CURRENT TOPICS 2001

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Introduction

Welcome to the 2001 edition of the FASS Current Topics paper. This year for the first time we have contributions from the consultancy member offices of our society. For the General Insurance section of the paper we needed to look further afield and we are yet again indebted to our colleagues from south of the border for their contribution.

We have continued with the tradition of sections for each of the core examination subjects (for the time being), with again this year an additional section on the vitally important area of Stakeholder Pensions. There have been plenty of issues in the past year to consider and our contributors have without doubt created an interesting and useful paper.

The authors for each part of the paper are as follows:

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The paper is not definitive and we apologise, and take full responsibility, for any errors or omissions.

Finally we would like to thank all those who assisted in the writing of the paper. It is stressed that any opinions expressed are those of the authors and not necessarily those of our employers, colleagues or local actuarial societies.

PART I - LIFE INSURANCE

1 New Business

1.1 Current Sales Volumes

New business figures produced by the Association of British Insurers (ABI) for the last five and a half years (2000 only available up to end of second quarter at time of writing) indicate the following trends:

Total Individual Life and Pensions Business (Excluding CIS)			
	New Regular Premiums £m	**New Single Premiums £m**	**Equivalent Annual Premiums £m**
1995	2,145	16,984	3,843
1996	2,451	23,939	4,845
1997	2,707	26,948	5,402
1998	3,214	30,973	6,311
1999	3,157	38,073	6,964
1999 Qtr 1	776	9,457	1,722
Qtr 2	844	9,360	1,780
Qtr 3	778	9,758	1,754
Qtr 4	759	9,498	1,709
2000 Qtr 1	721	9,587	1,680
Qtr 2	774	9,398	1,714

Notes:

- Equivalent Annual Premium (EAP) = AP + SP/10
- The figures for new regular premiums agree with those from the ABI New Business Figures and last years' FASS Current Topics Paper. However, the new single premiums agree with those from the latest ABI New Business Figures and not with last years FASS Current Topics Paper. This is due to a change in the way the ABI presents the New Business Figures data.
- The ABI figures cover Collective Investment Schemes (CIS) separately.

Based on total premiums, new business for the first two quarters of 2000 remained unchanged increasing by 0.2% over the same period last year. Although it would appear as though there has been little change over the year, this is incorrect. Breaking this result down we note that new pension business premiums have decreased by 5.1%, continuing the trend reported last year. Continued uncertainty regarding Stakeholder pensions, which are unavailable until April 2001, combined with the current low annuity rates and fears over the pension miss-selling scandal have affected the market. The confusion over Stakeholder pension schemes has continued despite the publication of decision trees. Many pension providers have already voiced concern that these overcomplicate what was meant to be a simple product.

In contrast, new life assurance business continues to rise. Total new life assurance business for the first two quarters of 2000 increased by 3.6% over the same period in 1999 with single premiums up 5.0% and regular premiums down 21.8%.

Sales of Insurance ISAs have improved but remain low at 78,000 new contracts in the first two quarters of 2000, compared with 1,094,000 new contracts in the same period for cash and equity ISAs. This may be partially due to the fact that contributions are capped at £1,000.

1.2 Distribution Channels

The following table shows the distribution of individual life and pensions business by sales channel over the past five and a half years.

Total Individual Life and Pension EAP Split by Distribution Channel %

Year	Quarter	IFAs	Direct Sales Force	Tied Agents	Direct Marketing	Telesales	Other	Total
		%	%	%	%	%	%	%
1995		43.6	49.4	4.8	2.2	n/c	N/c	100.0
1996		48.0	45.5	4.5	2.0	n/c	N/c	100.0
1997		51.9	41.3	4.9	1.9	n/c	N/c	100.0
1998		52.0	40.6	4.7	1.8	0.4	0.5	100.0
1999		55.6	37.0	4.4	1.7	0.5	0.8	100.0
1999	Qtr 1	52.7	40.0	4.1	2.0	0.5	0.7	100.0
	Qtr 2	56.0	36.9	4.4	1.8	0.4	0.5	100.0
	Qtr 3	56.6	35.6	4.6	1.5	0.6	1.1	100.0
	Qtr 4	57.3	35.4	4.6	1.4	0.4	0.9	100.0
2000	Qtr 1	58.8	32.4	5.2	2.2	0.6	0.7	100.0
	Qtr 2	60.9	30.7	5.3	1.9	0.7	0.7	100.0

Notes:

- The n/c labels imply that the data were not collected.
- This table is based upon the New Business Premiums published by the ABI.

This split by source of new business shows that the trend, of an increasing proportion of business sold by IFAs at the expense of direct sales forces (which has been highly publicised over recent years), continued during 2000. Continued confusion over Stakeholder pensions has helped IFAs to continue their assault on pensions sales: customers without an advisor may have been unaware that many existing products are designed to be 'Stakeholder friendly'. Their share of the new regular premium individual pension business, increased to 64.1% in the second quarter from 59.2% in the same period in the previous year. IFAs continued to dominate the sales of single premium individual pensions, accounting for 83.2% of the business sold during the second quarter of 2000.

As reported last year, ISA (cash and equities) sales are dominated by direct sales forces which accounted for 52.5% of single premium and 70.0% of regular premium sales during the second quarter of 2000. However, these percentages represent decreases from 66.0% and

82.4% for single and regular premium sales respectively during the same period in 1999. This is due to the continued closure of insurers' direct sales forces, including Royal & Sun Alliance in 1999, as insurers are tending to concentrate on sales through IFAs.

2 Financial Strength

2.1 Free Asset Ratios

In 1999, free asset ratios improved for the majority of UK life insurers. The average free asset ratio in 1999 was 14.8% (including implicit items) compared to 11.7% in 1998 (Source: A.M. Best Company, Inc. publication "Best's Viewpoint").

There were two key factors causing this increase. Firstly a rise in interest rates (base rates up 1% during 2000, longer term rates increased more modestly) helped reduce the pressure on the solvency position of life offices, caused in part by the 1.9% fall in long-term interest rates in 1998, not fully reversed in 1999. In particular, the reserves for guaranteed annuity options were likely to be lower at the end of 1999 than at the same time a year earlier. Secondly, the good performance of the stock market towards the end of 1999, would have increased the market value of assets.

At the end of 1999, six companies included implicit items (for example future profits) as a capital item. These were the same six companies who had included implicit items in 1998.

Over the year 2000 the rising interest rates and stock market strength have seen a significant turnaround. These developments are likely to signify a reduction in free asset ratios at the year end. Further into the future, the low charging structures on Stakeholder pensions and the possible entry of the UK into the Euro could cause a further reduction in free asset ratios.

2.2 Revision to the Resilience Test

Last year's Current Topics paper gave details of a revision to the temporary modification of the second resilience test as set out in the Government Actuary's letter to Appointed Actuaries dated 30 September 1999. This was pursuant to further consideration of the original guidance in the context of the possible interrelationship that may exist between gilt yields and movements in the value of equities.

The Government Actuary wrote to Appointed Actuaries again on 15 May 2000 detailing a further change to the resilience test. The Government Actuary's Department believes that the change is appropriate following the recent revisions to the Insurance Companies Regulations 1994 (see 5.3) which include a revised formula for determining the yield on investment made more than three years in the future, with consequent effects on shorter term assumptions. This new regulation allows for the effect of a sustained reduction in long-term interest rates, which causes two of the existing resilience test scenarios to have overly severe effects.

The new resilience test considers the following three scenarios:

(1) A combination of

(i) a fall in the value of equities of 10%;

(ii) for fixed interest securities

(a) of less than five years outstanding term to redemption, and for short term deposits, a fall in the risk free yield of 20%

(b) for fixed interest securities of fifteen or more years outstanding term to redemption, a fall in the risk free yield of 10%

(c) for fixed interest securities of more than five but less than fifteen years outstanding term to redemption, a fall in the risk free yield of (25-{outstanding term in years and part years})%

(iii) a fall in property values of 10%

(iv) a fall in the real yields on indexed gilts of 25% (e.g. from 2% to 1.5%)

(2) A combination of

(i) a fall in the value of equities of the greater of

(a) 25%, subject to the fall being restricted to such as would not produce a P/E ratio on the FTSE Actuaries All Share Index lower than 75% of the inverse of the long term gilt yield (as defined in regulation 69(9)) before the assumed fall in paragraph (ii), and

(b) 10%,

(ii) for fixed interest securities

(a) a fall in the yields on risk free securities of less than five years outstanding term to redemption and on short-term deposits to the level which is calculated under regulation 69(9) for future investments (or remain constant if already at or below this level),

(b) the yields on risk free securities of at least fifteen years duration remaining constant,

(c) a fall in the yields on risk free securities of more than five but less than fifteen years outstanding term to redemption to levels obtained by interpolating between the figures given by (a) above and the 15

year gilt index yield (or remain constant if already at or below this level),

(iii) a fall in property values of 20%, and

(iv) a rise in the real yields on indexed gilts of 10% (e.g. from 2% to 2.2%)

(3) a combination of

(i) a fall in the value of equities of 25%,

(ii) a rise in the risk free fixed interest yields of 3 percentage points,

(iii) a fall in property values of 20%, and

(iv) a rise in the real yields on indexed gilts of 1 percentage point

For those fixed interest securities which are not risk free, actuaries are expected to assume the yield differential to risk free does not reduce in a resilience test.

A working party has been reviewing the resilience test. At the Birmingham Convention, Mike Urmston gave a preview of the new test which will use four scenarios. Two are of the type currently in use, and involve a random change in equity and fixed interest prices/yields. A stochastic asset model and a jump in inflation rates generate the other two scenarios. The working party hopes that the new test will provide a more stable and predictable regulatory environment.

3 Legislation and Guidance

3.1 Insurance Companies (Amendment) Regulations 2000

The changes to the Insurance Company Regulations 1994 described in last year's paper came into force on 29 May 2000. They are specified in the 'Insurance Companies (Amendment) Regulations 2000'.

The key amendments are:

- To allow the use of a gross premium valuation method for non-profit business.
- To amend the maximum yields that may be assumed for investments to be made 3 or more years after the valuation date.
- To clarify the meaning and application of PRE with respect to reserves for accumulating with profits business and valuing options.

This final area is the one that generated most debate and controversy as the regulations were developed. The regulations now require that reserves are sufficient to meet cash surrender

values on the valuation basis. The surrender values should be in line with PRE, without taking account of reasonable (or other) expectations about future non-guaranteed additions. In particular, for accumulating with profit business the surrender value to assume is the lower of:

- An amount consistent with reasonable expectations

and;

- That same amount ignoring any discretionary elements.

The most contentious issue is the application of the regulations in a post resilience test scenario environment, in particular the treatment of accrued terminal bonus and market value adjustments. The Life Board Supervision Committee reported:

'.. the objective of the regulation and associated guidance has been to clarify the requirement, and ensure that discretionary bonuses can be disregarded, and allowance made for market adjustments, but only if appropriate and consistent with policyholders' reasonable expectations in the revised circumstances'.

The Government Actuary issued the 'Dear Appointed Actuary Letter number 14' on the Resilience Test to reflect revised yield restrictions contained in the new regulations. This was described in section 5.2 above.

GN8 is currently under revision to reflect the new regulations, and some other issues. The draft also gives guidance in the area of non-unit reserves on unit-linked and unitised with profit policies and the use of the inception/annuity methodology for PHI reserves.

3.2 Financial Services and Markets Act

The Financial Services and Markets Bill (FSMB) has now completed the Parliamentary process and received Royal Assent on 14 June 2000. The Financial Services and Markets Act ('the Act') will not come into force until some pieces of secondary legislation have been passed. It is expected that a phased introduction is likely, with FSA officials quoting "Summer 2001" as the estimated deadline for the final transition to the new regime. The legislation is essentially a framework only. The detailed rules, which for insurers have until now have been contained in the various Insurance Companies' Regulations, will become part of the "source book" (or rule books) of the FSA.

In addition to the legislative changes the FSA is also developing its own practical approach to regulation, in particular how it will operate a risk based approach.

The FSA have issued a number of consultation papers regarding both the future practical approach and the source books and guidance material which will form the detail of the rules under the new Act.

Further details are available at http://www.fsa.gov.uk/pubs/cp/index-2000.html.

4 Stakeholder Pensions

From a purely actuarial perspective there have not been any major developments on Stakeholder Pensions since the extensive coverage in last year's paper.

Several companies, including Standard Life, Scottish Widows and Norwich Union have committed to reducing the charges on existing pension products to bring them into line with the 1% per annum maximum charge on Stakeholder pensions. For proprietary companies this may have a detrimental impact on achieved profits for 2000.

Detailed guidelines for selling Stakeholder pensions have been issued, but have been criticised for ignoring the needs of the very low income group who will not benefit from contributing to a Stakeholder plan.

The introduction of this product is set to have far reaching implications for the industry, in terms of product design, profitability and capital requirements. This is likely to provide further fuel for the trends discussed in section 5.8.

5 Equitable Life

Significant developments at the world's oldest mutual life company warrant a section of their own.

In response to the unexpected cost of covering guaranteed annuity options on With Profit business, The Equitable had adopted a two-tier terminal bonus structure designed to offset the cost of honouring the guarantees. This practice was challenged in the courts by unimpressed policyholders. The case swung one way then the other until it reached the House of Lords in the summer.

In July 2000 the House of Lords ruled that the Equitable cannot give a different level of final bonus to those with-profits policyholders who have Guaranteed Annuity Rates (GARs) in their policies. The ruling meant that, because of Equitable's 'Managed Fund' approach to managing With Profit asset shares: no estate in excess of current policyholder interests, the forced increase to policy benefits for some policyholders meant inevitably there would be a decrease in benefits for other policyholders. No bonuses were added to with profit policies for the first 7 months of 2000 to cover the expected cost of the GARs.

The other main outcome of the ruling was that the Directors decided to put the Equitable up for sale in the best interests of all members. Many companies expressed an initial interest in the sale, with three companies entering into detailed discussions. It was hoped that a deal would be struck by Christmas, but the last of the interested parties withdrew from talks in early December. With no prospect of any financial support for the With Profit Fund, the Directors decided to close to new business with immediate effect, a decision that was supported by the FSA.

The Equitable is still solvent, but has warned of the need to switch to a more cautious investment strategy, and has increased the exit charges on With Profit policies to avoid a 'run' on the fund.

Late in the year, talks were being held with a view to selling some parts of the Equitable to bolster the With Profit fund. The famously productive salesforce and the Permanent Insurance Company were attracting most interest. It is thought unlikely that there will be any transfer of the With Profits Fund.

Voices from within the profession have become increasingly critical of the management of The Equitable and its perceived arrogance in dealing with the GAR problem. However, many other companies are currently sitting rather uneasily as the detailed implications for their own Guaranteed Annuity liabilities emerge.

6 Sales Issues

Mis-selling problems continued to hang over the industry in 2000. The three product areas in the spotlight were Free Standing Additional Voluntary Contributions (FSAVCs), Personal Pensions, and Mortgage Endowments. To avoid possible future repeats of these problems the ABI launched its Raising Standards Quality mark scheme. Details follow:

6.1 FSAVCs

The FSA published guidance in May 2000 for the review of FSAVCs sold between 29th April 1988 and 15th August 1999. This guidance was adopted by the PIA, SFA and IMRO.

Four different situations are within the scope of the review:

- 'Matched': the in-house alternative provided additional employer contributions
- 'Subsidised': the in-house alternative provided other subsidised benefits such as 'added years'
- Conversions from personal pensions: policies taken out during the 'waiting period' for an occupational scheme and then converted on joining that scheme.
- 'Requests for review' from investors.

The review is to be completed by 30th June 2002 (the same date as the Pensions Review), but priority cases (deaths/retirements) must be dealt with within six months of identification.

All the deadlines for identifying cases that fall within the initial scope of the review have now passed and firms will be at various stages of the mailing and reminding program.

If firms are unable to establish that sales of affected cases were made in compliance with relevant guidelines, and a loss has occurred, they will be liable to offer redress to the investor. Reinstatement is, not surprisingly, the preferred option for defined benefit cases.

Augmentation is the likeliest route for defined contribution cases, with appropriate allowance for charges.

At a time when the industry is short of appropriate resources due to the ongoing Pensions Review (see 5.6.2), compliance with this guidance and its deadlines may be difficult and expensive. Extensive press coverage is likely to swell the number of ‘Requests for review’, as is the alleged activity of some Trades Unions who are encouraging their members to request a review.

6.2 Pensions Review

The personal pensions mis-selling review continued to tie up significant actuarial and other resources within the industry during 2000. At the end of 1999 the FSA had announced that an aspect of the PIA’s pensions review guidance relating to assumptions made in respect of SERPS, might result in material mis-statement of loss for a significant number of Phase 2 transfer cases. This led to a delay in firms being able to make offers of redress in respect of these cases (although firms could continue to perform loss calculations for the affected cases and then make an adjustment when the final guidance was issued). The FSA issued guidance relating to the SERPS adjustment in June.

Companies should now be fully aware of the order of magnitude of the cost of completing the review and providing appropriate redress, as well as the nature of their exposure to changing economic environment.

6.3 Mortgage Endowments

Is it a little misleading to include Mortgage Endowments in this chapter since it remains the FSA’s view that, on average, people with endowment mortgages have done at least as well to date as they would have done with a repayment mortgage. As a result no industry-wide proactive review is currently planned.

However, the FSA is continuing to gather information to identify whether there were systemic failings in the selling practices of particular firms that may have caused widespread loss. To the extent that such cases exist, the FSA will not hesitate to employ enforcement powers to ensure that these firms put matters right for their customers. In late November Royal Scottish Assurance was fined £2m for failing to charge realistic premiums for a Flexible Mortgage Endowment product, and subsequently requesting that customers increase premiums without disclosing their error. Royal Scottish also faces a £50m bill for compensating affected customers both retrospectively and prospectively.

