Regulation of UK Life Insurers by appointed actuaries monitoring Policyholders' Reasonable Expectations

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Summary

Insurance contracts provide a significant part of the long-term savings market in the United Kingdom as well as providing protection in the event of early death or longevity in retirement.

Insurance companies are regulated by The Insurance Companies Act 1982 (the 1982 Act), which requires every life insurance company to appoint an actuary to undertake certain duties.

The 1982 Act does not seek to regulate insurance companies either in the design of contracts or in the determination of premium rates. Rather the emphasis is on continual monitoring by the Appointed Actuary, with a duty to report annually and on a "whistle blowing" basis in the event that the directors fail to act on his recommendations.

The Appointed Actuary system is regarded as providing a more effective degree of monitoring than can realistically be expected of the Financial Services Authority, which is the Regulator. It has proved highly effective in protecting policyholders in recent years.

The Financial Services Authority has significant powers of intervention for protecting policyholders or potential policyholders of the company against the risk that the company may be unable to meet its liabilities or to fulfil the reasonable expectations of policyholders or potential policyholders.

Because the 1982 Act does not contain any definition of policyholders' reasonable expectations, the regulators and the actuarial profession have built up an informal framework over the years to determine what are policyholders' reasonable expectations.

Recently a test case involving the Equitable Life Assurance Society Ltd was taken to The House of Lords. Their judgement in the case differed in important respects from what had become the accepted wisdom on policyholders' reasonable expectations.

It remains unclear the extent to which The House of Lords' judgement is applicable to other insurance companies. The paper describes the various inquiries and the Financial Services Authority review of with profit business subsequently set up to review the regulatory framework.

1 Background to UK long-term insurance contracts

1.1 Insurance contracts provide a significant part of the long-term savings market in the United Kingdom as well as providing protection in the event of early death or longevity in retirement.

1.2 UK Long-term insurance contracts used for savings differ from other UK savings in that the policyholder is committed for the long term but the benefits are often at the discretion of the company or society.

1.3 With-profits contracts share profits with shareholders in proprietary companies in a proportion, normally constrained by the articles of association to policyholders receiving at least 90%. In mutual insurance companies and friendly societies policyholders receive 100% of distributed profits. Profits in proprietary and mutual companies and societies are allocated to policyholders at the discretion of the directors, after receiving the advice of the Appointed Actuary.

1.4 Unit-linked contracts have a more direct link between investment profits and policy benefits but the company often has discretion to vary charges for investment, administration, mortality and guarantees.

1.5 Directors of life insurance companies are seen as having a fiduciary responsibility towards policyholders, because of the nature of the business, whereby premiums are received from members of the public in return for a paper promise. The ability to deliver satisfactorily on that promise, not only in contractual terms, but in accordance with policyholders' reasonable expectations, possibly many years into the future, necessitates sound financial management and is the background to the need for a significant level of regulation of the business.

2 The Role of the Appointed Actuary

2.1 The Insurance Companies Act 1982 (the 1982 Act) contains the primary legislation relating to life insurance companies. In many areas the 1982 Act lays down broad principles leaving detailed supervision to be covered by regulations. This is shortly to be replaced by the Financial Services Authority (FSA) Interim Prudential Sourcebook but the essence of the regulation is unchanged.

2.2 Section 19 of the 1982 Act requires every life company to appoint an actuary, known as the Appointed Actuary, to undertake certain duties. The Appointed Actuary has wide responsibilities in relation to monitoring the adequacy of the assets to meet the liabilities on a continual basis.

2.3 The 1982 Act does not seek to regulate directors either in the design of contracts or in the determination of premium rates. Rather the emphasis is on continual monitoring by the Appointed Actuary who has a duty to report annually and on a "whistle blowing" basis in the event that the directors fail to

act on his recommendations. This is regarded as providing a more effective degree of monitoring than can realistically be expected of the FSA.

2.4 The Appointed Actuary system of regulation is regarded as having proved highly effective in protecting policyholders in recent years.

