NATIONAL REPORT FOR THE UNITED KINGDOM

(P N Thornton MA FIA)

1. Association of Consulting Actuaries

Since the last report the membership of the Association has increased to 562, of which 392 are Full Members. This substantial increase reflects a change in the constitution in November 1988 which enabled consulting actuaries in recognised consulting actuarial firms other than partnerships to become members for the first time. Apart from this there has been a continuing expansion of consulting activity in pensions, life assurance and other areas.

Members of the Association meet regularly to discuss topical matters and, through its sub-committees, review developments affecting the work of consulting actuaries and make submissions to government and other bodies as appropriate. The Association is a founder member of the Occupational Pensions Joint Working Group which includes members of other bodies involved in pensions and is a further point of influence on government.

2. Economic Background

Since the last report, price inflation in the UK has shown a tendency to increase with the 12 months rate increasing from 4.2% in May 1988 to 8.3% in May 1989. Average earnings increased by 9.0% over each of these two years. Unemployment has been declining.

High rates of investment return have been available to institutional investors over most of the period since

the last report, although the October 1987 crash had a significant effect on market values. Including this the return achieved by a typical pension fund over the two years 1987 and 1988 was 7% p.a. Returns achieved over the first half of 1989 are estimated to be about 19%. Income from UK equity shares however has risen by about 35% over the past two years, i.e. by about 20% relative to prices, which is considerably more rapid than the long term trend.

At the time of writing the exchange rate between US dollars and the pound sterling is 1.62 to 1.

3. Work of Consulting Actuaries

Whilst the most significant area of work for consulting actuaries is pension work, there is also considerable and increasing activity in the areas of life assurance, non-life insurance and investment consulting, as well as in other more specialised areas. A recent concern for consulting actuaries has been with developments in the European Community. Apart from the need to react to legislation and proposals for legislation emanating from the European Parliament, the creation of a Single European Market by the target date of 1992 is giving rise to opportunities and needs for UK companies to expand into Europe, and also for continental companies to enter the UK. This is of particular interest in the financial services sector, where many past restrictions on cross-border activities are being removed.

4. The Financial Services Act

Reference was made in the last report to the Financial Services Act. This affects consulting actuaries directly, as they now have to be authorised to give

certain types of investment advice, including advice on insurance contracts. In most cases consulting actuaries have obtained authorisation through the Institute of Actuaries, which is a Recognised Professional Body for this purpose. The Act has also had a considerable effect on the way in which insurance business can be sold, with organisations selling life insurance now having either to be "tied" to a particular company or acting as "independent intermediaries" in which case they have to disclose to clients the levels of commission received. This and the abandonment of the maximum commissions agreement has caused many changes in the marketing approaches of different insurance companies.

5. Pensions Legislation

The past two years have been a very busy period in the UK as regards the legislation affecting pension schemes. The report to the 1988 IACA Conference described the changes in State pension arrangements under the Social Security Act 1986. Apart from a reduction in the scale of State earnings related pension accruing in future years, the Act abolished compulsory occupational pension scheme membership and introduced Personal Pensions. This has created the opportunity for individual employees to choose not to join the company pension arrangement, which would typically be of defined benefit type, but instead to take out a defined contribution Personal Pension arrangement. Furthermore, Personal Pensions can be contracted out of the State Earnings Related Pension scheme. To encourage this and hence reduce the burden on the State scheme in future years, an additional incentive is available from the Government in the form of an extra contribution paid into the Personal Pension for the first 5 years from April 1988.

Employers have responded to the new environment mainly by being more active in communicating to employees the benefits of membership of their occupational scheme. The number of employees choosing to opt out of occupational schemes has so far been very small indeed (less than 1%) although the proportion of potential entrants who have chosen not to join where they would formerly have compulsorily had to join is more significant (probably in the region of 10% across all schemes).

It is estimated that some 3½ million Personal Pension policies have been sold since July 1988 although these have been mainly at the minimum premium level necessary to secure the special terms for contracting out of the State Earnings Related Scheme. There continues to be concern that the net effect of the changes will be that future generations of employees will fail to make adequate provision for their pensions.

The Occupational Pensions Board was commissioned to provide a Report on the balance of interests of employees and employers in occupational schemes. The Board collected evidence from many sources including the Association and its Report became public in February 1989. A number of proposals are made in the Report and representative bodies have had the opportunity of commenting on these. It is understood that the Report has been broadly welcomed by Government and that legislation is likely to follow in due course, much along the lines recommended.

One of the most significant recommendations is that revaluation of accrued benefits should be incorporated on a winding up to match price increases up to a ceiling of 5% p.a. over the period to retirement. To the extent

that assets in a winding up are insufficient to cover the liabilities on this basis, the shortfall would be a debt on the employer. This therefore raises the minimum acceptable discontinuance solvency level for funding purposes.