The FSA is actively encouraging investors to complain if they are concerned. This could well lead to a large number of complaints, and hence some provision for the associated redress and administrative costs may be appropriate. At the end of November the FSA issued a Consultation paper proposing guidelines for reviewing mortgage endowment complaints and, in particular, for assessing loss and calculating redress.

6.4 ABI – Raising Standards

In October 2000, the Association of British Insurers (ABI) launched its Raising Standards Quality mark scheme. The ABI announced that 41 brands, representing 78% of the life and pensions market, had publicly committed to the scheme by the time of the launch, including household names such as Prudential, Norwich Union, Scottish Widows, Standard Life, Eagle Star and Allied Dunbar.

Formerly known as the Savings and Long Term Risk (SALTR) project, the scheme has been developed under the auspices of the ABI to foster public confidence in the long-term savings and protection market. Improved public confidence should lead to a positive operating environment and a growth in the size of that market.

The scheme will encourage brands to raise standards sufficiently to be granted the use of a new quality mark. Brands using the quality mark will make consumer promises covering three areas:

- Clarity and comparability of information.
- Appropriateness of the products purchased.
- Customer Service.

An independent body, the Pensions, Protection and Investments Accreditation Board (PPIAB), will grant the right to use the quality mark once brands have demonstrated that they are meeting all the standards. The directors of this body are non-industry practitioners and the Board has been set up under an independent trust.

The PPIAB also has responsibility for making sure that brands using the quality mark continue to meet the standards and that they are using the quality mark appropriately.

The PPIAB is expected to announce the names of the first companies to be granted use of the quality mark in October 2001. Brands that want to be in the first group must apply to the PPIAB, with evidence that they meet the standards, by the end of June 2001. Brands will be able to apply to use the quality mark at any time thereafter.

The scheme will have a significant impact on product designs in future adding further momentum to the 'Stakeholder' inspired drive towards transparent charging structures. In particular, the following restrictions on charges will apply:

- Certain charging structures, such as capital units and excessive rounding on unit allocations, will not be allowed. No maximum charges have been set. This simplification will give a more explicit illustration of charges (but the product design could be altered to achieve the same effects).

- Deductions for risk will not be allowed to be more than 20% above the risk-adjusted, long-term view of the Appointed Actuary. Deductions above this amount will need to be disclosed as a charge and will increase the Reduction In Yield value. Additional work will be required from the Appointed Actuary to justify the deductions for risk used.

- Bid/Offer spreads can still be used internally. However, if the policyholder is aware of their existence, then this fails the clarity test.

6.5 Persistency

Persistency rates are used by the FSA as an indicator of the quality of the selling process. The charging structure of many policies is such that ceasing to pay premiums early results in a loss to the investor. If investors buy policies on the basis of good advice they would not normally be expected to stop paying premiums, unless forced to do so by unexpected changes in their personal circumstances.

Each year the FSA requires insurers to submit information about the persistency of their life assurance and pensions business on a prescribed basis. The results of the sixth survey were published in November 2000. The report extended the information published in previous reports
with one, two, three and four year duration persistency rates for business sold in 1998, 1997, 1996 and 1995 respectively.

Lapse Rates for Regular Premium Policies (All Sales Channels)

Policies started in	**1995**	**1996**	**1997**	**1998**
Lapses in year 1 (%)	10.3	9.3	9.3	9.5
Lapses in year 2 (%)	7.4	9.3	8.8	
Lapses in year 3 (%)	6.9	7.3		
Lapses in year 4 (%)	5.9			

These figures show that, for every 1000 policies taken out in 1998, 95 lapsed during the first year.

The one-year duration persistency rate for regular premium policies sold in 1998 fell slightly. (A higher persistency rate means that there are fewer lapses.)

The proportion of regular premium policies lapsing in subsequent years reduces as the period from commencement increases. Nevertheless, nearly a quarter of regular premium policies written in 1995 were discontinued by their third anniversary and 30% by their fourth anniversary. The PIA is concerned about the level of lapses and recent trends indicate that improvements are very slow.

At each duration in force the lapse rates for regular premium policies have deteriorated and the PIA is concerned about whether sufficient attention is paid to preserving existing business. This lack of improvement in persistency rates as duration in force increases is particularly noticeable in business sold by IFAs.

Lapse Rates for Single Premium Policies (All Sales Channels)

Policies started in	1995	1996	1997	1998
Lapses in year 1 (%)	1.7	1.4	1.5	1.4
Lapses in year 2 (%)	2.3	2.0	1.8	
Lapses in year 3 (%)	2.7	2.2		
Lapses in year 4 (%)	2.8			

For single premium business written in 1998, the one-year persistency rate improved slightly.

Persistency rates for single premium business are much higher than for regular premium policies and, for policies written in more recent years (1995 onwards), appear to be somewhat better than for policies written in earlier years.

As in previous surveys, the results show that the persistency rates for policies written by IFAs or in response to direct offer advertisements are generally higher than for business written by company representatives, including those representing Industrial Assurance companies. For example, the rates for regular premium policies sold in 1997 (for regular premium policies) are:

	Company Representatives	Industrial Business	IFAs	Direct Offer
Lapses in year 1 (%)	9.5	14.3	7.3	7.6
Lapses in year 2 (%)	8.8	9.3	8.4	8.3

Possible explanations for these differences in persistency rates are:

IFAs tend to advise those on higher and more reliable incomes who may be better able to afford the policies sold, and policies selected from the whole market by an IFA or by the investor (in the case of direct offer business) are more likely to meet the needs of the investor.

7 Corporate Activity

The momentum in the insurance industry towards mergers, demutualisations and take-overs continued during 2000….with one notable exception. At the time of writing Lloyds TSB appear to be trying to buy Abbey National and stop the union with Bank of Scotland.

7.1 CGU and Norwich Union

In February 2000, the Boards of CGU and Norwich Union announced that they had agreed the terms of a merger of the two companies to create CGNU. The merger cleared its regulatory hurdles in May.

Under the terms of the nil-premium merger, CGU Shareholders retained their CGU shares (renamed CGNU) and Norwich Union Shareholders received 48 new CGNU Shares for every 100 Norwich Union Shares.

The combined group's head office is in London. The UK life insurance operations are headquartered in York and UK general insurance operations in Norwich. The merger is expected to result in some 5,000 job losses world-wide (out of a total combined workforce of more than 70,000), of which approximately 4,000 would be in the UK. The merger is expected to generate at least £275 million in annualised pre-tax cost savings within 18 months of completion.

The merger has created the 6th largest insurance group in the world and the largest in the UK. It is the largest writer of new life and pensions business in the UK with a diversified distribution capability incorporating IFAs, financial institutions, agents and direct channels. CGNU is the second largest asset manager in the UK by reference to funds under management in excess of £200 billion.

The group has identified, and will develop its strongest brand in each market, for example, in the UK the Norwich Union brand is being used for both life and general insurance, while the Hibernian brand is to be developed in Ireland.

CGNU is well placed to be the leader in its core markets and one of the leaders in the European financial services industry.

Since the merger, CGNU has seen strong organic growth in its long-term and savings business. It has also announced the actual or intended disposal of general insurance businesses in the US, Germany, South Africa, New Zealand and the London Market and the disposal of its private client investment manager, Quilter Holdings and its Australian property fund manager, Paladin.

7.2 Bancassurance

In July, CGNU and the Royal Bank of Scotland announced that they had agreed the terms of their bancassurance partnerships. Both Royal Scottish Assurance and NatWest Life will be restructured through joint venture agreements, with the Royal Bank of Scotland and CGNU having a 50% share of each business.

It was agreed that CGNU would pay £600m to the Royal Bank of Scotland for its 50% stakes. The total embedded value was estimated at £630m. The partnership is designed to bring together CGNU's skills in the design and delivery of insurance products with The Royal Bank of Scotland's retail distribution capability.

It was also announced that the Royal Bank of Scotland and CGNU would seek to identify opportunities to develop their respective businesses through further commercial co-operation.

7.2 Royal London and …..

United Assurance

In April 2000 Royal London completed a take over of the United Assurance Group, including Refuge Assurance and United Friendly Insurance, at a total cost of £1.5bn. This was the highest value take over of a proprietary company by a mutual in the UK.

The purpose of the deal was to create a much larger company in the home service market, with combined premium income of £800m per annum and funds under management of around £20bn. Integration of the two businesses has continued during the year and annual maintenance cost savings of the order of £60m have been identified.

A Scheme has been established to transfer the life business from the United Assurance companies to Royal London with effect from 1 January 2001.

Scottish Life

In October 2000, Royal London and Scottish Life announced that they had entered into an agreement providing for the transfer of Scottish Life's business to Royal London. The combination of Scottish Life and Royal London will create a group with strong positions in the home service sector and the IFA sector together with a significant presence in asset management. The enlarged group will have pro forma premium income of £1.9 billion and funds under management of nearly £30bn.

Under this agreement, Scottish Life members and policyholders will benefit from cash and additional policy benefits totalling approximately £1.1 billion. This consists of:

- £111 million cash payment to Scottish Life members as compensation for the loss of their membership rights representing £500 per member,

- £160 million to be declared as an additional reversionary bonus to with-profits policyholders after completion, and

- £829 million to be paid out to with-profits policyholders in the form of enhanced final bonuses.

The terms are subject to the agreement of the members of Scottish Life in the Spring of 2001. The deal is designed to support Royal London's strategy of developing new channels of distribution, broadening its product offering and increasing its funds under management. It provides the Royal London group with a well regarded IFA brand and a platform to access the IFA market through which it can diversify its product offering.

7.3 Abbey National and Scottish Provident

On 7 September 2000, following an extensive review of its mutual status, the Board of the Scottish Provident Institution announced that it had entered into an agreement providing for

the transfer of Scottish Provident's business to Abbey National plc. The members of the Institution will vote on this proposal in Spring 2001 and, if successful, following the necessary court and regulatory approval, the deal will complete in the Summer of 2001.

The key terms of the transaction are:

- Abbey National will pay £1.8 billion subject to adjustment for movements in embedded value. This will comprise approximately £1.6 billion in cash to policyholders as compensation for loss of membership rights and around £200 million which will be paid into the life fund in return for a one ninth share of future bonuses allocated to the conventional WP policies.

- Average up front compensation for eligible with-profits members is expected to be around £4,500

- A minimum £500 will be paid to each qualifying member.

- Average total compensation (including additional policy benefits) which is expected to be paid to eligible with-profits members is expected to be around £6,000

The acquisition is a major step towards delivering Abbey National's stated target of achieving 65% of profits from business other than mortgages and savings.

The acquisition of Scottish Provident by Abbey National brings it together with the current Life Division businesses of Scottish Mutual and Abbey National Life. The addition of the Scottish Provident brand will make Abbey National a leader in the high growth sector of individual Protection products in the important UK IFA Market as well offering scope to develop products for the Abbey National retail branch network.

Scottish Provident's international operations fit well with Scottish Mutual International, one of Abbey National's fastest growing businesses and this move will see international expansion plans accelerate.

The transaction will also increase Abbey National's funds under management from approximately £20 billion to around £30 billion.

Abbey National has not addressed, publicly at least, what it is going to do about the overlapping areas within its enlarged Life Division. The problem is not as great as with CGNU, but some rationalisation of product lines, staff and infrastructure is likely.

7.4 Winterthur Life and Colonial Life

In May, Winterthur Life UK acquired the UK life and pensions business of Colonial. The purchase price was around £300m.

Winterthur has grown rapidly over the past 10 years in the UK focussing on upmarket pensions business (including self invested personal pensions and group pensions) via IFAs and house related products through a major estate agency network tie.

The acquisition gives Winterthur the opportunity to add 'With Profits' to its range of investment options for products in its core areas, and consider what other markets it can now enter as a result of the new strengths of the enlarged UK operation.

7.5 Standard Life

During 2000, Standard Life received a demutualisation resolution from a policyholder group led by Monaco based Fred Woollard. The demutualisation resolution required support from 75% of voters to succeed.

The case for and against demutualisation was argued strongly, and occasionally emotionally, by both sides. The Directors conducted a strong defence of the company and argued against demutualisation on the basis of financial strength and a market leading position. They aimed to demonstrate the benefits of mutuality to customers by:

- Providing a promise to all holders of endowment policies giving some comfort that the targeted maturity value will be reached.

- Leading the market in cutting the charges on its existing pensions products so that all customers benefit from the new stakeholder charging regime.

Amongst the many exchanges, there were allegations of a less than helpful approach by Standard Life to advising policyholders exactly how much they would receive from any demutualisation windfall. These allegations were strongly refuted by the company.

Ultimately, the choice was that of the members and, notably, at a Special General Meeting in June 2000, 54% of the votes cast were in favour of retaining mutual status. It is expected by many that Standard Life will be called upon to defend its mutuality again in the coming years.

8 International Accounting

Accounting for companies generally differs between countries and, within countries, between industries. This is particularly true for insurance companies. In an age of increasing globalisation of markets and regulation, and decreasing demarcation between banks, insurance companies and other financial enterprises there is a demand for a common reporting methodology for insurance companies worldwide. This is essential to:

- allow comparison of capital strength,

- to reduce accounting arbitrage, and

- to ensure capital efficiency

The International Accounting Standards Committee (IASC) has been examining the fundamental operation of insurers and assessing the required financial reporting for these operations against the fundamental accounting concepts set out in the IASC's Framework Document. The aim is to find a globally acceptable financial reporting methodology.

A Joint Working Party is due to report, around the time of writing, with proposals for a set of concepts for an international accounting standard for financial assets and liabilities. This is expected to propose that financial instruments are accounted for on a Fair Values (FV) basis. As the definition of an insurance contract

> "a contract under which one party (the insurer) accepts an insurance risk by agreeing with another party (the policyholder) to make payment if a specified uncertain future event occurs (other than an event that is only a change in a specified interest rate, security, commodity price, foreign exchange rate, index of prices or rates, a credit rating or credit index or similar variable)"

fits the definition of a financial instrument, the IASC is favouring the use of FV for insurance policies. This would lead to consistency between the different accounting regimes for the financial services industries. The IASC is aiming to issue a draft statement of principles in 2001, an exposure draft in 2002 and a new IAS in 2003.

Fair Value

The definition of 'fair value' is:

> "The amount for which an asset could be exchanged or a liability settled between knowledgeable, willing parties in an arm's length transaction."

The IASC has indicated that an embedded value presentation will not be acceptable because it relies on the over-prudent liabilities being offset by an artificial asset, namely the value of in-force business. As a result, the methodology will have to focus on putting a realistic value on the net liabilities, with added market consistent margins to reflect the uncertainty around that 'realistic' value. These margins are called 'market value margins' (MVMs) – "the price a willing buyer would charge above best estimate to assume a liability from a willing seller for taking unhedgeable, non-diversifiable risk". A replicating portfolio ("risk-minimal asset portfolio that, given the assets available, replicates the risk adjusted cashflows as closely as possible under different future economic scenarios") can then be used to find the fair value of the cashflows concerned.

So much for the technical foundations. The continued development and eventual implementation of the new IAS has significant implications for actuaries, especially those involved in financial reporting. European legislation demands that all EU listed insurance companies report in accordance with the IAS from 2005. Change is definitely coming.

9 Inherited Estates

9.1 Background

After a stream of attributions of inherited estates between 1991 and 1997, the position of the regulator seemed to preclude the possibility of further major attributions of inherited estate where the shareholder would enjoy a larger share of undistributed surplus than had been the case for distributed surplus. The exceptions to this are where 'there was clear evidence that a different proportion was appropriate in respect of the surplus arising from some particular part of the business'. In some cases, part of the inherited estate can be traced to capital injections from shareholders or profits on non-profit business pre-dating the writing of with-profit business in a fund. This constitutes 'clear evidence', and in such cases the regulator can be more generous to the shareholders.

9.2 AXA Equity & Law

During 2000, AXA Equity & Law has secured approval from the FSA to offer policyholders the choice of

a) a share of inherited estate amounting to around 40% of surplus now, in exchange for revoking rights to future claims on the inherited estate; or

b) no immediate share of the inherited estate and the continued right to participate in future distributions on unknown terms

Given the usual 90:10 split for With Profits surplus, this signals a departure from (or at least broader interpretation of) the regulator's former position.

As more than 35% of policyholders accepted, all policyholders will receive a 'reorganisation bonus'. The 'Yes' policyholders will receive an incentive payment in cash. The 'Yes' proportion of inherited estate will then be attributed to shareholders, but the assets will remain in the Long Term business fund. The balance of the inherited estate will be transferred to the 'No' Fund where it will continue to be inherited estate.

The policyholders therefore have to choose between a guaranteed windfall now or some unknown benefit, which cannot be delivered before 2006: there will be no release of attributed shareholder assets or remaining inherited estate for 5 years following the reorganisation.

AXA is currently the subject of a fairly vociferous backlash from some policyholders, supported by the Consumers Association. The objectors are unhappy about the terms of the offer and clarity of communication. Nevertheless, the reorganisation has been given the go ahead by the Courts.

The following table gives some estimates for inherited estates in other With -Profit Funds. These estimates have been produced by the author with the help of a variety of sources except in the case of CGNU where the company have published the information:

Company	Estimated Inherited Estate 31.12.99 (£bn)
Prudential	8
CGNU	4
Pearl Assurance	3
Legal & General	2
Britannic	2
Royal & SunAlliance	1
Total	**£20bn**

It is likely, given the success of the AXA proposal that these other companies will be reviewing there options with a view to releasing some shareholder value.