3 Practising Certificates

3.1 Subordinate legislation under the 1982 Act has prescribed that an Appointed Actuary must be a Fellow of the Faculty of Actuaries or Institute of Actuaries and have attained the age of 30. The Faculty and Institute of Actuaries permit their members to take up a position as Appointed Actuary only if they hold a current Practising Certificate from the profession. In deciding whether to grant such a certificate, the profession requires several years of relevant experience, an unblemished professional record and compliance with a scheme of Continuing Professional Development. Evidence of a failure to comply with professional conduct standards or standards of practice set out in Guidance Notes could lead the Faculty and Institute of Actuaries to refuse to renew an actuary's certificate.

4 Professional guidance to Appointed Actuaries

4.1 The Appointed Actuary to every life insurance company has to comply with professional guidance notes GN1 and GN8 issued by the Faculty and Institute of Actuaries. They are practice standard guidance notes, and are thus mandatory on the Appointed Actuary. In this way GN1 and GN8 have a place in the insurance company regulatory framework. GN1 deals with general matters and GN8 deals with interpretation of valuation regulations.

4.2 GN1 makes it clear that continuously monitoring the financial condition of the company involves keeping track of everything that might impinge on financial condition. This includes:

- being consulted on the design of new products, the setting of premium rates and marketing plans
- monitoring options and guarantees
- monitoring investment policy to ensure that it is appropriate to the nature and term of the liabilities
- current and likely future level of expenses
- reinsurance arrangements
- the level of free assets.

4.3 In addition, guidance note GN2, which is recommended practice, sets out the profession's view on the advisability of supplementing the annual investigation into a company's financial condition with a report to the directors on the results of a dynamic financial analysis. This dynamic financial analysis involves testing the company's ability to withstand possible

future adverse conditions, making use of cash flow projections on a variety of assumptions.

5 Insurance Companies Act 1982 and Subordinate Regulations

5.1 The reserving standard which was intended with the passage of the 1982 Act, and which was subsequently embodied in the Insurance Companies Regulations and the actuarial Guidance Note GN8, incorporated the requirement to make proper provision for all liabilities on prudent assumptions that shall include appropriate margins for adverse deviation of the relevant factors. There is also a requirement to make provision for policyholders reasonable expectations (PRE) and not just for contractual liabilities. It was thus much more than a solvency standard for the guaranteed liabilities.

6 Policyholders' reasonable expectations (PRE)

6.1 Although the 1982 Act uses the term "reasonable expectations of policyholders", it does not contain any definition of PRE. Because the concept of PRE is not defined in statute, any interpretation is inevitably a matter for the Courts. However, until the recent Equitable Life case, there had been very few legal cases which have tested the concept, so the industry, the Regulators and the actuarial profession, have built up an informal framework over the years to determine what are PRE.

6.2 There are a number of references to PRE in actuarial guidance note GN1, for example:

Paragraph 1.1
"It is incumbent on all Appointed Actuaries to ensure, so far as it is within their authority, that the long-term business is operated on sound financial lines and with regard to its policyholders' reasonable expectations."

Paragraph 3.3
"It is part of the Appointed Actuary's continuing responsibility to advise the company of the Appointed Actuary's interpretation of its policyholders' reasonable expectations. In general terms this interpretation should have regard to the broad nature of the company and its approach to the treatment of policyholders both individually and (where appropriate) collectively as a group vis-à-vis shareholders".

Paragraph 8.3.4 of GN1 is concerned with the Appointed Actuary justifying recommendations regarding the allocation of bonuses. In so doing, the Appointed Actuary must take account of his interpretation of PRE. It is stated in paragraph 8.3.4 of GN1 that PRE is influenced by policy literature and by other publicly available information. The Appointed Actuary:
"should assume that among the conditions for the fulfilment of those expectations are:

- that, in the recognition and allocation of profits in accordance with the company's terms of participation and its policy in respect of [the nature and timing of allocations of profits to policyholders], groups of participating policies are appropriately and equitably distinguished having regard inter alia to the terms of the policies, their duration and their relevant pooled experience; and
- that the company conducts its affairs, including its new business and investment strategies, with due regard for its financial resources".

6.3 On 24 February 1995, Mr. Jonathan Evans, President of the Board of Trade, stated in response to a Parliamentary Question on "Orphan assets" that:

"The Department considers that policyholders' reasonable expectations in respect of attribution of surplus are influenced by a range of factors, notably:

- the fair treatment of policyholders vis a vis shareholders;
- any statements by the company as to its bonus philosophy and the entitlement of policyholders to a share in profit, for example, in its articles of association or in company literature;
- the history and past practice of the company;
- general practice within the life insurance industry."