The Report also goes as far as possible without proposing legislation in the direction of encouraging employers to make provision for post-retirement increases in occupational schemes. One of the ways of encouraging this is the suggestion that where schemes do not provide increases at least at the level of matching price inflation up to an annual ceiling of 5%, then there should be an option offered to pensioners at retirement to convert their scheme entitlement into a pension which is guaranteed to increase on this basis. The practical difficulties of operating such an option if it had to be offered might well encourage employers simply to provide the desired level of increases through the scheme.

The Report also recommends that present legislation regarding revaluation of benefits for early leavers in the period up to retirement should be extended so that increases would apply to the whole of the benefits of future leavers and not as at present only to the part accrued since 1 January 1985. The rate of revaluation required is 5% p.a. or the increase in the cost of living if less over the period from leaving service to retirement. The Report recommends that previous generations of leavers should, if possible, receive similar increases on their benefits.

Apart from this, the Report makes recommendations aimed at protecting members' rights in takeover and merger situations, largely by relying on actuarial certification

that members' rights and expectations have been properly protected. It proposes the establishment of a pensions tribunal to provide assistance to scheme members who need it and incorporates proposals aimed at limiting the level of self-investment in sponsoring companies.

There have been further developments in the area of equal treatment of men and women. The position in the UK is at present very confused as there are Directives already issued and in draft emanating from the European Parliament which will have to be complied with in the foreseeable future, whilst the UK Government has so far failed to address the problems arising from having fixed State retirement ages of 60 for women and 65 for men. As an example of the confusion which this is causing, the recent Social Security Act 1989 specifically prevents schemes from paying supplementary pensions to male members retiring before State pension age designed to offset the absence of State retirement benefits in this period unless a comparable benefit is paid to female employees even beyond their State retirement age. The net effect will be quite contrary to the spirit of the European legislation which is to encourage equal treatment of men and women in schemes.

Confusion also arises from Employment Law which has recently been amended so that women are entitled to work on to age 65 where this is the male retirement age even though scheme provisions may retain a pension age of 60 for women. Another complication has arisen from a recent case brought to an Industrial Tribunal involving early retirement benefits paid on redundancy to a male employee who claimed that actuarial reduction factors should not have been applied since they would not have been applied in the case of a female retiring in the same

circumstances at the same age. The case in question has gone to Appeal in the European Court.

In general, it is difficult for employers at the present time to know how best to attempt to implement the concept of equal treatment of men and women.

6. Pensions Accounting Standard

This period saw the introduction of an accounting standard on pension costs (Statement of Standard Accounting Practice No 24 - Accounting for Pension Costs). The Standard, known colloquially as SSAP24, applies to company accounts for periods beginning from 1 July 1988. The Standard had a very long gestation period, having been preceded by an Exposure Draft and an earlier discussion document. At all stages of the process the accountancy profession sought the advice of the actuarial profession including, in particular, members of the Association. Consequently the content of the Standard has been generally welcomed by actuaries in the UK since its approach is straightforward and flexible and the role of the actuary is fully recognised.

SSAP24 will have a major effect on the treatment of pension costs in company accounts since it will no longer be possible to take these costs as being simply the sum of contributions paid to a pension scheme plus pensions paid directly out of revenue. Thus, for example, companies who have been taking a short-term contribution holiday as a result of scheme surplus will find that their profits are reduced, since an element of pension cost will in future have to be incorporated.

Pension cost under the Standard is the sum of regular cost and variations in regular cost. The regular cost is

the normal on-going cost of the scheme (which can often be equated to the future service contribution rate). No particular method or set of actuarial assumptions has to be used for this purpose although the Standard requires the actuary's "best estimate" of the assumptions as a whole and appears to prohibit any actuarial method which is not based on an on-going scenario for the scheme.

Variations in regular cost arise as a result of experience factors, changes in benefits and changes in the actuarial method/assumptions. In general they have to be spread over the average working lifetime of the employees although there are specific circumstances (e.g. the sale of a subsidiary company, a significant reduction in workforce, a refund of scheme surplus) where a different treatment may be applicable. It is this spreading requirement that can result in a positive total pension cost arising even though no contributions are being paid to the scheme.

The question of discretionary or ex-gratia pension increases receives special attention under the Standard. Encouragement is given to recognising such increases in the regular cost and variation figures. However, if this does not happen, the increases have to be capitalised as they occur.

There are a number of other aspects of SSAP24 which will require the special attention of the actuary, including the treatment of costs of overseas subsidiaries and the general requirements of consolidation of accounts for a corporate group.