PART II - STAKEHOLDER PENSIONS

1 INTRODUCTION

Last year’s Current Topics paper discussed the reasons why the Government is introducing Stakeholder pensions and the possible impact they may have on the insurance industry.

This year’s paper discusses the key features of Stakeholder and how they may impact on employers and individuals.

Stakeholder pensions are being introduced in April 2001. Stakeholder pensions are the Government’s most important pensions initiative in this Parliament. They will be promoting them in an extensive media campaign which started in Autumn 2000. One of the likely effects will be to raise pensions awareness amongst all individuals, even though the Government's stated objective is to persuade low and moderate earners to save for retirement.

The main issue for employers is the impact this will have on their existing pensions provision and how this will be perceived by employees.

Stakeholder schemes are designed to be simple, low cost, tax effective, flexible pensions. They are intended for those employees who are not eligible to join their employer’s scheme or for whom a personal pension is inappropriate.

2 EMPLOYER’S OBLIGATIONS

From 8 October 2001 employers will be required to nominate and provide access to a Stakeholder pension scheme for all their relevant employees. Access to a Stakeholder pension scheme must be provided after three months of employment.

Employers are only required to nominate a Stakeholder pension scheme for relevant employees. The following are not relevant employees and, therefore, do not need to be provided with a Stakeholder pension scheme:

employees who have earned less than the National Insurance Lower Earnings Limit (currently £3,484) for one or more weeks within the last three months; or,

those who have been continuously employed for less than 3 months; or,

employees who are ineligible to contribute due to Inland Revenue restrictions.

Employer Exemptions

Employers will be exempt from the Stakeholder requirements if: -

they have fewer than five employees (to be reviewed in 2004); or

they offer an occupational scheme to all employees (except those under age 18 or within 5 years of normal pension age) within 12 months of starting work; or

they offer to contribute at least 3% of basic pay into a personal pension scheme for all employees and there are no exit charges from the scheme.

Occupational Pension Schemes

Relevant employees must be eligible for scheme membership within 12 months of starting work. This includes temporary and part-time staff, contract workers and staff employed outside the United Kingdom. If they are not eligible to join, they must be offered access to a Stakeholder scheme within 3 months. Employees under age 18, or within 5 years of normal pension age, do not need or to be offered a Stakeholder pension scheme. Similarly, employees who have chosen not to join or opt-out of the occupational pension scheme may be excluded.

Currently, most employers do not allow temporary employees and contract workers to join their schemes. If these employees are employed through an agency, it is the agency's responsibility to provide access to a Stakeholder Scheme.

In order to avoid the Stakeholder requirements, the employer could allow temporary employees and contract workers to join its occupational scheme after one year's service and ensure all such employees are employed for less than one year. This can be done even if permanent employees have a shorter service requirement, unless this can be considered to be indirect sexual discrimination.

There are no requirements for a particular level of benefits to be provided by an occupational scheme. The scheme could, therefore, provide minimal benefits but still qualify for the exemption so long as all relevant employees are eligible. As it stands, death benefits-only schemes would be sufficient to provide an exemption. It will be interesting to see how many employers exploit this loop-hole and whether the Government will close it.

Group Personal Pension Plans

If an employer has made a contractual promise to every employee aged 18 or over to pay contributions of at least 3% of basic pay to a personal pension scheme, it will be exempt. Basic pay for this purpose excludes bonuses, commission or similar payments.

In addition, there must be no financial penalties if a member ceases to contribute or transfers the funds to another scheme. Any exit charges must not exceed the regular charges which would have been payable if the member had not transferred out.

The employer must be able to deduct contributions from employee's salaries and pay them over to the trustees or managers of the personal pension scheme.

The employer can make it a condition that employees match the employer contributions, up to a maximum of 3% of basic pay.

Where schemes were set up prior to 8 October 2001 it will be sufficient for the employer to demonstrate that the appropriate contributions are already being made and any request to match contributions from the employee can exceed 3%. However, if the employer requires matching contributions in excess of 3% from new entrants to the scheme after 7 October 2001, then these employees - who are on new contracts - must also be offered a Stakeholder (although the employer need not contribute to this).

This exemption route is inconsistent with the Occupational Scheme route. First of all it specifies a minimum level of employer contributions whereas under the other route no minimum level of benefits is required. In addition, it specifies a maximum level of employee contributions whereas the Occupational Scheme does not.

It is possible that employee contributions to group personal pension schemes could be reduced to make employers exempt and if this is done, employers are likely to reduce their own contributions.

It is worrying that these contribution limits could be regarded as being sufficient to provide appropriate levels of benefits.

Employer Access Requirements

Employers who are not fully exempted by the regulations will be required to nominate a Stakeholder scheme for all relevant employees. Nominating a scheme does not mean that employers have to run or contribute to a Stakeholder, but that they must provide access for relevant employees to join the scheme. Employers will have a duty to: -

ensure that at all times at least one Stakeholder scheme is designated from OPRA's list of registered schemes, to offer membership to all relevant employees;

consult with the relevant employees and any representative organisations on the choice of scheme;

provide employees with the name and address of the Stakeholder pension scheme;

allow providers of the chosen scheme reasonable access to the relevant employees in order to supply information about the scheme;

offer a payroll deduction facility and pay over contributions within prescribed timescales;

periodically check that their designated scheme is still registered as a Stakeholder scheme. If a scheme ceases to be registered with OPRA, the employer must provide access to an alternative provider within four months.

Any employer who fails to comply with any of the above requirements will be subject to a fine from OPRA. OPRA has the power to impose fines of up to £50,000 on an employer.

After this date, if an employer loses its exemptions it will have three months to comply with the requirements. After 8 July 2001, if an employer takes on a fifth employee, it must designate a scheme within three months of the fifth employee joining.

Payroll Deduction Facility

Where requested by employees, the employer must deduct the amounts requested from the employee's pay and pass on the contributions to the designated Stakeholder scheme. The employer must also keep a separate record of the contributions deducted.

All employee contributions must be paid over to the provider within 19 days of the end of the month in which the deduction was made.

Employees may vary the contributions deducted through their payroll once every six months, although they can stop contributing at any time.

Employer Liability

The employer is **not** required to: -

make any investigations about the designated scheme other than to ensure that the scheme is registered with OPRA and will offer membership to the relevant employees;

investigate or monitor the investment performance of the scheme;

endorse a scheme, or to give advice, only to provide sufficient information for the employee to contact the scheme;

contribute to the Stakeholder - employers may choose to contribute to the Stakeholder but they are under no obligation to do so;

deduct and pay over contributions to any alternative schemes where employees have chosen not to join the designated scheme, although they may choose to do so.

As stated above, employers are not required to investigate the investment performance of their designated Stakeholder Scheme or endorse the Scheme. This in theory protects employers from legal action from employees if investment performance doesn't meet with expectations but employers may prefer to investigate and monitor performance to reduce the risk of disgruntled employees.

As employers are not required to contribute to Stakeholder Schemes, it is difficult to see how private pension provision will increase significantly. Most employers are likely to be content to maintain their existing level of provision for their employees. However, it is possible that increased public awareness could lead to pressure on employers to increase provision. Similarly, employees may decided not to contribute to a designated scheme if their employer does not although some may choose to do so because it is easier than buying a personal pension.

3 KEY FEATURES OF STAKEHOLDER PENSION SCHEMES

Stakeholder pension schemes are simple money purchase schemes, and may be approved as occupational or personal Stakeholder schemes.

Stakeholder schemes may be established under trust or under contracts with scheme managers authorised by the Financial Services Authority. Trustees or Scheme Managers will be responsible for ensuring that the scheme operates correctly and does not breach the conditions for registration as a Stakeholder scheme.

Trust-based schemes will operate under the terms of the trust deed and one-third of the trustees must be independent of the service providers or managers. There are no specific requirements for member-nominated trustees.

For schemes set up under contract, scheme managers will run the scheme on terms set out in a contract between the scheme and its members. The activity of managing non-trust Stakeholder pensions will count as investment business.

Schemes will be able to restrict membership to particular employers, trades or professions.

Benefits

The funds from a Stakeholder pension scheme may only be used to provide benefits on retirement. Benefits may be taken between ages 50 and 75, irrespective of whether the member is still working. Up to 25% of the accumulated fund will be available as a tax-free lump sum on retirement and the balance must be used to purchase an annuity or go into income drawdown. Protected rights may only be used to provide a pension.

A single arrangement may have more than one pension date. This allows the member to have phased withdrawal of benefits by purchasing one or more annuities at different times.

No more than 10% of the contribution may be used to purchase life assurance, and no part of the contribution may be used for waiver of contribution insurance.

Contributions

Schemes will be able to set a minimum contribution level, so long as this does not exceed £20 but must accept payments in respect of tax relief and NI rebates, even if these are less than £20. Schemes will have the right to refuse contributions paid by cash or credit card. There is no requirement to pay regular contributions and members can stop or start contributions to a Stakeholder at any time without penalty.

Charges

Stakeholder pension charges will be limited to 1% of the value of the member's fund, to cover all normal operating costs. No other charges may be deducted from the member's

fund, with limited exceptions such as the administrative costs of a divorce, income drawdown or annuity purchase.

Additional services, other than scheme management, can be charged for separately, but must be offered on a discretionary basis. There must be a separate written contract for these services and any additional charges must be declared.

Last year's paper discussed the implications of and risks to insurance companies arising from this charging structure.

The main risks are:

expenses incurred are higher than charges received

initial expenses are not recovered before retirement or transfer to another arrangement.

Insurers are seeking to reduce expenses by installing new systems, many of which are internet based. Indeed some insurers have stated they will only sell Stakeholder schemes to employers who can comply with their internet administration system. However, large market shares may be required to ensure profitability. This may lead to some insurers withdrawing from the market.

Advice and Decision Trees

The 1% charge is to include the cost of providing a basic explanation about the Stakeholder scheme. The aim is to provide sufficient generic advice to enable most scheme members to decide whether to join the scheme, and on what terms. Individual advice will fall outside the overall scheme charge limit and should be expressed in terms of a clearly disclosed fee.

Within the overall scheme charge, providers will supply information packs, typically including:

details of the key features of their scheme;

contact names;

charges;

investment options;

projections of potential benefits; and,

a reminder that members should seek more specific advice if they require it.

They will probably also include decision trees, which will be issued by the Financial Services Authority to help people decide whether they should join a Stakeholder scheme.

To ensure the success of Stakeholder pensions, decision trees must be in a simple, easy to understand, format. They could be daunting for those with little knowledge and individuals

may find it difficult to reach a conclusion. There is also a danger that members could opt out of a better arrangement.

The Government has played down the need for advice, but individuals will need to make many decisions before they will know whether Stakeholder is the right choice. They will have to consider how much they should save, what funds to invest in and whether to contract in or out.

To reach the right conclusions, people are likely to need individual financial advice, which will only be available for a charge. As the target audience for Stakeholders are low and moderate earners, this will be a deterrent.

Investment

Schemes will have to offer a default investment option for members who have no wish to choose how their pension funds are invested. All schemes will be required to produce a Statement of Investment Principles, to cover the trustees' or manager's policy on investments and must take into account the need for diversification when investing funds.

Any Stakeholder pension scheme with-profits funds must be ring-fenced so that all the funds are allocated to Stakeholder members. These assets must not be held in a with-profits fund which also includes assets from schemes other than Stakeholder pension scheme. This could lead to lower bonuses as there will be no initial capital to help make profits.

Transfers

In order to make Stakeholder pension schemes portable, members will be allowed to transfer in and out of Stakeholders for no additional charge. Stakeholder schemes must accept transfers in.

Contracting Out

The scheme as a whole need not contract out of SERPS but members may use the schemes to contract out on an individual basis. If they do so, a rebate will be paid into their account to secure protected rights.

A review of the contracting out arrangements is due in 2001. For 2001/02 the existing rebates for contracted out money purchase schemes (COMPS) and appropriate personal pensions (APPs) will apply to occupational Stakeholder pension schemes and personal pension Stakeholder schemes respectively.

Regulation

OPRA will supervise the operation of Stakeholder schemes, overseeing compliance with the registration and employer access requirements. OPRA will also maintain the register of Stakeholder schemes.

The Financial Services Authority will concentrate on the marketing of Stakeholder schemes, the provision of advice, and the supervision of firms responsible for managing the funds invested by Stakeholder schemes.

Schemes will have to set up a complaints and disputes procedure. Trust-based Stakeholder schemes will have access to the Pensions Ombudsman and members of arrangements run by Stakeholder Managers will be able to take complaints to the Financial Services Ombudsman. Stakeholder schemes will have to be approved by the Inland Revenue.

Pensions Act Requirements

Stakeholder schemes will be subject to the main provisions of the Pensions Act 1995 which apply to other occupational money purchase schemes. All Stakeholder schemes will have to: -

produce annual reports;

report late payment of contributions;

operate an Internal Dispute Resolution Procedure;

have a Statement of Investment Principles in place;

appoint a reporting accountant (contract-based schemes) or a scheme auditor (trust schemes) to make an independent check on the financial operation of the scheme.

the scheme trustees or managers will have to make an annual declaration confirming that the Stakeholder regulations have been complied with. The scheme auditor or reporting accountant must then send a statement confirming whether or not these statements were reasonable.

Schemes will have to issue annual benefit statements to members within three months of the scheme year-end, setting out the value of the members' rights. The statements must include information such as the opening and closing values, details of the investment returns and any deductions, the amounts and dates of receipt of all contributions, including protected rights.

4 THE TAX REGIME

A single integrated tax regime will operate from April 2001 for all personal and Stakeholder pension schemes which modifies the existing personal pension regime.

Under tax legislation Stakeholder pensions will be a type of personal pension, and for approval purposes all of these arrangements will be referred to as personal pensions. Individuals will be able to have as many of these schemes as they choose, provided that the aggregate contributions made by the employee and employer do not exceed the total contribution limits.

Money purchase occupational pension schemes may opt into the new tax regime. Caution must be exercised, as schemes will not be able to reverse this decision. If schemes wish to move in to the new regime, they will need to meet a number of approval conditions.

Tax Relief

Stakeholder pension schemes will receive the same tax relief as other approved pension schemes.

Contribution Limits

The contribution limits apply to the aggregate of all contributions from employers and individuals including the tax relief recovered on the individual's contributions from the Inland Revenue. Contributions of up to £3,600 (the earnings threshold) per year may be paid irrespective of earnings.

Higher level contributions will be allowed up to the existing personal pension limits. Evidence of earnings may be used to support contributions at the higher level for the following 5 years.

An individual can continue to pay higher level contributions for 5 years after relevant earnings have ceased (for example, during maternity leave) without further evidence of earnings.

Who can Contribute?

Any UK resident under age 75, irrespective of whether taxable earnings are received, will be able to make contributions of up to £3,600 to a Stakeholder pension. There will be no minimum age for contributions. Individuals may also contribute if they are serving, or the spouse of someone serving, on crown duties abroad. This effectively allows individuals to contribute on behalf of their spouses or children.

Concurrency

Individuals will be allowed to contribute to as many schemes within the new regime as they choose, so long as the overall contribution limit is not exceeded.

Partial concurrency will be available for members of occupational defined benefit schemes and occupational money purchase schemes that have not opted into the regime. A member of an occupational pension scheme will be allowed dual membership of a Stakeholder scheme provided he:

earns less than £30,000 a year. This is not linked to inflation although the Treasury has stated they will reserve the right to review this limit from time to time;

is not a controlling director and has not been one in the previous five tax years;

contributes no more than £3,600 to the Stakeholder in any tax year.

A Stakeholder scheme may be more appropriate for eligible members than an AVC scheme – apart from the strict charging structure under a Stakeholder scheme, members will also be allowed to take a part of their benefits as tax free cash which is prohibited for members joining an AVC scheme after 1987.

This tax advantage has lead to pressure on the Government to permit all members of AVC schemes to take part of their benefits as tax free cash.

Carry Forward/Carry Back

The personal pension carry forward/carry back rules for tax relief and contributions will be replaced from April 2001. The carry forward provisions are to be abolished. Therefore, unused relief will be lost. Unused relief may not be carried forward into 2001/02 or any later year.

The carry back rules are to be amended with effect from 6 April 2001. Under the new provisions, individuals may elect for a payment made by 31 January (the filing date for self-assessment returns) to be treated as if the payment was made in the previous tax year.

5 SUMMARY

In effect, Stakeholder Pension Schemes are simply low cost personal pensions which individuals will be given easy access to through their employers, unless their employers meet certain conditions.

There would seem to be little incentive for individuals to contribute more than they currently do so to a personal pension and it is unlikely employers will increase their level of pension provision as a result of the introduction of Stakeholder.

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PART III - PENSIONS

1 MFR REVIEW

In early 1999, the government commissioned the Faculty and the Institute of Actuaries to carry out a fundamental review of the MFR. The following documents have been published:

a) The Actuaries' Review of the MFR
b) DSS open consultation document on the MFR alternatives

The intention of the MFR was to improve the security of member's pensions. However, it is questionable whether this aim has been achieved. The MFR has created significant additional problems, primarily because of its inflexibility in the face of huge changes in the period since it started. Changes such as the removal of ACT from UK dividends and changes to corporate dividend policy were not anticipated when the MFR was designed, and it has proved difficult to adapt the MFR to allow for them.

The Actuaries' Review of the MFR

The actuaries have proposed a fundamental change to the MFR methodology. The main changes are:-

Post retirement liabilities should be discounted in line with a composite index comprising gilts and corporate bonds rather than only long-dated gilts.