6.4 The actuarial profession agrees that these are the relevant factors to consider in determining PRE and in the wider context of distribution of bonuses would add

- fair treatment amongst different groups and generations of policyholders.

6.5 It is worth noting at this point that the House of Lords judgement differed in important respects from what had become the accepted wisdom (see Section 11 below).

7 Actuarial working party on PRE

7.1 Recognising the difficulty for actuaries in advising on PRE, the actuarial profession set up a working party which first reported in 1990. No formal guidance resulted.

7.2 In relation to a series of interviews conducted with Appointed Actuaries, the first report of the working party stated:

"In almost every interview the point emerged as to what level of sophistication it was relevant to attribute to the policyholders in PRE. The point was repeatedly made that the policyholder himself generally had little understanding of the kinds of technical issue raised by PRE. Generally the view emerged that the expression should be interpreted in the context of professional advisers acting on behalf of policyholders, the courts, the press and similarly well informed observers of the life insurance industry".

7.3 In paragraph 3.2 of the same report, it was stated in relation to policies which have a discretionary element:

"The holders of such contracts may reasonably expect that life offices will behave fairly and responsibly in exercising the discretion which is available to them. They may also expect a reasonable degree of continuity in an office's approach to determining variable charges or benefits ".

7.4 The working party also concluded that:

"in the normal day-to-day actuarial management of a life office PRE is virtually synonymous with equity and the almost universal method for measuring it is asset-share calculations ...".

7.5 Asset shares are the accumulation of premiums less expenses incurred allowing for the investment return earned for a group of similar policies. In making the calculations the asset share would normally be charged for the cost of accruing guarantees.

7.6 The asset share is a guideline or benchmark rather than an absolute constraint. In practice there may be good reasons why a particular group of policyholders should be entitled to more than just asset shares, or in some circumstances less, for example because of the effect of smoothing of investment returns.

8 The Equitable Life Assurance Society Court Case

8.1 The only significant test of PRE in the Courts came in 1999. The dispute arose between the Equitable Life Assurance Society (Equitable Life) and a number of with-profits policyholders who have policies containing guaranteed annuity rates (GARs). The latter disputed the manner in which the directors of Equitable Life exercised their discretion as to the allocation of final bonus.

8.2 Equitable Life brought its representative action against a policyholder, Mr Hyman, in order to obtain a declaration in particular that its directors had, in principle, exercised their discretion properly in relation to final bonus.

8.3 When a with-profits pension policyholder retires, part of the accumulated fund (including all bonuses) may be taken in cash form and the balance used to purchase an annuity. Due to falling long term interest rates and improving mortality, annuity rates have over recent years become much less favourable to policyholders.

8.4 Most with-profits pensions policies written by Equitable Life up to July 1988 contained GARs. None written after this date did so.

8.5 As is the case for virtually all other companies' with-profits policies, the bonuses granted to Equitable Life policies are in two forms:

- reversionary bonuses which, once granted, form contractual additions to policy benefits; at retirement the combination of the basic original policy benefits plus all previous additions of declared bonus is referred to by Equitable Life as "the guaranteed fund";

- terminal bonuses (called "final bonus" in Equitable Life's current terminology), which are credited only when a policy becomes a contractual claim, and up to that point the value of which is not guaranteed.

8.6 Equitable Life's position was that the guaranteed minimum annuity amount at retirement was determined by the application of the GAR contained in the policy to the guaranteed fund. The actual annuity amount could clearly be greater than this minimum, but the minimum is as just defined. Equitable Life's practice in relation to this matter was to seek to allocate final bonus amounts which ensure that the actuarial value of the annuity taken is no greater and no less than the policyholder's fair share of the with-profits fund, subject to the guaranteed minimum annuity amount referred to above. If and to the extent that final bonus is added to the guaranteed fund, the GAR would also apply to such final bonus amounts. The term "actuarial value", as used here, can be summarised as the consideration which a third party would require in order to issue an annuity of the same amount, based on current levels of interest rates and a realistic assumption as to future mortality.