The implementation of the Standard will present companies with a choice of accounting treatment in respect of

existing pension scheme surpluses or deficiencies (known technically as the cumulative adjustment). The cumulative adjustment can either be accounted for immediately as a balance sheet item or spread forward over future years. There is also flexibility in the method used for spreading. UK actuaries are currently involved in calculating cumulative adjustments (which involve updating earlier actuarial valuations) and in advising clients and their auditors on the alternatives available for dealing with them.

The Standard also has extensive disclosure requirements both in relation to accounting policy and funding policy. In particular the scheme's achieved level of funding at the latest valuation must be shown together with the main assumptions used in the valuation. This higher level of disclosure is bound to attract greater interest in the company's pension arrangements from directors, shareholders, analysts and potential buyers.

It is instructive to note the differences between SSAP24 and FAS87, the US equivalent as set out in the table at Appendix I. Whilst both standards will presumably comply with the International Accounting Standard Number 26 it seems unlikely that they will permit the same pension cost figures to be used in many cases. Other countries also have their own accounting standards for pensions and a multi-national employer will face considerable problems in reconciling the various requirements in the different countries.

The new Standard brings with it a need for closer co-operation between the actuary and the accountant. A protocol document for liaison between the professions is being considered by the relevant bodies of the accounting

and actuarial professions with a view to its becoming an approved guideline for operation.

7. Pensions Taxation

Pensions tax principles in the UK are briefly covered in the primary legislation but secondary legislation and matters of Inland Revenue discretion represent the overwhelming body of documentation. 1988 was a quiet year in legislative terms but both the Inland Revenue and the pensions industry, including representatives of the Association, spent a considerable time discussing ways of simplifying the legislation and resulting administrative burden.

The Chancellor of the Exchequer in his 1989 Budget speech incorporated some of these suggested simplifications, for example in relation to the calculation of lump sum retirement benefits, and introduced more generous maximum benefit limits on early retirement. He also however introduced, unexpectedly, some fundamental changes to pensions tax law. Some of these were politically based such as the decision to allow companies to operate approved pension arrangements qualifying for tax relief only up to a pensionable earnings ceiling of £60,000 (US$100,000). In addition it is now possible to operate unapproved "top up" arrangements to provide extra benefits on a non tax-favoured basis without prejudicing the approval status of the lower level schemes.

It is possible that these new proposals are the first stage in a political plan to dismantle the tax privileges of pension schemes, particularly as the limit is to be indexed to prices rather than earnings. This would be consistent with the Government's move towards personalising pensions whilst at the same time creating a

tax regime where no one area of investment is tax-favoured ("level playing fields"). In any event the Government's continuing interest in pensions has generated a considerable amount of work for consulting actuaries.

8. Local Government Superannuation

There has been a move recently to privatise municipal transport companies, regional airports and latterly polytechnics. Whilst arrangements have been made to enable employees to retain membership of the Local Government Superannuation Scheme, further arrangements have had to be made to ensure that proper cover is established to cover the pension increase liabilities for such employees. This has required some innovative thinking, as the LGSS cannot, at present, pre-fund for pension increases.

The objective of the number of interim valuations being made by Local Authority Superannuation Funds during the period 1984-1989 was to allow a reduction in employer's contributions to be made in respect of those funds which have gone into surplus due to the substantial improvement in investment earnings over the period. The Department of the Environment acted in July 1988 to prevent the implementation of any recommendation from future interim valuations and at the same time introduced regulations allowing for local government valuations to be completed once every 3 years instead of 5.

In a recent political move, the Government has agreed that future pension increases (linked to price inflation) should be reflected in the funding of Local Government Schemes, but that at the same time only 75% of a scheme's

liabilities should be funded. The political aim is to reduce the burden of pension costs falling on local authorities, although at present it would appear that this funding approach will not meet the requirements of the accounting standard SSAP24 referred to elsewhere in this report.

9. Life Assurance

During 1988 the Inland Revenue issued a consultative document in which they put forward various alternative proposals for the future taxation of life assurance business in the UK. The range of proposals extended from adjustments to the existing regime to completely new taxation methods. In the event, the 1989 Budget followed the first approach and introduced amendments to the existing regime with particular reference to the treatment of pensions business expenses and the spreading of relief for initial expenses and commission. Further amendments to existing provisions are expected.

The full implications for the life assurance industry of the Financial Services Act began to emerge during 1988/89. Life assurance companies are rapidly realising the importance and value of a guaranteed "distribution channel" for their products. As a result there has been considerable activity in companies buying and "tying" such distribution channels.

The single European market due to be established by 1992 is resulting in much corporate activity in the UK insurance sector with interest being shown from both continental Europe and other overseas financial institutions.