Pre-retirement liabilities should be discounted with the bond index plus 1% rather than long-term returns with market value adjustments. This margin of 1% allows for the expected out-performance of assets such as equities over the bond index in the long term.

The equity easement for those schemes with pensioner liability in excess of £100 million should be removed.

The future service contribution rate will be based on current market rates rather than long-term assumptions.

It is likely that implementation of the above proposals would result in a much more volatile test. This is recognised in the report and, in order to mitigate this, the proposals also include:

Longer period for employers to fund MFR deficits (to get to 90% in 3 years and 100% in 5 years).

Abolishing requirement for annual re-certification of contributions.

It has been recognised by the DSS that if the above proposal is implemented, there would be an increase in the divergence between the actual investment portfolio of the scheme and the MFR-matched portfolio implied under the new test.

Interest has been expressed by the DSS in moving the MFR to a true long-term funding test, on an ongoing basis. This would be a fundamental change to the MFR and it is suggested that it may be suitable in conjunction with some other measures to protect the members in the event of the discontinuance of the Scheme. However, the actuaries' brief was to consider security for members' benefits and as they believed the use of an ongoing basis conflicted with this brief, the ongoing standard was rejected by the actuaries.

Interim Proposals

In addition, there are three interim proposals to the current MFR basis as follows:-

Mortality Assumptions - The assumption for the mortality is based on old data, which fails to allow for recent improvements in mortality. The actuaries propose that mortality rates be decreased to reflect an extra two years of longevity (moving from PA90-2 to PA90-4).

Equity Market Value Adjustment (MVA) - This adjustment no longer works for schemes invested in UK equities as it is based on dividends paid by UK companies, and there has been a substantial change in dividend policies. The proposal is that the reference yield for calculating this MVA be revised from 3.25% to 3.0%.

Pension Increases - It is proposed in the interim that allowance should be made for the possibility that price levels may fall. This adjustment would affect current pensions in payment only.

The actuaries state in their report that the current MFR is "broken". If the methodology underlying the MFR is indeed broken, it is questionable that the implementation of the above interim changes would solve the problem.

The interim proposals will, for most schemes, add to the liabilities and so make it a more onerous test. It is somewhat ironic that given the current difficulties already experienced by employers and trustees that the above proposals have been suggested. However, it can be argued that the MFR is too weak in relation to buyout costs and should indeed be strengthened to redress this discrepancy.

DSS Proposals

The DSS have raised a large number of options in their document, and indicated that these are not mutually exclusive. The following possibilities have been raised:-

abolition of the MFR;
amending the current MFR;
prudential supervision of pension schemes;
compulsory commercial insurance;
compulsory mutual insurance;
central discontinuance fund;
tiering; and
increasing member disclosure.

Abolition of the MFR

This is only canvassed very gently and it is clear that there is perceived to be political difficulties in doing this unless there is some other security mechanism to replace it.

Amending the current MFR

Comments were required on the proposed method in the Actuaries' report by 31 January 2001. The DSS also wish to investigate alternatives which would incorporate a measure of equity returns.

Prudential Supervision

Active supervision of pension schemes has been proposed which would examine qualities of the scheme that go beyond funding. Currently, there is a reactive role which is given to OPRA. However, this is likely to impose significant extra costs on pension schemes.

Compulsory Commercial Insurance

Employers would be required to insure the solvency of their pension schemes. In order to keep insurance premiums down, this would provide an incentive for employers to fund their pension schemes to a reasonable level. However, there is no significant insurance market for this type of insurance at present which is likely to make it expensive initially and it's recognised that a downturn in equity markets may cause a flood of large claims on this type of insurance.

Compulsory Mutual Insurance

Compulsory Mutual Insurance, where the cost of failure is shared across all defined benefit schemes is proposed as an alternative to Compulsory commercial insurance. Premiums levels would be based on the state of funding of the Scheme, and the risk of insolvency of the sponsoring employer. The major problem with this method (which is similar to the system operating in the US) is moral hazard, where the good funds pay the costs of bailing out the bad funds - this is unfair on those employers who run their pension schemes well.

Central Discontinuance Fund

Schemes with insolvent employers would be combined into a central fund - instead of having to buy out liabilities or seek transfer values to other schemes – which could benefit from economies of scale, increased investment freedom and pooling of risks such as mortality. However, there is a risk of under-funding and without some form of guarantee nothing significant is added to the present system. It should be noted that the Government have stated that it will not act as guarantor of a Central Discontinuance Fund.

Tiering

A suggestion is to have different requirements for different pension schemes (distinguished by size or type of liability). The distinction could be by way of differing funding standards, or by requiring insurance for one group and not another.

Increased Disclosure to Members

This has been recommended by the actuaries. Distinction is drawn between a "security level" disclosed to members and the MFR funding level. They recommend that the actuary should be required to certify a level of scheme security, broken down by different liability categories. The new MFR would be a default basis, but it would be the responsibility of the actuary to determine the basis to be used for each scheme in practice.

Both the actuaries' and the DSS report are currently with the Government having undergone a consultation period. Due to the wide range of issues it is likely that there will be a very lengthy implementation process on any final proposals.

2 MYNERS' REVIEW OF INSTITUTIONAL INVESTMENT

The Chancellor of the Exchequer had announced that he would be setting up a review of institutional investment, as there were concerns that institutional investors were not making full use of venture capital markets. Paul Myners (of Gartmore Investment Management) has produced an interim report which covers a wide range of pension topics, in addition to venture capital. In summary, Myners has recommended that the MFR should be abolished and replaced by a regime of greater transparency and disclosure.

Myners' Comments on the MFR

Several valid criticisms of the MFR have been made:-

Distorts investment decision-making by use of a set of reference assets to calculate discount rates for liabilities; namely, UK quoted equities and gilts. There is some evidence of schemes attempting to "match the MFR portfolio" - to the extent that assets are not being invested in an optimal way, thus increasing the cost of defined benefit pension provision.

MFR states the funding position at one point in time so creates a false sense of security by providing a misleading statement to members. It is common in schemes to show MFR of more than 100%, and yet be unable to provide members' benefits in full on discontinuance.

Distorting pension fund investment and imposing greater costs on defined benefit pension funds is creating additional incentives for employers to close such schemes.

Myners concludes that the MFR does not provide the protection that many members assume it does, as the standard assumptions it makes may (and usually do) prove to be wrong.

Myners has also commented on the actuaries' proposal and states that it still shares the same problems as other funding/solvency standard approaches. It imposes standard assumptions on investment returns to determine whether a fund is either side of a line in the sand at a particular moment in time. This could lead to distortions and affords neither consistent nor effective protection.

The flaws in the MFR lead Myners to conclude that it is seriously inadequate as a form of protection, that it distorts investment decisions, that it is unnecessarily adding to the pressures of moving companies away from defined benefit provision, and it should be replaced.

Myners' Proposals

Two proposals are made:-

1) There should be a regime of transparency and disclosure in making investment decisions.
There should be tougher protection against fraud.

The Transparency Statement

Myners felt that the key issue for pensioner protection is the judgement of assumed investment returns, and the preferred approach would be to expose it and make it the key focus of discussion. The best protection for pension scheme members is to ensure that the investment assumptions are as robust and well considered as possible.

He proposes that every defined benefit pension scheme would be required each year to set out in clear and straightforward language the following:-

the current value of assets and what asset classes they were invested;
assumptions used to determine liabilities;
planned future contributions;
planned asset allocation for the following year or years;
assumed returns and volatility of those returns for each asset class sufficient to meet liabilities;
justification by trustees of reasonableness of asset allocation and investment returns assumed; and
explanation of the implications of the volatility of investment values for possible under-funding.

This statement would be produced annually, having taken advice from experts with appropriate skills. Further detailed information on the state of the fund including a solvency statement on assumed immediate wind up, would be available to members on request.

The idea behind the above transparency statement is to force trustees to think carefully about whether their investment strategy is sound. Making it publicly available will expose it to

outside scrutiny, which should be encouraged. The transparency statement would be distributed to members and lodged with OPRA, who would make it publicly available through the Internet.

In the first instance, members concerns should be addressed to the trustees. If this was unsatisfactory and provided a minimum percentage of members (possibly between 5% and 10% of the membership) voted in favour, trustees would be required to commission an independent report on their funding and investment policy, paid for by the fund. Failure to act on this report would trigger action from OPRA.

Small Schemes (< 4000 members) - there would be a further requirement for mandatory scrutiny of the investment return assumption, to be undertaken by the scheme actuary after taking investment advice. This is odd since the scheme actuary sets the assumptions in the first place.

Protection Against Fraud

Myners proposes that compensation for fraud under the Pensions Act 95 should be at or near level equal to the cost of securing liabilities rather than the MFR level. As a consequence to the revised compensation and scrapping the MFR, the transfer value regimes would need to be amended. He also proposes that external custody should be mandatory.

FRS17

The Accounting Standards Board has published the new accounting standard, FRS17, on how pension costs should be allowed for in company accounts. The new standard does not become fully effective until accounting periods ending after June 2003, although companies will be required to make some disclosures from June 2001. The key requirements are more in line with international accounting standards than SSAP24, and are similar to those proposed in the exposure draft FRED20.

How FRS17 Works

The Balance Sheet

The proposals in FRS17 are to value the assets at market value, and discount the liabilities using the yield on AA rated corporate bonds. The difference between the assets and liabilities gives a surplus or deficit, which goes on to the company's Balance Sheet. Starting with the Balance Sheet is a fundamental change to the way that pension Schemes are to be treated in companies' accounts.

The proposed methodology is likely to lead to volatile pension assets and/or liabilities appearing on the balance sheet unless the scheme is heavily invested in corporate bonds.

The Profit and Loss (P&L) Account

The P&L is split into three:

Operating Account

This is the Company's normal operating activity. For pension schemes, the operating account comprises the service cost (i.e. the cost of that year's benefit) plus the full capital cost of any benefit improvements. The costs are calculated using the yield on AA rated corporate bonds at the start of the year, so there is little discretion for the company in how it is costed.

Financing Account

This is the Company's treasury activities. For pension schemes, the financing account is the expected long-term return on the assets less the interest on the liabilities.

Statement of Total Recognised Gains and Losses (STRGL)

These are items outside the normal operating activity of the Company. For pension schemes, this effectively is a balancing item and will include immediate recognition of all actuarial gains and losses. Most of the volatility in the P&L account will be recognised "below the line" in the STRGL. However, the basic methodology set out in FRS17 is inherently more volatile than that set out in SSAP24, and it is likely that the pension cost (even ignoring the STRGL) will be slightly more volatile than under SSAP24. The actual impact will vary significantly from scheme to scheme.

Implementation

The following transitional arrangements will apply for the implementation of FRS17.

Company Years ending after 23 June 2001

The closing balance sheet numbers need to be calculated and disclosed, but will not form part of the Balance Sheet.

Company Years ending after 23 June 2002

The P&L figures and the Balance Sheet figures at the beginning and end of the year need to be calculated and disclosed, but again do not form part of the actual numbers.

Company Years ending after 23 June 2003

The P&L figures and the Balance Sheet figures at the beginning and end of the year need to be calculated, and will form part of the numbers in the accounts.

When FRS17 is first fully implemented, the current prepayment or provision in the Balance Sheet will disappear and be replaced by the surplus or deficit under FRS17.

Differences between FRS17 and SSAP24

	SSAP24	**FRS17**
Balance Sheet Entry	Cumulative impact of difference between contributions and expenses	Pension Scheme surplus
Assets	Discounted Cashflow	Market Value
Discount Rate	Based on assets held	Based on AA corporate bond yields. However, the additional return expected on the actual assets held is effectively picked up in the financing costs.
Valuation Method	Normally Projected Unit	Projected Unit
Measurement Frequency	Latest valuation	Annually
Amortisation	Over average working lifetime	Immediate recognition in STRGL unless benefit improvement, in which case recognition in Operating Costs

3 ACTUARIAL VALUATION – MARKET RELATED METHODS

The issue of how to value defined benefit pension schemes is not really a current topic in the same sense as the other issues discussed in this paper. However, it is an issue of contention in the profession which could easily be the basis of an exam question. For this reason alone, it is discussed below.

It is well known that market related methods are becoming more common as more and more scheme actuaries see flaws in the traditional discounted income method of carrying out valuations.

The Market Based Valuations Working Party surveyed Scheme Actuaries last year asking them how their last actuarial valuation was carried out and what their preferred method for future valuation is. The survey showed that the majority of respondents had used a market related method for their last valuation and, although a significant number had last used the discounted income method, the overwhelming majority intended to use a market related method going forward.

It is interesting to note that the current Pensions Fellowship Tuition Notes give double the space for setting a long-term discount rate as it does for setting a market-related discount rate and while describing how to set other long-term economic assumptions do not discuss setting other economic assumptions in a market-related valuation. However, the Notes do point out that there is no agreement in the profession on how to set a market-related discount rate.

What is Wrong with the Discounted Income Method?

Traditionally, actuaries have almost universally used this method which involves the use of the actuary's prudent estimate of long term economic conditions to value a scheme's liability and applies a Market Value Adjusted (MVA) to the market value of the scheme's assets. This is the method used in the Inland Revenue Surplus Test and a variation is used in the MFR. The purpose of the MVA is to ensure assets and liabilities are valued consistently by attempting to put a value on the assets if the market reverted to the actuary's long term assumptions.

The MVAs are calculated by assuming that assets are valued as a discounted value of their expected future income (and capital) payments. For example, MVAs for equities are based on the discounted value of future dividends, based on the actuary's expected future dividend growth.

In the current economic environment of low interest rates and dividend yields, an equity MVA is currently writing down market values by typically up to 35%. In the past, the equity MVA has usually written market values up or down by around 10%.

This has lead to doubts that both the model for valuing equities and the method of costing future accruals are appropriate.

The model for valuing equities assumes that investors are "rational" and value shares based on their expected dividend income. This model makes no allowance for expected capital gains through selling the shares and assumes dividends are of primary importance.

However, two developments in the equity market have reduced the importance of dividends.

The removal of the pensions scheme's right to reclaim Advanced Corporation Tax has meant that dividends are less tax efficient for these institutional investors. This has lead to companies seeking to reward investors in alternative ways such as share buy backs.

The increase in the number of low or nil dividend paying companies such as Vodaphone and Microsoft has reduced the dividend income from a typical equity portfolio.

These developments have meant that a model which assumes that all the return from investing in equities arises from dividends is no longer appropriate.

The standard method of doing a discounted income valuation involves the cost of future service benefits being calculated using long term assumptions. This leads to an inconsistency as once contributions are received they become part of schemes' assets and

therefore an MVA will be applied to calculate their actuarial value. In the past when MVAs only adjusted market values by around 10% and were expected to average 100% in the long term, this inconsistency in the method was deemed immaterial. However, in the current climate, contributions are effectively up to 35% too low.

Some actuaries are attempting to resolve this issue by applying an inverse MVA to the contribution rate to counteract the write-down on receipt. However, there are difficulties in deciding what MVA is appropriate, especially if contributions are not due for three years.

Both the problem of large asset write-downs and the inconsistency in the calculation of contribution rates are problems with the current basis for the MFR.

The Current Position with Market Related Valuation

As mentioned above, there is little agreement within the profession as to how the assumptions for these valuations are set. This is more than a disagreement about the setting of the level of assumptions which should always be in the realm of actuarial judgement.

Most actuaries set the discount rate using gilt yields at the valuation date as a starting point. If this is done without adjustment, the valuation basis would be similar to a discontinuance basis as gilt yields are the starting point for insurance companies' buy-out prices.

However, most actuaries and their clients would argue that such a methodology is overly prudent as it fails to allow for expected higher returns achieved through equity investment. Therefore a 'risk premium' usually added to the gilt yield.

The calculations of the risk premium is the main area of disagreement in the profession, with some using a fixed risk premium and others using a variable risk premium.

It is argued that a fixed risk premium is simple to apply and understand and that as a whole, the calculation of the discount rate is objective. However, a fixed risk premium would seem to be an over-simplification in that equities have not provided a fixed return in excess of gilts and as a result successive actuarial valuations will not be consistent if the relative strength of equity and gilt markets has changed in the inter-valuation period.

If a variable risk premium is used, the main difficulty is in deciding what premium is appropriate given the relative strength of the markets and expected future returns from equities and gilts. This could lead to consecutive valuations being inconsistent and unintentionally a greater variety in the strength of valuation bases adopted.

Some actuaries are using formulae to calculate an appropriate risk premium but currently none of the formulae in use have been widely adopted by the profession.

This difficulty is the main argument for adopting a fixed risk premium based on long term experience.

Further issues also arise in setting the other economic assumptions such as salary growth and pension increases. As previously mentioned, with a discounted income valuation, these

assumptions are set based on the actuary's long term expectations. How these assumptions should be set in a market related valuation to ensure consistency with the discount rate is also not yet widely agreed.

Sales and Purchases

The current disagreement in how to set assumptions used in a market related method and lack of understanding of how to fully judge the strength of such an actuarial basis is making bulk transfer exercises difficult and risky.

It is possible that actuaries are inadvertently agreeing bulk transfer values which are not at the level intended.

As an extreme example which would not occur in practice, transfer bases could be agreed where the assumptions used to project and discount the liabilities are of the same strength as those in a discounted income valuation, but as no MVA is applied, the basis is up to 35% weaker than a discounted income basis.

This could be why MFR based bulk transfer bases are becoming more common.

Conclusion

It is clear that more research in this area is required by the profession. Also, it would seem that the Tuition Notes need further coverage of market related methods to ensure that students are educated in current actuarial techniques. However, it is difficult to see how this can be done thoroughly before there is agreement in the profession on how market-related actuarial valuations should be done.