8.7 The position of Mr Hyman was that the guaranteed minimum annuity amount at retirement should be determined by the application of the GAR contained in the policy not just to the guaranteed fund but also to any final bonus amount otherwise available. Mr Hyman thus argued that the final bonus should be the same whether the policyholder took the benefits in guaranteed annuity form or elected to take the benefit in fund form, and should not be reduced to reflect the cost of providing the guarantee.

8.8 In order to illustrate, I have presented below two worked examples. The examples assume that all of the fund is taken in annuity form, whereas in practice part is taken in cash form in most cases. In Example 1 the guaranteed minimum does not cut in. In Example 2 it does cut in.

Example 1

Current annuity rate:	£8.30 per annum per £100 of fund
Guaranteed annuity rate:	£10.00 per annum per £100 of fund

Guaranteed fund	£ 75,000
Non-guaranteed final bonus	£ 25,000
Total fund	£100,000

Equitable Life approach:

Current annuity = £100,000 x (8.30/100)
= £ 8,300 pa
Guaranteed minimum annuity= £ 75,000 x (10/100)
= £ 7,500 pa
So actual annuity paid = £ 8,300 pa

In order to achieve an annuity of £8,300 pa, Equitable Life reduced final bonus from £25,000 to £8,000, [since (£75,000 + £8,000) x (10/100) = £8,300 pa]

Mr Hyman argument:

Annuity should be = £100,000 x (10/100)
= £ 10,000 pa

Example 2

Current and guaranteed annuity rates as in Example 1.

Guaranteed fund	£ 85,000
Non-guaranteed final bonus	£ 15,000
Total fund	£100,000

Equitable Life approach:

Current annuity = £100,000 x (8.30/100)
= £ 8,300 pa
Guaranteed minimum annuity= £ 85,000 x (10/100)
= £ 8,500 pa
So actual annuity paid = £ 8,500 pa

In order to achieve an annuity of £8,500 pa, Equitable Life reduced final bonus from £15,000 to nil [since (£85,000 + £0) x (10/100) = £8,500 pa]

Mr Hyman argument:

Annuity should be = £100,000 x (10/100)
= £10,000 pa

9 Guaranteed Annuity Options

9.1 The interpretation of PRE for policies with guaranteed annuity options (GAOs) is made by boards of directors, acting on the advice of their Appointed Actuary. Directors are bound by the terms of contracts and declared bonus policy, and may be specifically restricted by Articles of Association or Board resolutions.

9.2 On 18 December 1998, Mr Martin Roberts (Director, Insurance) wrote on behalf of HM Treasury to all managing directors of insurance companies to confirm HM Treasury's view at that time (expressed as without prejudice to

any decision of the Courts which might affect it) that, in appropriate circumstances, any final bonus added at maturity for contracts containing GARs might be lower than for contracts which did not contain GARs.

10 Actuarial briefing statement on Guaranteed Annuity Options

10.1 The Public Relations Committee of the Faculty and Institute of Actuaries, in association with the UK profession's Boards, produces from time to time various briefing statements to enable its officers, members of its Council and senior members of staff to respond to questions from the profession, the public and the media about important topical issues and developments. These statements are not formal guidance, neither are they necessarily a definitive expression of the views of the profession as a whole on the subject.

10.2 In March 1999 the Faculty and Institute of Actuaries issued a statement on annuity guarantees which was publicly available on the Internet.

10.3 The statement recognised that there are various acceptable approaches to the determination of bonus for policies containing GAOs. The following is an extract:

"... In this case the policyholder is likely to receive the full value for the funds built up to support the policy, regardless of whether they take a cash option or pension option under their policy. The final bonus rates for individual policies will be set so that the accumulated fund equals the cost of the annuity provided. The "guarantee" may seem to be lost, but the position is no different from the position of the past under older policies with a guaranteed conversion the other way - from pension to cash. The guarantee will still bite if final bonus rates fall to zero".

