OFT proposed cash disclosure of commission and illustrations of prospective benefits (early surrender and maturity, using offices own expense levels), both at the point of sale, as solutions.

The industry succeeded in persuading SIB that a compromise of disclosure of commission rates, of expenses as a reduction in prospective investment return and of early surrender values, all post-sale, would sufficiently promote competition.

The OFT did not agree and, after considerable debate, the Government finally came down in support of the OFT and used its powers under the Act to compel SIB to introduce the OFT's requirements. However, as is often the case, the intervening years had refined opinions of what was necessary. So 1995 will see not only:

- (i) disclosure in writing of the exact amount(s) of commission that would be paid to a IFA if a policy being recommended is purchased, and
- (ii) compulsory illustrations of prospective benefits (at all stages of the policy's term) using offices' own expenses and mortality rates (on three different standard interest rates), again pre-sale

but also:

- (iii) disclosure for tied agents of the 'commission equivalent' which they will receive in cash, material benefits or services for selling a recommended policy.

The third item came about because IFAs successfully persuaded the Government that imposing disclosure of commission on them alone would disadvantage them relative to tied agents if the latter were not also subject to equivalent disclosure.

Making regulations is always easier than solving the practical ways of implementing them. The actuarial profession has been prominent in resolving two of the problems which arose in practice from the Government order:

- (a) what are the 'expenses' incurred in the sale and administration of a with-profits policy (for a unit-linked policy, the explicit expense loadings are an acceptable proxy)?
- (b) what is the 'commission equivalent' for tied agents paid in ways other than commission (e.g. salary, company car, use of an office, etc)?

The regulations require insurers to seek the opinion of their Appointed Actuary (the actuary statutorily responsible for reporting on the solvency of the company) on these two matters. Appointed Actuaries can in turn refer to professional guidance issued by the Institute of Actuaries and the Faculty of Actuaries.

The Outlook for 1995

What impact will this heightened disclosure have on the market in 1995 and beyond? I would hope to be able to provide an oral report at the 1995 AFIR Colloquium. However, certain distinct positions are already being taken by market participants.

- (i) 'Live in Hope' - Some insurers intend to disclose existing expense levels. Some IFAs and tied agents intend to disclose unchanged commission. In such cases, both expenses and commission will remain 'up-front'.

- (ii) 'Bow to the inevitable' - Some insurers intend to replace existing products with level load products and to pay level commission only as a result.
- (iii) 'Get aggressive' - Some insurers apparently intend to market level loaded products whilst paying initial commission, with a view to increasing market share (at a cost).

Inevitably, there will also be other approaches, some intermediate to the above. For example, a gradual move from (iii) to (ii), 'weaning' the intermediaries off up-front commission.

Insurers are likely to continue to pay front-end commission on life insurance products not regulated by the Act (term assurance, PHI, etc) and also on those where the investment element is not material (e.g. unit-linked whole life), so the effect of a move to level commission on investment products will not necessarily reduce intermediaries' remuneration excessively, particularly where the intermediary has other income sources (e.g. general insurance, estate agency, etc). Nevertheless, a further reduction in the number of both tied agents and independents intermediaries is anticipated.

Another effect will be the number of prospective purchasers deterred from investment-orientated life assurance products altogether. A survey commissioned by SIB in 1994, concluded that the whole market could contract by 10% in 1995 as a result of purchasers being deterred by high disclosed commissions or expenses. Of course, the introduction of new, consumer-friendly products could have an opposing effect.

What type of life insurance company will succeed in the post-disclosure environment? Low cost companies will be able to illustrate better benefits. Most bancassurers should fall into this category because of their captive client bases and the ability to share overheads with main banking operations. A 1994 study by consulting actuaries Bacon and Woodrow suggested that up to 40% of existing insurers might be vulnerable on expense grounds in the new disclosure environment.

Companies which introduce level load regular premium products will hope to benefit from customer demand for their products. However, high early

surrender values inevitably means lower projected maturity values - and customers will not necessarily go for the 'safer' product, some (many?) preferring to gamble on staying the course.

Proprietary offices with access to capital or well-solvent mutuals ought to be able to provide both these consumer-friendly products and at least temporary finance for intermediaries to ease their passage to level commission.

Turning now to intermediaries, tied agents commissions may emerge as higher than IFAs as, historically, tied channels have been less efficient (and often implicit cross-subsidies have existed). There may therefore be a tendency for tied agents numbers to continue to fall more rapidly than IFA numbers.

Also, in theory, intermediaries choosing still to receive up-front commissions should find business harder to obtain. However, the extent to which commission disclosure alone will sway potential purchasers is yet to be discovered.

Conclusion

As a consequence of its use of the life assurance vehicle to market investment products, the UK life assurance industry has become subject to general investor protection regulation. This has introduced for the first time a responsibility for any financial losses which might occur to individuals as a result of advice given to enter into a life assurance policy, notwithstanding that the policy conditions themselves were fulfilled.

Initial failure by company management to control agents adequately has led to the accrual of significant compensation liabilities and the incurring of significant costs. The public image of the life assurance industry has been tarnished.

Action has been taken in terms of increased regulatory supervision, better training of intermediaries and heightened disclosure. As a result, the quality of investment advice being provided and of investment products being sold to the UK public is improving. However, a further consequence is that sales growth has stagnated or even reversed, competition between firms is

increasing and a significant number of weaker firms are potentially under threat. Whether the gain to investors from heightened competition will exceed the costs of increased regulation is still to be seen.

In such an environment, product pricing becomes more than usually difficult. Sales volumes are difficult to predict, contingency margins may be needed for redress for bad advice and adequate training and compliance costs must be included. Yet excessive conservatism will be exposed to prospective purchasers through explicit disclosure.

Authorities and insurance companies in European Community countries now relaxing controls over product design as a result of the Third EC Life Directive will be well advised to ensure that they do not underestimate the emerging potential for abuse, however unintentional, of the insurance buying public.

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