4 GMP EQUALISATION

Basics of Equalisation

Historically, many defined benefit schemes have provided members with benefits based on Normal Retirement Ages (NRA) of 65 for males and 60 for females. This was usually done to provide consistency with State benefits.

This meant that typically females received more valuable normal and early retirement benefits in respect of each year of pensionable service, although males were able to accrue benefits for longer and could receive higher death and ill-health benefits if these were based on prospective pensionable service.

The European Court ruling in the case of Barber versus GRE known as the "Barber Judgement" decided that pension benefits are regarded as deferred pay and as such, both sexes must receive the same benefits. The Judgement took effect from 17 May 1990.

Schemes have equalised benefits in two stages. The first, simple stage involved changing members' NRAs to the same age for future service with effect from the scheme's dates of equalisation. To keep costs down, most schemes changed the female NRA to 65 reducing the value of female members' future service benefits to that of male members.

The second stage was to equalise the benefits accrued between 17 May 1990 and schemes' dates of equalisation. As it is illegal to reduce the value of members' accrued benefits, this usually meant that male members' benefits accrued in the period are effectively granted on NRA of 60 rather than 65. There is a huge variety in how equalisation was achieved with varying degrees of complexity and generosity.

Nearly all schemes chose to equalise total benefits without allowing for the impact of GMPs. This was done for three reasons.
There are doubts that GMPs need to be equalised.

It can be argued that GMPs on their own are not classed as 'pay' as defined by the Barber Judgement. Support for this argument is drawn from the fact that equalisation was formally brought into UK legislation in Section 62 of the Pensions Act 1995, and the Contracting-out Regulations which govern GMPs were made after the Pensions Act 1995 and do not allow for GMP equalisation.

GMPs are designed to be approximately equal to SERPS and, as the Government has chosen not to equalise SERPS, there is no need to equalise GMPs. The Government is phasing in the change of the female State Pension Age from 60 to 65. The proposed new state benefits will be the same for both sexes.

It is not clear how to equalise GMPs and the Government has not given any guidance on this issue. The difficulties with equalising GMPs are discussed below.

Recent Developments

In January 2000, the Pensions Ombudsman found in favour of a complaint, Ian Williamson, who claimed the Trustees of the Sedgewick Group Pension Scheme of which Mr Williamson was a deferred member, should have equalised GMPs.

The Ombudsman did not accept the Trustees' arguments that because SERPS had not been equalised, GMPs did not need to be.

The Ombudsman did not give guidance on how GMPs should be equalised and, in fact, declined to do so.

The Problems with Equalising GMPS

GMP accrual rates depend on members' 'working lives' which are calculated with reference to unequalised State Pension Ages. By treating males as females, accrual rates can be equalised.

However, the concept of equalising GMPs is misleading because the process does not simply require the calculation of the GMP part of a member's pension to be the same for both sexes. The process actually requires the impact of GMPs on members' total benefits to be the same for both sexes. The fact that the value of members' accrued benefits cannot be reduced needs to be taken into account as well.

GMPs attract more favourable rates of revaluation in deferment than non-GMPs which could make it preferable to have a higher GMP at date of leaving. However, once in payment, GMPs could increase at a lower rate than non-GMPs, meaning that a lower GMP is preferable.

The issue is further complicated by the fact that each sex's GMPs are payable from different ages and that if a male member retires before 60, GMP revaluation in deferment between retirement and State Pension Age can be offset against increases granted on the total pension in the same period.

Current Position

The Trustees of the Sedgewick Group Pension Scheme have appealed against the Ombudsman's ruling and the High Court's ruling is due shortly.

In the meantime, trustees of other schemes do not know what to do and employees do not know how much it will cost. Schemes which are winding-up are being advised by their legal advisers to not settle benefits until the uncertainty is resolved which can only add to the distress members of these schemes are experiencing.

5 S2P REBATES

The Secretary of State for Social Security announced the configuration of NI rebates to the State Second Pension (S2P) on 4th February 2000. The Rebates will commence with the introduction of S2P on April 2002 and will be structured as follows:

all rebates for contracting out into a personal pension, including a personal pension based Stakeholder pension, will be calculated to reflect the enhanced three part accrual rate in the State Second Pension;
rebates will continue to be calculated as they are now for all occupational pension schemes, which will not be required to change their benefits;
employees in all contracted out pension arrangements on low pay (up to £9,500) will get a top up from the State Second Pension, and
the top up should be extended to employees on moderate earnings in contracted out occupational pension schemes.

This structure means that contracted out final salary schemes will not have to change their benefits. There is, however, arguably higher potential for complications, because:

different schemes will contract out of different parts of S2P, and so there are bound to be fundamental differences in the rebates between schemes;

there is, as yet, no new definition of occupational pension scheme. A typical final salary scheme is clearly an occupational scheme, but it is not clear whether money purchase schemes are included; and

the contracting out environment for contracted out final salary schemes will be very difficult for members to understand. Members will be contracted out of SERPS (which will have to be notionally calculated) via the Reference Scheme Test, and will then receive a top up to S2P from the state.

In August 2000, the Government Actuary published his consultative document on the appropriate assumptions for contracted out rebates for the period April 2002 – 2007. The overall conclusion on the proposals is that they would lead to rebates which would often be too low to justify on financial grounds advice to contract out. In particular, for contracted out salary related schemes the rebates might be so low as to justify advice to contract back in.

6 MONEY PURCHASE ILLUSTRATIONS

The DSS has published a consultation paper, prepared jointly with the Institute and Faculty of Actuaries which will require all money purchase schemes - occupational, personal and Stakeholder - to provide members with annual projections, based on current prices, of their fund at retirement and the amount of pension it might buy.

The DSS is aiming to have the regulations ready by April 2001 and hopes schemes will start to provide these illustrations from then even though they would not be mandatory until April 2002.

The proposals are a step towards the Government's initiative to provide members with a single statement of their projected private and State pension benefits.

The Government believes that providing more information will encourage people to plan properly for retirement. This is a laudable aim and the proposals are sensible. However, it is imperative that the projections are relevant, realistic and easily understood.

Basic Assumptions and Caveats

The proposals require illustrations to assume:

contributions for an active member will continue in accordance with the terms of the scheme or contract or at a rate agreed by the Trustees or provider;

tax relief will continue at the appropriate rate and any contracted-out rebates will continue to be payable; and

pensions will be purchased with increases in payment in line with price inflation and a spouse's pension of 50% of the member's pension.

The above assumptions are all sensible and seek to keep the projections simple and easy to understand.

The proposals include the sort of wording to accompany the projects. Proposed caveats include:

there are no guarantees provided by the illustrations;

eventual proceeds will depend on actual investment returns and annuity rates; and

standard assumptions have been used.

Such caveats are almost universally used and understood already. The proposals do not make any suggestion of how understanding of benefit projections can be increased. This has always been a difficult problem and perhaps further consideration of how this can be best achieved is required before April 2002.

Projection Assumptions

The basis for the illustrations will be set out in a Technical Memorandum prepared by the Faculty and Institute of Actuaries who have issued a draft version.

The main assumptions are:

price inflation - 2½% pa
salary growth - 2½% pa
annual management fees - 1% (or the actual expenses of the contract, if known)
cost of annuity purchase - 4%
investment return on the accumulated fund is the sum of:

50% of the sum of the FTSE Actuaries' Government Security Index-linked Yields over 5 years assuming a) 5% inflation and b) 0% inflation; and

1½%

The proposed basis is by necessity a compromise between realism and simplicity. However, the proposed basis is not consistent with existing PIA bases which could lead to confusion in members who receive projections on both bases.

The assumed investment return will be the same irrespective of the assets in which the members' contributions are invested.

This could be misleading as members will receive the same illustrations irrespective of their investment choice. In particular, if schemes offer members an investment choice and already provide illustrations using assumptions consistent with each option, the illustrations on the proposed basis would impact on the usefulness of the existing illustrations and could lead to members making inappropriate investment decisions.

However, the Technical Memorandum does permit schemes to provide additional illustrations on alternative bases, perhaps to illustrate the impact of different future investment returns or to illustrate the effect of different investment choices.

The assumptions themselves do not need to be listed or explained in the annual projections. However, members must be told where to find this information. This could simply be directions to the Technical Memorandum on the Faculty and Institute of Actuaries' website. Hopefully schemes will do more than this as many members might not go to the website and some may struggle to understand the content and implications of the Technical Memorandum. As many people are put off by the time and cost of financial advice, this could lead to inappropriate decisions being made, especially if the member has received illustrations on a different basis.

The basis needs to be easily changed to allow illustrations to remain valuable should there be fundamental changes to the economy. This has been a problem with other statutory bases in the past but efforts are being made to resolve this.

Conclusion

The intentions of the proposals are worthwhile and broadly the proposal method and assumptions are sensible. However, further consideration of how to communicate the implications of the annual projections would seem to be required.

7 MORTALITY IMPROVEMENTS

The Institute and Faculty of Actuaries produced Continuous Mortality Investigation (CMI) Report Number 19 towards the end of 2000.

The investigations look at actual deaths compared to those expected using the projections from the 1992 tables. For males, there is evidence that even compared to these relatively recent statistics, mortality is continuing to improve faster than projected. For females, the same is probably true, but the position is less clear cut.

It is no secret that life expectancy has increased significantly over the recent past. From a pensions standpoint, this is not necessarily good news. Increased life expectancy means increased pension costs across the board. Employers who aim to provide a reasonable standard of living for employees in retirement will face increases in their costs, unless the burden is passed on to the employees themselves. It would appear that this latter suggestion is becoming more common, as employers face increasingly steep pension bills.

In the Defined Benefit market, many employers already have problems meeting the requirements imposed by the Minimum Funding Requirement. When we consider that the

mortality table used is PA90 rated back two years, it is recognised that the allowance for mortality is insufficient. However, as many employers are already struggling to meet the minimum requirement as it stands, it is often difficult to impress upon them the need to increase costs further in order to adequately allow for mortality improvements. It is already clear that modern mortality rates could increase pension fund liabilities and contributions by up to 20%, over and above PA90, should their current mortality allowance not accurately reflect experience.

The Defined Contribution market will be affected by similar increases in costs, although it appears much clearer who will bear the brunt of any additional outlay. Employers have no obligation to pay more, so it will be up to the member to ensure that there are adequate funds at retirement. As professional advisors, it is up to the pensions industry to ensure that employers and members alike are suitably educated regarding the consequences of inadequate saving.

The message here is simple. Improvements in mortality are increasing the cost of pension provision. This means that saving for an income in retirement is going to become increasingly onerous, and as a profession we have a responsibility to communicate these facts, loudly and clearly.

8 PART TIMERS

The House of Lords has ruled in favour of part-time employees seeking to backdate their pensions rights. The upheld a legal argument given in the Preston case.

Mrs Preston wished to backdate membership of her pension scheme. The Court of appeal held that backdating was restricted under British law to two years. Mrs Preston argued that under Community law equal access had been available since 8 April 1976. This test case was referred to the European Court from the House of Lords to clarify the issue of time limits.

The key points from the judgement are:

Claims can be backdated to 8 April 1976. Previously, under UK law, claims could only be backdated up to two years prior to the start of the action. However, the European Court did not clarify exactly how far back claims should be dated and this issue will be referred back to the House of Lords for decision.

Employees must pay contributions for the period for which they are claiming entitlement, in accordance with scheme rules.

Claims must be lodged within 6 months after cessation of employment, provided that the limitation period is not less favourable for actions based on Community Law than for those based on domestic law. This time period is also referred to the House of Lords for ratification.

From 1 July 2000, employers are required to be more flexible in their approach to part-time workers who will have new rights for pay, pensions, training and holidays. Historically,

claims made by part timers have been on grounds of sex equality, as part time workers are often female. However, in future part timers will no longer need to prove indirect discrimination. They will automatically be entitled to the same terms and conditions as an equivalent full time member of staff, proportionately reduced in accordance with the number of hours worked.

9 PENSIONS AND DIVORCE

Prior to 1 December 2000, a Court determined that divorcing couples could offset pension rights against other joint assets, or make pension rights the subject of an earmarking order. From divorces petitioned on or after 1 December 2000, pension sharing will be an additional option available to couples for divorce.

Earmarking of pension rights involves the courts directing the Trustees to pay some or all of a scheme members benefit to their ex-spouse at the time the benefits come into payment. Pension sharing enables the courts to direct that a cash equivalent transfer value of the scheme members pension rights is calculated at the time of divorce, and that this value is apportioned between the member and the ex-spouse. For divorces lodged in England, the entire transfer value is apportioned but in Scotland only the transfer value relating to the period of marriage is apportioned.

For a final salary schemes, there will be a pension debit taking the form of a negative deferred pension, calculated at divorce and re-valued to payment date. This result will be deducted from the members benefit. A pension credit can be set up for the spouse by offering an option of membership of the scheme or a transfer to another arrangement. If the scheme does not wish to offer membership, the transfer value can be used to buy a personal pension.

However, there is a potential problem with discharging a pension credit in this way without the consent of the ex-spouse. The Divorce Regulations allow Trustees to discharge a pension credit without consent but the Transfer Regulations do not. Currently, these regulations still conflict.

All approved pension schemes must offer pension sharing, although the courts may still decide to deal with pension rights by offsetting them against other marital assets or by earmarking.

10 OPRA POWERS

The Government relaxed some of the reporting requirements for contributions paid later than the date on a Schedule with effect from 30 December 1999. However, these changes only applied to contributions made under a Schedule of Contributions or Schedule of Payments.

Initially, this did not apply to employee contributions which still had to be paid within 19 days of the end of the month in which they were deducted. However, with effect from 3

April 2000, employee contributions have been brought into line with the new relaxed guidelines.

The new practice:

Trustees will have a duty to report all late payment of contributions to OPRA, unless
the payment has been made within 10 days of the due date, and
the default is only the first on second default in the last year.

If a report applies,
it must be made to OPRA within 30 days of the due date, and
members must be informed by 90 days of the due date, unless the contributions have been paid within 60 days.

The offence of paying contributions later than due has been changed from a criminal offence to a civil offence which makes it much easier for OPRA to levy financial penalties. There appears to be an increase in financial penalties levied as a result of this downgrading of the offence.

From 3 April 2000, if Trustees of pension schemes fail, without reasonable excuse, to produce audited scheme accounts, on time, they may be liable to pay a fine to OPRA. If a fine is levied, it has to be paid within 28 days of the date it was imposed. The late issue of scheme accounts is now also a civil offence (previously a criminal offence), making it consistent with the offence of paying scheme contributions late.

11 BARCLAYS BANK AND THE PENSIONS OMBUDSMAN

It is well known that many employers are changing their form of pension provision from defined benefit to defined contribution. This is seen to be more appropriate for current working patterns and easier to control benefit costs.

Some employers would like to use surpluses in their defined benefit scheme to meet the contributions to their new defined contribution arrangements. This would seem to be acceptable if both arrangements are separate sections of the same pension scheme and the Trust Deed and Rules permit this use of surplus.

The Pensions Ombudsman made a controversial ruling on such an employer last year.

Barclays Bank (“the Bank”) had sponsored the Barclays Bank UK Retirement Fund (“the Fund”) since 1964. The Fund has historically provided benefits on a final salary basis.

During 1996, the Bank decided future new entrants would receive benefits on a money purchase basis with effect from 1 July 1997.

After discussions with its advisors and UNiFI, one of the Bank’s staff’s trade unions, the Bank announced to its employees that it intended to establish a money purchase section in the Fund to be known as the Retirement Investment Scheme (“the RIS”) into which the

Bank would contribute 5.5% of pensionable salary. The final salary section of the Fund would be known as the 1964 Pension Scheme.

The Fund was in surplus and prior to the inception of the RIS, the Bank had been paying reduced contributions into the 1964 Pension Scheme. The Bank continued to do so with the contributions to the RIS being funded out of the surplus.

The Fund's rules prohibited any return of any part of the Fund's assets to the Bank, but did allow a reduction or nil contributions to be paid.

Mr Holmes, a pensioner in the 1964 Pension Scheme and chairman of UNiFI, complained to the Ombudsman that the Bank's use of surplus to Fund contributions to the RIS constituted maladministration on the grounds that it breached the clause in the Fund's rules prohibiting a return of the Fund's assets to the Bank.

On 17 March 2000, the Ombudsman upheld Mr Holmes' complaint, but not using Mr Holmes' argument. The Ombudsman concluded the two sections of the Fund were separate pension schemes and that there was no legal basis for the surplus in the 1964 Pension Scheme to be used to fund the RIS.

On 21 November 2000, the High Court ruled on the Bank's appeal against the Ombudsman's ruling.

The judge ruled that there was only one Fund and that the 1964 Pension Scheme and the RIS were not separate schemes. However, he stated that this did not automatically allow the Bank to use the 1964 Pension Scheme's surplus to fund its contributions to the RIS.

The judge also ruled that there was nothing in the Fund's rules to prohibit the Bank's use of surplus and commented that commercial common sense indicated that the Bank would not have intended to remove its right to pay reduced or nil contributions by introducing the RIS.

The judge also commented that "an employer is not obliged to provide a pension scheme" and "it is in the public interest that employers should be encouraged to provide pension schemes". (Perhaps someone should tell the Government!)

12 PENSIONS AND BANKRUPTCY

Approved pension rights can now be excluded from a bankrupt's estate, if the petition for bankruptcy was presented after 29 May 2000. Previously, protection was only given if there were effective forfeiture provisions in the Trust Deed of the particular pension scheme. Pensions which are in payment, however, will still count as income when calculating an income payment order.