11 The House of Lords Judgement

11.1 The case was finally referred to the House of Lords, the highest Court in the country. After hearing evidence that had been presented to the High Court and the Appeal Court, the House of Lords gave judgement in favour of Mr Hyman and against Equitable Life. Their reasoning was that, as counsel for Mr Hyman observed, final bonuses are not bounty. They are a significant part of the consideration for the premiums paid. The directors' discretions as to the amount and distribution of bonuses are conferred for the benefit of policyholders. In this context the self-evident commercial object of the inclusion of guaranteed rates in the policy was to protect the policyholder against a fall in market annuity rates by ensuring that if the fall occurs he will be better off than he would have been with market rates. The choice is given to the GAR policyholder and not to Equitable Life. It could not be seriously doubted that the provision for guaranteed annuity rates was a good selling point in the marketing by Equitable Life of the GAR policies. It was also obvious that it would have been a significant attraction for purchasers of GAR policies. Equitable Life had pointed out that no special charge was made for

the inclusion in the policy of GAR provisions but this factor did not alter the reasonable expectations of the parties.

11.2 Equitable Life had thought that if the case went against it, it could have declared a differential bonus which varied not according to the form in which the benefits were taken, but according to whether the policy did or did not include GARs. If the suggestion were sound in law, the directors could in that way erode the substantial value of the guarantees by different means. However the House of Lords determined that this suggested route was not open to the Society, because the object would still be to eliminate as far as possible any benefit attributable to the inclusion of a GAR in the policy.

12 Equitable Life Response

12.1 Immediately following the House of Lords judgement, Equitable Life announced that it was closing to new business and putting itself up for sale. In the event, no buyer was prepared to take on the liabilities to GAR policyholders and Equitable Life was unable to achieve a sale of the business. When it became clear that a sale could not be achieved, the infrastructure was sold to Halifax Group, a UK bank. Benefits to all policyholders were reduced by not adding reversionary bonuses for a period of seven months and more recently by reducing final bonuses. A Market Value Adjustment was introduced to discourage transfers to other offices. A new Court action is currently being considered whereby GAR policyholders would agree to limit their entitlements but at the same time gain greater certainty to their potential benefits.

13 Impact on the life Insurance industry

13.1 Prior to the House of Lords ruling, Equitable Life was interpreting PRE in the context of the HM Treasury letter of 18 December 1998 and actuarial profession's briefing statement of March 1999.

13.2 The requirement that the Appointed Actuary ensures that the company conducts its affairs, including its new business and investment strategies, with due regard for its financial resources, contained in GN1 was relevant to Equitable Life, since it is evident from the above and was shown in the High Court that the resources of the company were limited.

13.3 For example, it has been accepted wisdom that directors have discretion to reduce terminal (and final) bonuses, in the case of with-profits policies, to enable them to give policyholders the benefit of investment in a broad range of types of asset whilst protecting them from the full volatility of such investment. It is also a requirement of actuarial guidance note GN1 that groups of participating policies are appropriately and equitably distinguished having regard inter alia to the terms of the policies, their duration and their relevant pooled experience, to achieve fair treatment amongst different groups and

generations of policyholders, where the measure of fair treatment is almost invariably the asset share.

13.4 The House of Lords' judgement took account of the particular circumstances of Equitable Life and clearly differed in important respects from what had become the accepted wisdom on PRE.

13.5 It is unclear the extent to which the judgement affects other offices.

13.6 The judgement was in the context of Equitable Life and it was widely accepted that Equitable Life was unusual, in the way it conducted its financial affairs. The essence of the concept was that Equitable Life regarded with-profits policyholders as participating in a "managed fund". The premiums they paid, after meeting expenses and the cost of life cover and other benefits and options, were invested in the managed fund. The benefits a policyholder ultimately receives would reflect the value of the assets in the fund attributable to his policy, i.e. that policyholder's asset share.

13.7 Put simply, that is that the business belonged to the current generation of with-profits policyholders. Those policyholders participated in a pooled fund and, when they left, should take "full value" from the fund. In particular, Equitable Life did not believe in the concept of an "estate" in the sense of a body of assets passed from generation to generation and which belongs to no-one.

13.8 A natural extension of the managed fund concept was to regard each with-profits policyholder as having a specific stake in that fund.

13.9 The approach to operating without an estate or free assets did attract criticism from some actuaries who felt the simplicity has its price. Some had previously suggested existing and new policyholders ought to be made aware of the risks. It was pointed out that an insurer risks facing competitive difficulties sooner or later if it holds an estate significantly less than that held by its competitors.