In this period there has been increased interest in such matters as the policies followed by different life offices in determining bonus rates, the underlying financial strength of offices and related matters. The potential impact of AIDS has also been taken seriously and offices have taken steps to tighten up underwriting procedures and to introduce restrictions into policies.

10. Non-Life Insurance

Consulting actuaries are becoming more involved in advising on non-life problems in the direct market, the London market, Lloyds and for other institutions. There has been increasing talk about the possible introduction of a requirement for actuarial certification of non-life insurance companies reserves. Another area of discussion concerns the possible discounting of outstanding claims reserves, which could have significant taxation implications.

11. Actuarial Assessment of Damages

Interest in the actuarial assessment of damages in personal injury and fatal accident litigation has recently been stimulated by the activities of an organisation called "CITCOM" (Citizen Action Compensation Campaign), which has sponsored a Private Member's Bill. The Bill achieved a second reading with wide all party support, and went to the Committee Stage, although it did not achieve a third reading.

Of particular interest to actuaries was the fact that Clause 5 of the Bill, which sought to place a duty on the Courts to have regard to actuarial evidence if it were adduced by either party in assessing damages to be awarded, was based on a draft originally published by the

Law Commission in 1973 following discussions between that body and a working party of members of the Institute and Faculty. No action was taken on the Law Commission's recommendations, and nearly a decade later a small ad hoc committee of actuaries under the auspices of both the Institute and the Faculty sought parliamentary sponsorship for a similar draft clause to be added as an amendment to the Administration of Justice Bill 1982. The draft clause was duly tabled in the standing committee but was withdrawn on the understanding that the then Lord Chancellor would give his blessing to discussions between the actuarial and legal professions.

Although this initiative led to the establishment of an inter-professional working party of lawyers and actuaries, and the publication in 1984 of a booklet entitled "Actuarial Tables with explanatory notes for use in Personal Injury and Fatal Accident cases", these tables have not been accepted as relevant by any Court, although it is understood that they have been of assistance in reaching settlements.

The latest Bill therefore represented the third life of this draft clause, although it was again a short one. Nevertheless its publication and parliamentary discussion has already stimulated fresh discussion on actuarial techniques in legal and other professional journals and may have assisted the process towards reform in the future. The Government had in fact put down for debate at Report stage on the CITCOM bill an amendment which would have made the new tables referred to above admissible as evidence without further proof. The Solicitor General informed the House of Commons in July 1989 that it was now consulting the judiciary on this matter, and that subject to the outcome of those

consultations it will be seeking a future legislative opportunity to give effect to this proposal.

12. Friendly Societies

During 1987, the Association was involved in discussions with the Registrar of Friendly Societies and the Government Actuary's Department concerning the application of the EEC Life Directive to Friendly Societies.

The Association also took steps to ensure that Partnership Friendly Societies would be able to write Personal Pensions business in competition with Insurance Companies and other institutions, and this objective was achieved.

13. Investment

Consulting actuaries in the UK have been involved since the early 1970s in the measurement of investment performance for pension funds. This has led to consulting work on investment management arrangements generally including assisting clients with the selection of investment managers. At the same time actuaries in the UK have regarded themselves as qualified to comment on the broader aspects of the suitability of different investment policies in relation to the liability profiles of funds. In the last few years this has led to more activity by consulting actuaries in the "asset allocation" area, in some cases supported by extensive computer simulation techniques based on selected investment models.

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Calculating Pension Expenses - A Comparison

	SSAP24	FAS87
Actuarial method	Unspecified (but should result in stable regular cost as percentage of payroll).	Specified.
Actuarial assumptions	Long-term best estimates.	Market-related best estimates.
Amortization amounts	To be made over working life, but method unspecified.	Usually to be made over working life; based on straight-line amortization or apportioning equal amounts of capital repayments per year of service. (Note: 15-year option for transitional amount and 10% corridor for gains and losses.)
Refund of surplus	If desired, credit may be taken for net refund in period received.	Not directly recognised in profit-and-loss account (only affects asset return in subsequent years); gross refund treated as accrued pension cost in balance sheet.
Discretionary pension increases	Preferred treatment is to allow for increases likely to be granted; otherwise recognised in period in which granted unless covered by surplus.	Only to be allowed for in advance if substantive commitment; otherwise cost spread when granted.
Asset valuations	Any reasonable method.	Market or market-related value which takes account of asset gains and losses on systematic and rational basis over period of not more than 5 years.

Extra-ordinary events*	Surplus or deficiency associated with event may be aggregated with other financial effects in accordance with SSAP6; otherwise accounted for over period during which contributions actually charged.	Immediate recognition of parts of unrecognised transitional surplus, experience gains or losses, or unrecognised costs of benefit improvements.

* e.g. sale of subsidiary, purchase of annuities, reduction in workforce.