Pension rights awarded to an ex-spouse, as a result of the pension sharing regulations will count as approved pension arrangements, for the purposes of bankruptcy. These provisions cover all approved pension schemes including personal pension arrangements.

13 LOCAL GOVERNMENT PENSION SCHEME (LGPS)

The Local Government Pension Scheme (Amendment) Regulations 1999, issued on 13 January 2000, allow private companies who win contracts for local authority services to participate in the LGPS as an 'Admitted Body'. This allows existing members of the LGPS to continue their membership even though they are now employed in the private sector.

This is an alternative to the contractor providing pension benefits to transferring employees through a pension scheme certified by the GAD to be broadly equivalent to the LGPS.

The differences between these alternatives relate to the cost of benefit provision, employer control, use of surplus and employee and union perception.

Cost of Benefit Provision

In theory, as the levels of benefits provided via both routes are broadly equivalent, the costs of benefit provision should be similar.

However, there are differences in the expenses incurred in providing the benefits.

If the contractor uses a GAD certified scheme, significant costs could be incurred in setting up the scheme or amending an existing scheme. There will also obviously be ongoing administration costs. However, it is possible the scheme could be used for further contracts spreading the impact of any set-up costs and leading to some economies of scale in the ongoing costs.

If the contractor chooses to participate in the LGPS, no set-up costs would be incurred and ongoing costs should be lower due to significant economies of scale achieved by the LGPS.

However, the contractor is required to take out an indemnity bond so that members' benefits are protected should the contractor fall into receivership. As these bonds are a new product, insurers will have limited relevant experience of the risks involved and are likely to price these bonds with a large degree of caution.

Furthermore, the issues discussed in the next two sections could also make the cost of providing benefits through the LGPS more expensive.

Employer Control

By using its own scheme, the contractor will have the same level of control over costs as it would for any defined benefits scheme. In particular, it could be involved in setting investment and contribution strategies and deciding how to manage surpluses and deficits.

The contractor would have no control over costs if it participated in the LGPS. Contribution rates are set unilaterally by the Local Authority's actuary, with the actuarial basis and the investment strategy being set with regards to the LGPS as a whole and not the profile of the employees under the contract.

Use of Surplus

As discussed above, if the contractor participates in the LGPS, the actuary sets the actuarial basis and investment strategy for the Scheme as a whole.

This could lead to significant surpluses or deficits in respect of the benefits of the contractor's employees. When the contract ceases, the actuary determines whether a surplus or deficit exists in relation to those benefits based on a notional sub-fund of the LGPS allocated to the contractor.

If the scheme actuary determines a deficit exists, the contractor is required to redress the deficit immediately. However, if a surplus exists, the contractor is unable to remove this from the LGPS making benefits cost more than necessary.

This is a significant source of risk to the contractor with no potential up-side.

Obviously, if the contractor chooses to operate its own scheme, the contractor has more flexibility in redressing any deficits and is able to make use of any surpluses.

Employee and Union Perception

Employees and unions are likely to have reservations about transferring to the contractor's own arrangement, even though the GAD will have certified the scheme's equivalence to the LGPS. For example, full index-linking is often seen as a valuable benefit that will not generally be provided by the contractor.

This could lead to union opposition to potential contractor's winning contracts.

However, contractors may provide alternative benefit structures which employees could consider to be more favourable. For example 60ths accrual with commutation for cash could be preferred to the LGPS benefit structure as it provides more flexibility.

Conclusion

Initially, the opening up of the LGPS to contractors seems like a good opportunity for private firms. The ability to reduce or remove set-up and ongoing administration costs, albeit mitigated by the need to take out a potentially expensive indemnity bond, is appealing.

However, the risks associated with the loss of control and the risk of leaving behind surpluses or the need to redress deficits could outweigh the above benefits.

The number of contracts and the number of employees involved may be the crucial factors. If there are few employees, the contractor may be better to join the LGPS. However, if there are several employees involved, it may be worth incurring the costs of setting up a GAD certified scheme.

For a company intending to obtain several local authority contracts, the GAD certified route is probably the best option.

14 GUARANTEED ANNUITY RATES

The House of Lords upheld the ruling by the Court of Appeal that Equitable Life was required to treat its guaranteed annuity policyholders by awarding the same rates of terminal bonus as other, similar policies without the guarantee. The effect has been to force Equitable Life to close to new business, and place itself on the market, a fact that has received wide press coverage.

The uncertainty of the situation is causing great concern amongst policyholders. Equitable Life was a market leader in AVC provision, and occupational pension scheme members affected have been putting Trustees under significant pressure for advice about what action to take. When faced with concerned members, it is hard for Trustees to remain impartial and explain why they are unable to give this advice themselves but need to rely on appropriate Regulated Advisors.

If Trustees do not seek appropriate investment advice, then they are in breach of the Pensions Act and failing on one of their primary responsibilities. However, when it seems clear to most who have read the associated press coverage that returns will be lost should they remain with Equitable Life, members are finding it hard to understand why the advice is not simply to cut their losses and run.

Although the judgement has been upheld, it is still far too early to predict what the final outcome will be.
The situation is far from resolved and at the moment it is virtually impossible to say with certainty what the correct course of action should be.

However, at the time of going to print, the Halifax has tabled a bid to purchase the non-profit business. This bid is currently under consideration.

15 ETHICAL INVESTMENT

With effect from 3 July 2000, all occupational pension schemes were required to incorporate their stand on ethical investment into the Statement of Investment Principles. However, it would appear that many Trustees, particularly at the small to medium end of the market,

complied with the legislation without taking an explicit position. This is not to say that it was not given serious consideration.

Where this approach may have defeated the purpose of the legislation in some way, it is perhaps not surprising. A primary responsibility of Trustees is to invest the assets in the best interests of the member, and it is debatable whether restricting investment policy would meet this objective to all Trustees' satisfaction.

16 BUDGET CHANGES

The Chancellor's budget Statement of March 2000 included very little on pensions. The tax charge on the repayment by occupational pension schemes of surplus employee AVC funds reduced from 33% to 32% with effect from 6 April 2000. The Inland Revenue also announced that it will offer to help small firms get on line, with tax bill discounts if they pay them on line.

The Chancellor's pre Budget report in November 2000 announced a substantial increase in the Basic State Pension and the Lower and Upper Earnings Limit. Any pension scheme that has these as offsets will see a reduction in benefits from April 2001, unless salaries increase at the same rates.

17 ADMINISTRATION OVER THE INTERNET

The charging limits for Stakeholder contracts and the increasing costs of providing benefits has lead to the development of more efficient administration methods.

Two such developments include the use of e-mail and secure internet web-sites.

Use of e-mail for communication with members, trustees and employers has reduced response times and postage costs.

Pension scheme administrators are using secure web-sites to provide information to registered members, such as:

benefit projections
transfer values
member announcements
Trust Deed and Rules
member booklets
annual Trustees' Report and Accounts
Statements of Investment Principles
Internal Dispute Resolution procedures
annual benefit statements

In addition, the ability for members to change their contribution rates and personal details on-line and vote in MNT elections could also be provided.

While most people will be happy to download general information such as booklets and reports, increasing reports of internet fraud and security problems may make scheme members unwilling to have their benefit and personal details posted on the internet.

18 THE PENSION SCHEME OFFICE (PSO)

The PSO - the division of the Inland Revenue which deals with the taxation of pension schemes - is to lose its executive status in April 2001 and will become fully integrated into the Inland Revenue. It will lose its individual identity and become part of the Savings, Pensions and Share Schemes business stream.

19 GUIDANCE NOTES AMENDMENTS

Revisions were made to GN11, GN24, GN26, GN27 and GN31. A new Guidance Note, GN34, has been introduced. An exposure draft has also been circulated for GN29.

GN11 – Retirement Benefits Scheme – Transfer Values. Changes have been made to GN11 to make explicit provision for pension sharing.

GN24 – Provides detailed guidance to the actuary instructed as an expert witness.

GN26 – Pension Fund Terminology. Changes have been made to cover pensions sharing.

GN27 – Retirement Benefits Scheme – Minimum Funding Requirement. There have been various changes to cover a number of technical issued which have arisen since the MFR first came into effect.

GN29 – Occupational Pension Schemes – actuaries advising the trustees or a participating employer. Changes have been made on the exposure to widen the guidance to members of the profession who are not necessarily the Scheme Actuary. A fair amount of material has been removed from the previous version of GN29 as there was repetition of the Professional Conduct Standards.

GN31 – Actuaries to Appropriate Personal Pension Schemes in Terms of the Pensions Act 95.

GN34 – Illustration of Defined Contribution Pension Benefits – provides guidance to actuaries involved in advising an employer, trustees, members or other parties on a defined contribution arrangement.

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PART IV - GENERAL INSURANCE

1. Introduction

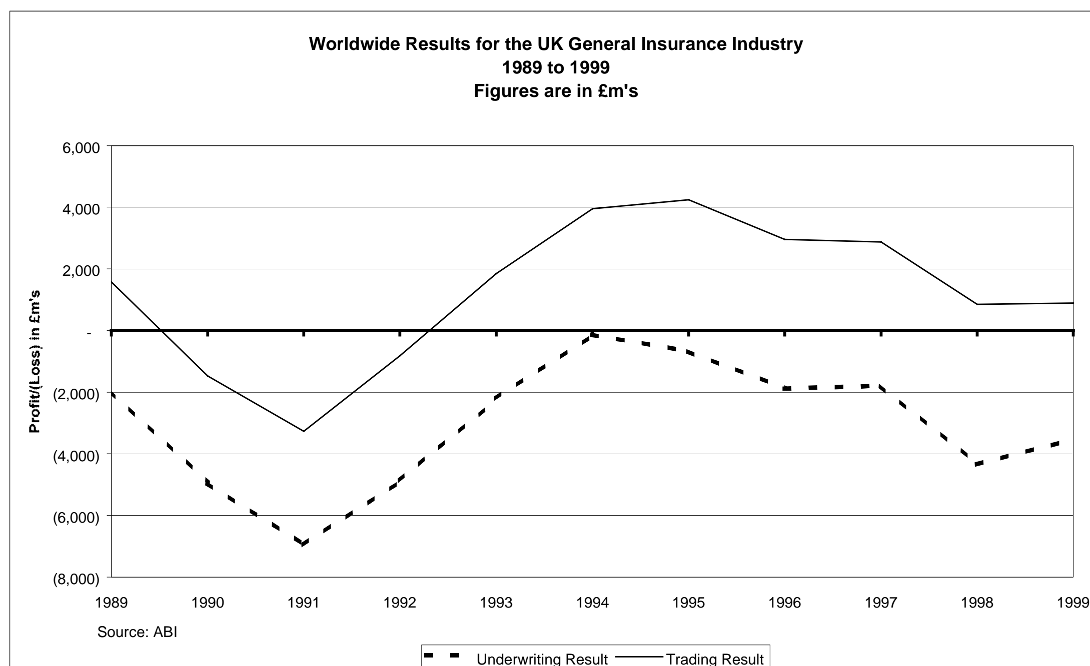
This year's paper has a slightly different format to that of last year. Those topics which have not been covered this year are largely those where there has not been any significant news to report. That said, last year's paper is good background reading to what is currently happening in the market.

A list of web sites referred to below, along with other useful sites, can be found at the end of the paper.

2. State of the Market

The latest available figures for the whole general insurance market are for 1999. For the third year in a row the UK general insurance industry wrote £41 billion of insurance and reinsurance worldwide. After allowing for reinsurance spend this reduces to £33 billion of which £7 billion was written at Lloyd's.

The chart below shows the worldwide trading results before and after an allowance for investment income. While the trading result have been in the black for the last seven years, the profit in the last two years (1998 and 1999) was only 2% of premiums. This implies that only the better performing companies and syndicates have achieved adequate returns for their shareholders in recent years.



The prospects for 2000 and beyond look good with many classes of business, such as Motor, moving from loss making years towards more profitable times. However, insurance is a

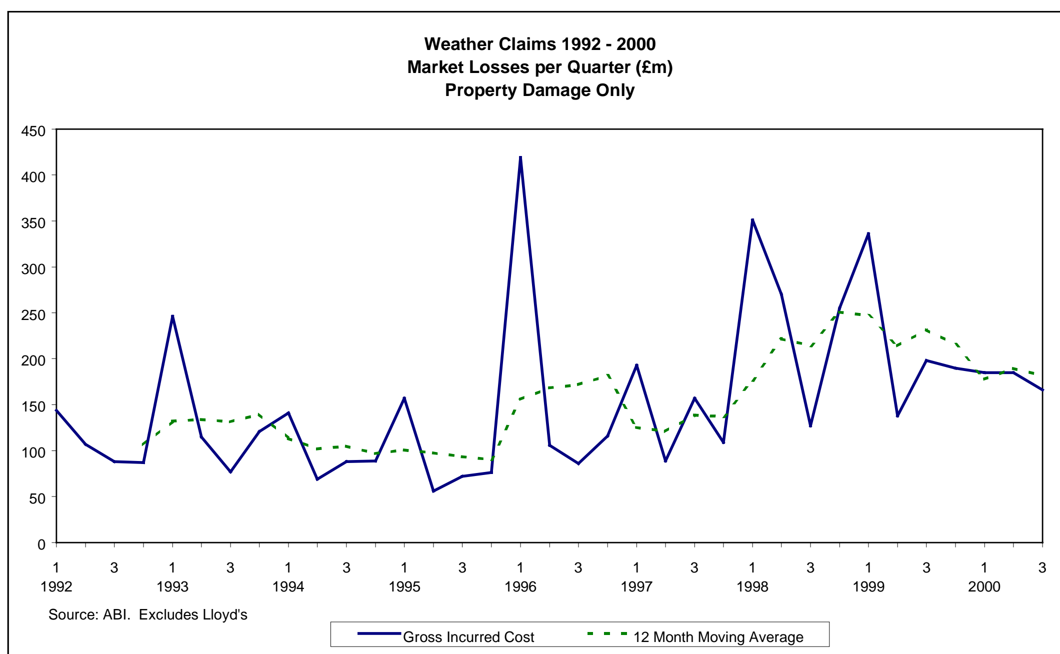
risky business and this paper highlights many of the issues that could counter the premium increases the industry strove to achieve in 2000.

3. Claims Experience

Last year's paper contained a section on the major claim causes. Experience on most of these factors will not have changed significantly over the period of one year, so only an update on weather claims is included below. The latest graphs and data for the other causes can be found on the ABI's website.

It should be noted that the ABI statistics are on a claims reported basis. The graphs should therefore be viewed carefully. For example, where a major weather incident occurs at the end of a quarter, most of the claims are reported the following quarter. This is especially so at the end of a year where Christmas and New Year bank holidays mean that there is less working time available for people to register claims. The cost would then be shown on the graph in the year following the incident, but in the company accounts the cost would be booked in the correct year because the IBNR reserve would be increased to cover the extra cost.

Weather



The historic figures have not been adjusted for inflation but the ABI have slightly revised the data since last year.

The highest peaks on the graph are:

- 1st quarter 1996 – due to severely cold weather between Christmas and the year-end in 1995
- 1st and 2nd quarters of 1998 – due to heavy storms and flooding in January and severe flooding over the Easter weekend

- 4th quarter 1998 and 1st quarter 1999 – due to violent storms in October, December and January.

None of these events were anywhere near as severe as the 1987 or 1990 storms. Those events cost the industry in the region of £1.2bn and £2.2bn respectively.
The graph shows that the cost of weather claims over the last three quarters of 1999 and the first three quarters of 2000 was fairly flat. However the cost was still running at around £175m a quarter. This compares to an average cost of around £125m a quarter in the quiet period between 1996 quarter 2 and the end of 1997.

The data for the fourth quarter of 2000, a torrid period for the UK, is not yet available. High winds and torrential rain hit the south of the country at the end of October and the start of November. This was then followed by a prolonged period of rain which caused widespread flooding throughout the country. The worst affected areas were Kent, East Sussex, Yorkshire and the West of England. Christmas and the New Year then saw heavy snowfalls particularly in Scotland. Freezing weather at that time of year can do a lot of damage as pipes in empty homes and businesses freeze and then burst when the thaw comes.

Initially there were wild estimates, some over £1bn, of the cost of the winds and floods. More recent estimates have put insured loss at around £500m. This will lead to the worst loss since the 1990 storms.

More flooding could be on the cards for early in 2001. The ground in many areas of the country is saturated and rivers are still swollen. Even a modest amount of rain in some places could cause further flooding.

The bad weather has sparked many debates about climate change and the possibility of some homes becoming uninsurable. Global warming does seem to be acknowledged as a fact by the scientific community but there is still uncertainty as to how much of it is caused by man's activity and how much is due to solar variability. The failure of the climate talks in The Hague showed that there is still a lack of commitment from many governments, to do whatever man is capable of, to tackle the problem.

Central government in the UK has accepted that building on a flood plain may not be a good idea, but it has yet to act decisively to stop it happening. Any actions that are taken will take time to filter down to the local planning process. If this practice continues then it can only lead to escalating future losses and it will increase the likelihood of some properties becoming uninsurable.

Asbestos

The insurance market is facing a severe deterioration in asbestos claims. US industry and insurers expected a downturn in 2000, but the reverse has happened. The increase in numbers and costs of claims, along with the failure of large-scale settlement schemes, has forced some large asbestos manufacturers into insolvency. Other defendants' lives will become harder as a result. The market is seeing a widening of the litigation net with non-traditional asbestos companies being sued, for example, IBM, AT&T and Ford. Small distributors, installers and even hospitals and schools are also being sued.