13.10 Legal opinion differs over the extent to which the House of Lords ruling is applicable to other offices. The actuarial profession briefing statement has been replaced by a recommendation that offices should seek legal advice. The Regulator's letter of 18 December 1998 was withdrawn shortly after the announcement of the House of Lords judgement and has not been replaced. Rather FSA have asked to receive copies of legal opinions obtained by other offices and have held individual discussions with offices that might be affected.

14 Peer review to strengthen supervision of Appointed Actuaries

14.1 In Spring 2001, the Faculty and the Institute of Actuaries took the decision to strengthen the position of appointed actuaries by introducing mandatory peer review of Appointed Actuaries (as well as peer review for the other areas where actuaries have statutory duties). The introduction of, and the scope of

work covered by, compulsory peer review are yet to be decided by the profession's Life Board. Sanctions for non-compliance with the requirement to obtain an appropriate peer review might include the non-renewal of a Practising Certificate.

15 Faculty and Institute of Actuaries Committee of Inquiry

15.1 On 21 December 2000 the Faculty and Institute of Actuaries announced that it was setting up a Committee of Inquiry to look into the implications of the events surrounding the closure of Equitable Life to new business.

15.2 The particular focus of the inquiry is actuarial professional guidance. The Committee is expected to report its findings to the presidents of the Faculty and Institute of Actuaries in the next few months.

15.3 The Faculty and Institute of Actuaries are looking at the situation with the interest of the public in mind. In particular they are considering the actuaries in the regulatory process to see if the guidance provided by the profession needs to be strengthened.

16 The Treasury Committee of the House of Commons Inquiry

16.1 Shortly after the House of Lords judgement, the Treasury Committee of the House of Commons set up an inquiry to investigate the Equitable Life affair and FSA set up their own internal inquiry. The report of the latter is yet to be made public but the Treasury Committee inquiry reported in March 2001. Among their conclusions were the following.

- The Faculty and Institute of Actuaries report should consider whether the actuarial guidance provided by the Faculty and Institute of Actuaries was appropriate at the time, and whether such general advice was suitable. It should also consider the extent to which the Faculty and Institute of Actuaries' opinion was based on the prudential insurance regulator's view.

- The relationship between firms' Appointed Actuaries and management boards, and with the body of policyholders, is in need of review, in the light of the Equitable Life affair.

- Equitable Life demonstrated that the information provided to policyholders, through the statutory accounts, and to the regulator, through the regulatory return, differed substantially in their treatment of the GAR liabilities and the consequential reserving that had been undertaken. As a result, policyholders were not able easily to establish the true position of the company. We ask both the FSA and the ICAEW to consider whether statutory accounts and regulatory returns should draw upon the same information and assumptions wherever possible, in order to improve transparency. In addition, the FSA should consider whether a life office's

reserving policy should be made clear to policyholders, either in statutory accounts or in some other way.

- We do not believe that the auditing arrangements for the statutory accounts and, in particular, the regulatory returns of life offices were adequate. We ask the FSA to consider the justification for the auditors' judgments and whether there are implications for future reporting practices by auditors generally.

17 FSA Review of With Profit Business

17.1 In February 2001 FSA set up a review of With-Profits Business to look at the prospects for change in four main areas:

- the extent of discretion available to management over the operation of with-profits funds and how that discretion is exercised;
- improvements in the transparency of published information about with-profits funds;
- better information for policyholders about the progress of their investments, including the language used to describe returns, and greater clarity about investment strategies and the way in which terminal bonuses are determined, and
- the principles which underpin the requirement for firms to have due regard to the interests of their customers and to treat them fairly.

17.2 The review will be wide ranging. The issues to be addressed will be taken forward under a series of inter-related sub-projects.

- Transparency in Policyholder Communications;
- Unfair Contract Terms;
- Governance and Discretion over the operation of with-profit funds;
- Disclosure to Customers, and Regulatory Reporting;
- Inherited Estates; and
- The Interests and Fair Treatment of Customers.

17.3 Consultation on the issues raised under these sub-projects will take place periodically during the year.

17.4 FSA expect to complete the review by Spring 2002. Depending on the outcome of the review, new FSA rules covering the operation of with profit business are likely to be made in 2002.