The combination of more frequent claims for more money against more insureds is bad news for insurance companies with US liabilities. Such companies had measured their exposure to these claims carefully, but without allowing for these new insureds. In addition, traditional claimants are claiming under different parts of their cover – the operations section of the general liability cover – as the product liability section is exhausted. The general liability cover tends not to have limits, making insurers' liabilities open-ended.

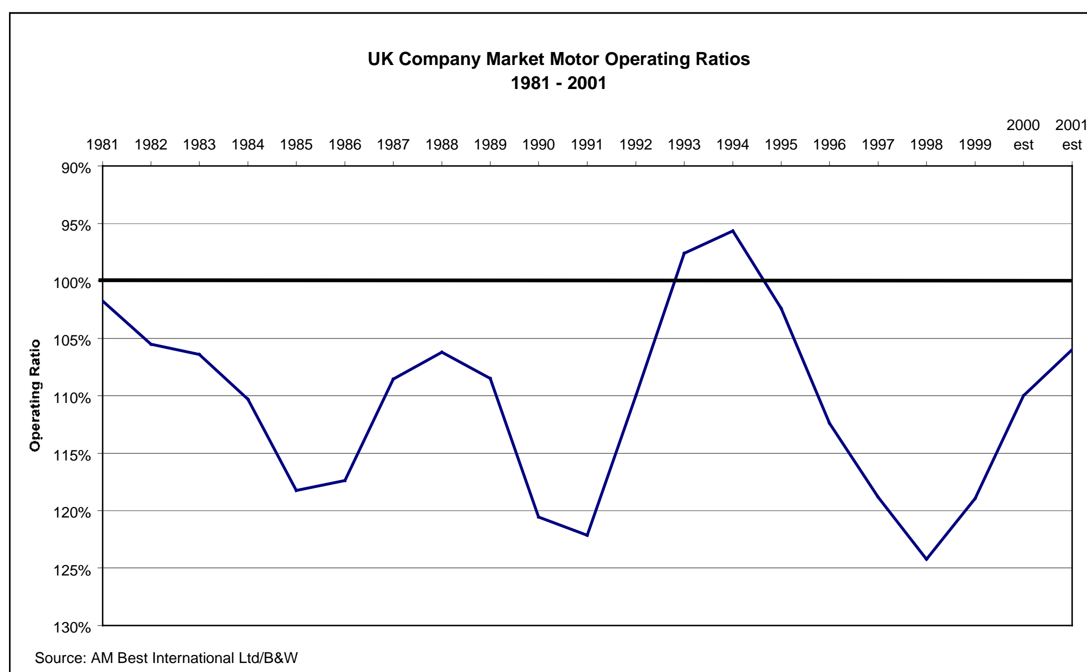
Equitas has bitten the bullet on this issue, increasing asbestos reserves by over $1bn last year. Other insurers will soon need to follow suit.

The continued costs of asbestos claims was one of the major reasons for the failure of Chester Street Holdings (see the section on Company News).

4. Motor Insurance

The end of the millennium saw the deepest and longest trough in the UK motor underwriting cycle. Total underwriting losses for the market for the years 1995 to 1999 were £5 billion and it is predicted that the market will make a further £1 billion of losses before it returns to underwriting breakeven. The pain has been eased by the investment returns made on the funds backing the motor account, cutting the losses to £2 billion over the cycle.

The chart below shows the operating ratio for UK motor business over the past 20 years. The figures for 2000 and 2001 are estimates. The vertical axis is inverted so that the good results are at the top of the graph.



How confident can we be about the projected upturn in the fortunes for UK motor underwriters? The cycle is largely a premium driven one and the key determinate of future profitability is the market's ability to achieve rate increases during 2001.

The table below shows the combined results of 2 surveys. The first survey was in October 2000 at GIRO in Birmingham where more than 350 delegates were asked their views on what rate increases the market might achieve in 2001. The second survey was carried out by Bacon & Woodrow in November 2000 and asked the same question of 100 motor underwriters and managers from over 50 companies and Lloyd's syndicates. The results have been combined as they were in broad agreement.

Percentage Rate Increase Expected in 2001	**Percentage of Delegates**
0 to 5%	8%
5% to 10%	33%
10% to 15%	40%
15% to 20%	15%
Over 20%	4%

The answer to the question about the prospects for 2001 is simple – it all relies on where in the wide range of forecasts the actual rate increase lies.

Legal Issues

The Fourth EU Motor Directive

The Fourth EU Motor Directive was adopted by the European Parliament on 15 May 2000 and must become law by July 2002 and be applied from January 2003. The aim of the Directive is to assist people injured in a road accident by a driver from another country to pursue their claim more easily than is currently the case.

One provision of the Directive is that each country will need to set up an Information Centre to provide insurer information from the registration number of the vehicle. In the UK this will be the Motor Insurers' Information Centre (MIIC) which is a subsidiary of the MIB. The MIIC will hold details of all individually registered vehicles in the UK. The database (MIID) should become operational in July 2001.

NHS Charges (RTA)

The Road Traffic (NHS Charges) Act 1999 came into force on 5 April 1999. This Act introduced a new, centralised system for the collection of charges for hospital treatment in England, Scotland and Wales following a road traffic accident. The scheme is administered by the Compensation Recovery Unit which is part of the Benefits Agency.

In the first annual report on the operation of the new scheme, covering the financial year ended 31 March 2000 the following statistics were provided:

- 417,031 new cases involving motor liability were notified by insurers
- 112,020 cases which were notified prior to 5 April 1999 had enquires
- Of the above cases, old and new, 244,034 have been identified as involving NHS treatment
- £30 million was recovered in the year 1999/2000
- During 1999/2000 an estimated £76 million was identified as potentially owing to NHS Trusts
- The Department of Health contributed a total of £1.5 million to the running costs of the CRU in 1999/2000.

The full report can be found at www.doh.gov.uk/rta_charges/report00.htm

Access to Justice - Conditional Fee Arrangement (CFA) and After the Event (ATE) Policies

In a CFA, the solicitor agrees that he will not receive a fee if the case is lost. In exchange the solicitor receives an increased fee if the case is won: the amount of the increase ('uplift') is agreed at the start of the case. The uplift is subject to maximum limits. Although the solicitor's fees will not be payable if the case is lost, the claimant is still faced with the possibility of paying for court costs, expert witnesses etc. These expenses are covered by taking out an 'After the Event' Legal Expenses Insurance Policy in conjunction with a CFA.

Currently, CFAs are only available in cases involving personal injury, medical negligence, insolvency, and cases before the European Court of Human Rights.

It is also possible to buy ATE policies which cover legal expenses when there is not a CFA in place. In this case these policies also cover the fees of the claimant's solicitor.

CFAs and ATE policies have been a hot topic in 2000 in both the trade and popular press, with compensation claims companies such as Claims Direct making regular appearances in the financial and consumer interest pages.

The Access to Justice Act 1999 (and in particular sections 28, 29 and 30) was the enabling legislation for CFAs. The way in which this legislation will be interpreted is by no means certain as shown by a recent exchange in the House of Commons (Hansard Debates for 19 Dec 2000):

"Mr. Andrew Dismore (Hendon): Does my hon. Friend agree that an issue that arises from the financing of court cases in Colchester and elsewhere is the recoverability of conditional fee insurance, which urgently needs to be dealt with by the insurance industry?

Mr. Lock: (Parliamentary Secretary, Lord Chancellor's Department) As always, I admire my hon. Friend's ingenuity for linking issues. He is right. The Government's policy is that the premium paid for cover against the risk of having to pay legal costs should be recoverable from the losing opponent. That ensures that the damages paid to claimants are not unreasonably eroded. In our view, that is the effect of the Access to Justice Act 1999. Although the interpretation of individual agreements is a matter for the courts, the Government believe that recoverability includes premiums on policies taken out before proceedings are issued in any particular case."

Further evidence of the uncertainty surrounding this issue can be found in a recent Mori Poll. CFAs provide a new and largely untested mechanism for injured people to seek compensation. In the MORI poll in November 2000 over half the respondents did not realise that Legal Aid has been withdrawn for personal injury claims, and on average people thought they would have to pay out around 30% of the compensation to the claims compensation company.

The poll gave an interesting insight into the UK compensation culture. 74% of respondents said they would sue their employer. Although 15% of respondents said they would never sue their child's school, 57% said they would. Suing their own doctor would cause concern for 48% of people.

Pain and Suffering – Court of Appeal Judgment (Heil v Rankin & others) -23 March 2000

In the first of two landmark judgments which have major implications for insurers, the Court of Appeal ruled on a group of test cases in which the claimants were appealing that their awards for pain and suffering were too low.

The debate on the 'right' level of compensation for the non pecuniary loss resulting from an injury is a long running one that can trace its origins back to the Law Commission Report No 225 published in 1994, 'How Much is Enough?'. The 1999 Law Commission Report No 257, 'Damages for Personal Injury Non-Pecuniary Loss', concluded that levels of damages for pain and suffering in serious personal injury cases were too low. Based on the results of a survey of members of the public it recommended that:

- Awards of £3,000 or more should be increased by between 50% and 100%
- Awards between £2,000 and £3,000 should be increased by up to 50%.

The Court of Appeal did not adopt the Law Commission's proposals on levels of damages for pain and suffering, and recommended tapered increases in awards over £10,000, up to around a third for the most serious cases. Awards below £10,000 were not to receive any increases. The increases were to be retrospective.

Replacement Vehicles For Innocent Motorists – House of Lords Judgment (Dimond v Lovell) 11 May 2000

In the second landmark ruling of the year the House of Lords judgement clarified the situation where an innocent victim of a motor accident needs a replacement vehicle while their own is being repaired or replaced. Until the judgement there had been some challenges on the important issue of mitigation of a loss. The judgement made it clear that motorists have to act reasonably in incurring car hire costs

Ogden

In recent years the Government Actuary's Department's 'Actuarial Tables with explanatory notes for use in Personal Injury and Fatal Accident Cases' (The Ogden Tables) have been at the heart of the ongoing debate on how lump sums for compensation of pecuniary loss should be calculated. In essence, these Tables provide the annuity multipliers for converting an annual loss into a lump sum.

The Law Commission's Report No 263 (Claims for Wrongful Death) recommended that the Ogden Working Party be reconvened to consider and explain more fully how the Tables should be used in Fatal Accident Act cases. In August 2000 the Fourth Edition of the Ogden Tables was published to address the question 'Should the multiplier be calculated from death or from trial?'

This latest Edition of the Ogden Tables has a greatly expanded set of Explanatory Notes. It also updated the Tables to use the projected mortality for England & Wales assumed in the latest 1998-based population projections.

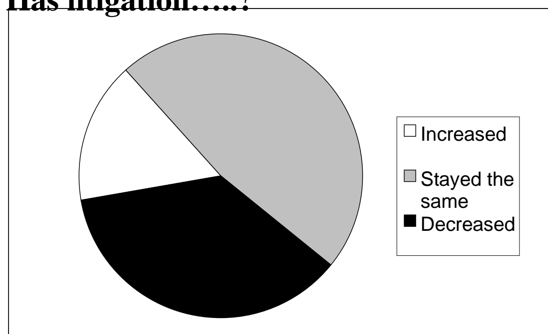
The Ogden Tables are available from The Stationary Office at
http://www.thestationaryoffice.com/.

Woolf

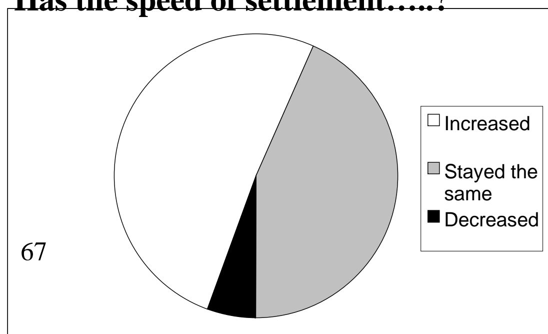
In April 1999 the entire civil justice system underwent arguably its most radical changes in a hundred years. The changes were new rules designed to enable the court to deal with cases justly and were known as the Woolf Reforms.

One year on, how are the new rules working? In April 2000 MORI published a poll it had carried out amongst the legal profession. Key findings are summarised below:

Has litigation…..?



Has the speed of settlement…..?

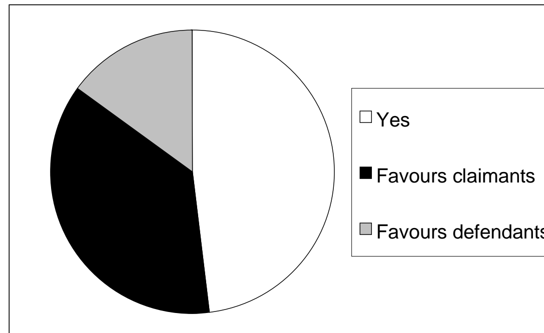


Is the new regime fair?

Overall, 76% of respondents thought that the reforms had been a positive change on the culture of settlement.

Structured Settlements

In March 2000 the Lord Chancellor's Department (LCD) produced a Consultation Paper on Damages 'The Discount Rate and Alternatives to Lump Sum Payments'. The Paper contains



a good overview of how damages are assessed and background reading on the issues being consulted on.

Consultees were asked 12 questions on their views about the Discount Rate and a further 8 questions on alternatives to lump sum compensation.

Currently nearly all personal injury cases are settled with lump sums and there is only limited use of structured settlements, where the damages consist wholly or partly of periodic payments under an annuity purchased for the claimant. In March 2000 the Faculty and Institute of Actuaries hosted a debate on the alternatives to lump sums. The Profession's submission to the LCD can be found on the Faculty and Institute website under 'social policy damages'.

At the time of writing this paper the LCD had not published the results of the consultation. The LCD web site is www.opengov.uk/lcd and the consultation paper can currently be found at www.opengov.uk/lcd/consult/genarcfr.htm.

5. Regulatory Issues

FSA Consultation papers

The FSA came into being from a revamp of the regulation of financial services. All regulators were combined and a holistic approach to regulation is being taken. Combining the regulation of life insurance, general insurance and banking is a major task, particularly as ever changing European regulation needs to be taken into account.

Currently an 'Interim Prudential Sourcebook' is being produced, which will bring all the current legislation for financial services into one place. Minor changes affect the timetable for producing annual returns.

The future will be different. In Consultation Paper 13, the FSA set out its principles for businesses. Consultation Paper 31 sets out the new framework for regulation, according to the risks run by firms – credit risk, market risk, operational risk and insurance risk. A key change for non-life business is that this will mean more emphasis being placed on proper capital management. This is an area that many actuaries will have little experience of. To this end, the profession is producing a sessional paper on 26 March 2001 on Financial Condition Reporting.

The General Insurance Board responds to relevant consultation papers on behalf of the profession. Among other responses the profession has responded to Consultation Paper 66 Prudential Requirements for Lloyd's Insurance Business. All responses are posted on the general insurance section of the Faculty and Institute web site.

EU Statutory Minimum Solvency Margin (SMSM)

The directives on "The review of the solvency margin requirements for life and non-life" were adopted by the European Commission (EC) on 25 October 2000. The proposals are now going to the European Parliament and the Council of the EU. Full copies of the directives can be downloaded (PDF format) from:
http://europa.eu.int/comm/internal_market/en/finances/insur/insolv.htm.

The principles behind the changes are that:

- Member States can require stricter rules
- Minimum guarantee funds (MGF) are increased with inflation, and the number is reduced for non-life
- Supervisors have increased power to intervene
- The reinsurance factor is now calculated over three years, not one
- The rules have changed for calculating the actual solvency margin (ASM), the capital items available to meet the SMSM
- The transition period is about 8-10 years
- The EC will report to the Insurance Committee in three years, probably on the progress of solvency II (see below)
- The SMSM is higher for three volatile non-life classes of business – marine, aviation and general liability
- Run-off companies have a proportionate run-down in the SMSM, rather than zero.

Other changes are mainly minor adjustments to the existing formulae.

The EC believes that the SMSM is only one part of assessing the overall financial position of an insurer and that the future operating environment will be more difficult than in the past. The EC has agreed that a 'fundamental and wide-ranging review' of the overall financial position of an insurance company should take place. The study, Solvency ll, is in its early stages. A high level briefing document has been produced and discussed with interested parties.

The aim is to have a ‘coherent and valid’ system for prudential supervision of insurance companies. The challenges of increasing competition, pressure of shareholder value, the Euro, capital market integration, the emergence of financial conglomerates and new distribution channels mean that a new system of prudential supervision is needed that can rise to these challenges.

The EC recognises the various conflicting constraints on a regulatory system eg:

- Protecting policyholders
- Being comparable and transparent
- Having a solvency margin matched to true risks
- Avoiding complexity
- Reflecting market developments
- Not being too prescriptive
- Fitting in with accounting principles
- Avoiding capital costs.

The EC sees provisions for general insurance business as a key aspect. Currently there is little harmonisation of non-life reserves. However, a group under the aegis of the conference of insurance supervisors, the Manghetti group, is researching methods of increasing consistency and coherency. This group has recently reported, but copies of their report are hard to come by.

The EC has appointed some consultants to advise on the practices in different countries. Any legislation is years away, but the next few years will be taken up with consultations with industry. The actuarial profession is being consulted via the Groupe Consultatif whose insurance committee has set up a working group to produce a statement of the Groupe’s views on this issue.

IASC Fair Value Accounting

The International Accounting Standards Committee (IASC) raised a project in April 1997 to produce an international standard for insurance accounting. In December 1999 a paper on the issues was published for consultation. Comments were received from several firms of consulting actuaries. The IAA responded on behalf of the profession as a whole. The steering committee met in September 2000 to review the comments. A Draft Statement of Principles will be produced in 2001, and the IASC will be field-testing the approach in 2001. Again, final agreement is years away but it is important that actuaries are aware of the proposals and that they are consulted.

The proposals for general insurance include treating life and non-life the same; insurance liabilities should be discounted and catastrophe and equalisation reserves not considered as being liabilities. The main proposal is to measure insurance liabilities to reflect risk as in the price of an arm’s length transaction between knowledgeable, willing parties. This is obviously a change from current practice and causes problems in cases where there is no secondary market in the liabilities.

The 2000 Budget

The 2000 Budget contained both good and bad news for insurers. On the one hand there was no increase in Insurance Premium Tax but on the other hand the Chancellor announced plans to tax claim reserves.

The Inland Revenue expects this proposal to yield around £250m a year but others in the industry have put the costs much higher.

Currently insurers pay tax on the profits they declare. Therefore if claim reserves are bigger than they need to be profits are delayed and the payment of tax is postponed. The proposals in the Budget were that claim reserves should be discounted for future investment returns and that if they were subsequently found to have been excessive then the company would be penalised.

The Inland Revenue issued a consultation paper on the measures to which interested parties were invited to reply. The Faculty and Institute was one body who wrote back. Their response did not deal with the general arguments as to whether or not reserves should be taxed but looked at the way that the Inland Revenue was proposing to do it. Their main objection was that the proposals appeared to contravene standard accounting practice.

The proposals are expected to be adopted without significant amendment. It is likely that they will apply for the 2001 financial year end, although this has not yet been finalised.

6. Public Interest Issues

In its Vision and Values document the Faculty and Institute acknowledges that one of the objectives of the profession is to serve the public interest. Actuaries have the skills and knowledge to identify issues which appear to be against the public interest. They should not hesitate to raise these issues for the benefit of others.

One way the profession has can do this is to produce position statements on relevant topics. Although not formal guidance, they aim to give authoritative and objective briefing. They may be used as the basis of public pronouncements.

Early in 2000 the Institute hosted a lunch for members of the trade press at which it briefed them on various topics within the industry. One of these topics was commission. The profession’s stance, as put forward in a letter to the GISC, was explained. Basically this was that volume related commissions should be abolished and all other broker commissions should be fully disclosed to policyholders. This was then reported prominently in Post Magazine along with negative comments from various brokers groups. Many actuaries were annoyed that the Faculty and Institute had published these views and they felt there had been insufficient consultation of their views.

A paper on General Insurance and the Public Interest was presented at the 2000 general insurance conference (GIRO). It contained a good discussion on the issues surrounding

position statements and how the views of more actuaries could be taken into account. It also considered some of the many public interest issues in General Insurance.

As a result of this position statements have been re-branded as briefing statements. They will focus more on explaining the issues surrounding a topic rather than setting out a view.

One topic covered in the paper was private motor insurance for younger drivers. The high premiums that young people are charged can mean that, for many, running certain types of cars is unaffordable. This may be a particular problem for those in rural areas who have no choice but to drive a car. The paper suggested a number of ways to reduce the premiums including:

- Limiting the scope of cover by allowing the young driver only to have one passenger under the age of, say, 25 in the car at any one time
- Limiting the cover by introducing a late night driving curfew
- Encouraging enhanced driving skills.

Further information on driving safety, in particular issues relating to young drivers, can be found on http://www.highwaysafety.org/.

The profession will be issuing an expanded briefing statement on the availability of personal lines insurance later in 2001.

A position statement, issued by the General Insurance Board, on Making General Insurance Buyers Better Informed was released in June. It recognized that there are occasions when consumers purchase, or are persuaded to purchase, general insurance products that may be inappropriate, unnecessary, misunderstood or poor value. For example, feeling obliged to purchase cover as part of another transaction. It recommended that bench-marked products, with standard terms and conditions, are made available by insurers. This would enable policyholders to compare products more easily.

A briefing statement has been released on Inertia Pricing. This is where policyholders, who are more likely to shop around at renewal, are charged lower premiums than those who are loyal, so as to retain more business. The statement examines why this practice might be found unacceptable and how it can be justified.

All the position and briefing statements can be found on the Institute and Faculty website.

7. Company News

Mergers and Acquisitions

Last year's paper contained a section outlining some of the reasons why there had been so many mergers and acquisitions over the previous two years. Whilst activity in this area was not quite so prevalent in 2000, it is still a significant topic.

The biggest news was the merger between CGU and Norwich Union to become the UK's biggest insurance group and a top five European life insurer. The holding company is now

known as CGNU although general insurance trades under the name of Norwich Union Insurance in the UK. The merged company has repositioned itself as, predominately, a life insurer. This has led it to sell its General Insurance business in the US to White Mountain and to pull out of the London Market.

Some other deals that have taken place are:
- The acquisition of Chartwell Underwriting's distribution network by Lloyd's insurer Hiscox
- The purchase of Lloyd's insurer Limit by the Australian company QBE
- The acquisition of insurance group Eastgate by professional services group Capita to form Capita Eastgate.

At the start of 2001 Abbey National announced that it had signed partnership deals with Norwich Union Insurance and Capita Eastgate to expand its general insurance business by around 40% to 2 million policies over the next three years.

Rumours continue to circulate regarding further activity in this area. In particular the possibility that the big European insurers will expand their UK operations by further acquisitions. There is sure to be more to come!

Another merger that will affect general insurance actuaries is that between the insurance arm of consultants Bacon & Woodrow and Deloitte & Touche. The new business will be known as B&W Deloitte and will give the insurance part of the business greater access to capital for future development.

Company Failures

The tough trading conditions in the motor market over the past few years finally took their toll this year. The FSA ordered Drake Insurance to stop writing new business in May and a few days later it was put into liquidation. Drake, who wrote only private motor business, had:
- Around 220,000 policyholders
- Over 2,000 intermediaries
- A premium income of £50m in 1999.

The FSA had requested that the American owner put more capital into the business to maintain an adequate margin of assets over liabilities. This was not forthcoming and so the company had to be closed to new business. The strong feeling in the press was that the FSA should have acted sooner so that Drake could have been run-off in an orderly and solvent fashion.

The Policyholders Protection Board (PPB), which is funded by a levy on insurers, agreed to act to ensure that claims were paid. The PPB pays 100% of third party claims but will only pay 90% of own-damage claims.

Of the 220,000 policies:
- 100,000 were cancelled

- 100,000 were transferred to five new insurers (Gouda and Groupama took half of these between them)
- 20,000 lapsed.

Attempts to find someone to take the whole book of business failed, perhaps because pockets of the business were losing so much money.

The financial security of an insurer is probably not a factor that many people consider when purchasing insurance. The collapse of Drake may have prompted some to consider it more carefully. However as the matter did not receive much national press coverage it is unlikely to have acted as a wake up call to many.

Chester Street Insurance Holdings owns the run-off of pre-1990 liability business for Iron Trades. In December it announced that it had come to an agreement whereby if there was a deficiency in the claim reserves it would make a part payment and the Policyholders Protection Board would make top up payments.

In January 2001 the news was made public that Chester Street had been put into liquidation. It is likely that increased asbestos claims contributed to their downfall.

8. Lloyd's News

The Lloyd's of London insurance market's capacity to accept insurance premiums rose by £1 billion in 2001 to reach £11 billion. The rise marks the largest single increase in the market's capacity since 1994. Growth in capacity came from the market's corporate members. Private capital with unlimited liability remained virtually static at £2 billion.

Reinsurance bad debt is an increasing financial burden for many syndicates. The Lloyd's Valuation of Liabilities rules require that a bad debt reserve is established not only for known disputes but also for the possibility of future default on reinsurance protections purchased outside Lloyd's. This even applies where the reinsurer is currently AAA rated. The last year or two saw a number of reinsurers, notably including a handful of down-under reinsurers, down graded in their security rating which will require increases in Lloyd's bad debt reserve.

At last, at the end of 2000, Lloyd's saw the underwriting cycle begin to turn towards profitability for some of its major classes. These include the Aviation and Motor markets.

The development in Asbestos claims highlighted earlier in this paper are of major concern to Lloyd's ongoing and the insurance vehicle 'Equitas' which covers the claims prior to the 1993 underwriting year.

Lloyd's is encouraging managing agents to produce realistic profit forecasts for syndicates' open years at an early stage of development. The unusual risks underwritten at Lloyd's can make this a challenging exercise for managing agents and their actuaries.

Lloyd's has recently named Henry Johnson, currently head of actuarial services at Swiss Re, to be head of Market Risk at Lloyd's. This function was established in 1997 and aims to evaluate and monitor the market's exposure to risk.

9. The Internet and e-commerce

No current topics paper at the moment would be complete without some mention of the internet. It is the hot topic for most industries, and general insurance is no exception. Most insurers have their own web sites now, as have many insurance related companies, for example, insurance magazines. Writing business over the web is a different matter. It's possible to get a motor quote from several insurers now, but it's quite painful as you have to type information in each time.

At GIRO a survey of actuaries' views on the web was done during the discussion of the paper on distribution channels of the 21st century. This covered actuaries' personal use of the internet and their companies use.

80% of actuaries had used the Internet to buy something, but only 10% to close an insurance purchase. This possibly reflects the lack of sites where business can be closed.

In terms of the future, the majority of actuaries (70%) thought that in five years business would still be mainly distributed through existing channels. Perhaps 25% would be through new channels. Despite this, only 25% of actuaries thought the insurers of today would be the key distributors in five years' time, with 50% going for financial services organisations and 25% for new entrant, high brand companies.

For actuaries, the challenge is assessing where the digital revolution will have most effect. The views at the conference were:

Product design and pricing	30%
Reserving	10%
Database and segmentation	50%
Profitability analyses and levels	40%

10. Giro Convention 2000

The 2000 General Insurance Convention was held at the Birmingham Metropole Hotel in October. Two books of papers were produced for the conference; they can be borrowed from the Institute or Faculty Library. Two papers are worth a particular mention here because they serve as good reference material for different parts of the market.

Employers' Liability Insurance

Employers' Liability is one of the few major areas, in the UK, where compulsory insurance cover is required. The Employers' Liability Act 1969 requires all employers carrying out

business in Great Britain to insure their legal liability for injury or disease sustained by their employees, arising out of and in the course of their employment under approved policies with an authorised insurer. Although there have been other pieces of legislation since, the 1969 act remains the predominate one. The total gross UK premium for Employers' Liability cover was around £700m in 1998.

This paper provides a good summary of the legal and contractual framework, the market's size and current major players, key features of claims and claims reserving and a discussion of current issues affecting the market.

The Aviation and Space Insurance Market

This is a specialist area of General Insurance and the paper gives an excellent description of the different parts of the market and the factors that determine the results in each area.

The total annual premium for the worldwide market is around £1.9bn for aviation and £500m for space risks. There are huge potential exposures arising from an individual accident. A collision between two 747's could result in a loss of over £2bn, more than the total annual premium for the aviation part of the market!

Some features of the market, for instance the way risks are placed, are highly unusual. This is done using a system called vertical placing. Normally in the London Market the broker puts together a presentation and agrees terms and conditions with the lead underwriter who takes a percentage of the risk. The broker then goes round the rest of the market (the follow market) to get others to take a portion of the risk, at the same terms, until 100% is covered. The difference for Aviation business is that risks are placed with the follow market first, conditional on a certain leader taking the risk. The follow market will not know the terms the leader is getting for the risk. It is not uncommon for an insurer to be writing the same risk as someone else but getting a premium 20% to 40% lower.

The paper also discusses current topics and suggests changes that insurers could make to improve the market.

GIRO 2001 will be held jointly with the Casualty Actuarial Society (CAS) in Glasgow. It will include a Ryder Cup type golf tournament on the Saturday.

11. Who's Who at the Faculty/Institute

General insurance is managed for the profession by the General Insurance Board (GIB). Julian Lowe, who is a member of Council and the Faculty and Institute Management Committee (FIMC), chairs the GIB. Julian has set up an e-mail list for actuaries interested in the work of the GIB – if you are interested, his e-mail address is julianlowe@norwich-union.co.uk. Alternatively you can keep in touch with some of the news by reading the GIB section of the Actuary. The GIB is currently in the process of making this more interesting.

William Hewitson, who chairs the Current Issues committee, is the deputy chair. The current issues committee monitors developments in current issues and identifies areas where the profession should take a lead.

Peter Clark (not the president!) chairs the Accounting Issues committee. They are responsible for all matters relating to the actuarial profession in connection with financial accounting and solvency supervision reporting for general insurance business (including accounting for investment returns).

The Education and CPD committee is chaired by Julian Leigh. They advise the Board on all matters relating to education, professional training and CPD that fall within the areas of responsibility to the Board.

The General Insurance Research Organisation (GIRO) committee is chaired by Richard Winter. They are responsible for research and development, for the General Insurance Conventions, and for arranging the preparation of papers on general insurance topics for discussion at other types of meeting not specifically covered by the General Insurance ECPD Committee.

John Ryan chairs the Professional Standards and Guidance committee, which looks after all matters related to professional conduct.

Kathryn Morgan chairs the Public Relations committee, which looks after all PR for the GIB. She also represents the UK profession on the Groupe Consultatif Insurance Committee along with Norval Bryson from the Life Board. This committee monitors EC insurance legislation affecting actuaries and submits views to the European Commission. It also maintains contact with European regulators.

Julian Ross chairs the London Market Actuaries Group. Other members of the GIB are Richard Bulmer, Martin Cross, David Hindley and Brian Huston.

12. Useful web sites

Insurance

Internet Address	Comments
http://www.insurancenewsnet.co.uk/	Insurance News Net
http://www.insurancetimes.co.uk/	Insurance Times Magazine
http://www.postmag.co.uk/	Post Magazine

http://www.propertyandcasualty.com/content/homepage/default.asp	US Property & Casualty news
http://news.ft.com/	Financial Times
http://www.lloyds.com/	Lloyd's
http://www.ilu.org/	Institute of London Underwriters
http://www.abi.org.uk/	Association of British Insurers
http://www.iua.co.uk/	International Underwriting Association

Reinsurance

Internet Address	Comments
http://www.newsre.com/	NewsRe - a reinsurance news network
http://www.re-world.com/	An online reinsurance magazine
http://www.raanet.org/	Reinsurance Association of America
http://www.globalreinsurance.com/gre_front.asp	Global Reinsurance News Service Network
http://www.swissre.com/e/publications.html	Swiss Re publications

Regulation and Legislation

Internet Address	Comments
http://www.fsa.gov.uk/	Financial Services Authority
http://www.gisc.co.uk	General Insurance Standards Council
http://www.iasc.org.uk/	International Accounting Standards Committee
http://www.asb.org.uk/	Accounting Standards Board
http://europa.eu.int/comm/index_en.htm	The European Commission
http://europa.eu.int/comm/internal_market/en/finances/insur/index.htm	DG Internal Market - EC pages
http://www.naic.org/	National Association of Insurance Commissioners
http://www.opengov.uk/lcd/	Lord Chancellor's Department
http://www.iso.com/	Insurance Services Office

Professional

Internet Address	Comments
http://www.actuaries.org.uk	Profession's website
http://www.sias.org.uk	Staple Inn Actuarial Society
http://www.fass.org.uk	Faculty Actuarial Students Society
http://www.actuaries.org.uk/groupe-	Groupe Consultatif

consultatif/index.htm	
http://www.casact.org/	Casualty Actuarial Society

PART V – INVESTMENT

1. INTRODUCTION

The focus of this section is to provide a market overview of 2000 and comment on two topical issues in equity and bond markets, namely corporate bonds and private equity

2. MARKET OVERVIEW – CALENDAR YEAR 2000

The table below shows the sterling returns achieved by the major market indices during the fourth quarter of 2000, and over the twelve months to 31 December 2000. The figures in brackets show local currency returns. The indices are the respective constituents of the FTSE series, unless otherwise stated.

Sector	Twelve Months to 31 December 2000 %
UK Equities	-5.9
Overseas Equities	-4.2 (-8.2)
US	-1.1 (-8.5)
Europe (ex UK)	1.7 (0.0)
Japan	-23.4 (-20.8)
Asia Pacific (ex Japan)	-14.3 (-13.3)
Overseas Bonds (JP Morgan)	10.5
UK Fixed Interest (Over 15 Years)	8.0
UK Non-Gilt (Merrill Lynch Over 15 Years)	10.6
Index-Linked Gilts (All Stocks)	4.3
Property (CAPS)	11.9
Sterling Cash (LIBID)	5.6

3. Economic Background

Key to most economies is the price of oil, which was extremely volatile during the year. Crude oil prices broke a succession of 10-year highs in the second half of the year reaching more than $35 a barrel, although there appeared no shortage of physical supply. High oil prices raised fears of inflation in western economies, and may have deterred central banks from cutting interest rates. OPEC's response to the price rally was four rounds of production increases during the year which helped to reduce oil prices during December to under $24 a barrel. However, OPEC now wants cuts in oil supplies to avoid prices dropping out of its preferred range of $22-28 a barrel.

During the year, there was evidence of a gradual cooling in the US economy. This evidence became more pronounced during the final months of the year with a continuation of falling sales and manufacturing output figures. Sentiment was also depressed at the end of the year by the US presidential election issue. After four interest rate rises in 2000, the Federal Reserve decided, on 3 January 2001, to reduce short-term interest rates by 0.5% in an attempt to boost the economy.

The Euro-zone economy continued to perform strongly over the first half of the year and the European Central Bank (ECB) saw justification in raising interest rates in the Euro-zone. The increases were mainly seen as a defensive move to put a floor under the flagging Euro currency, but also following the strength of recent business surveys. In September, the ECB, together with the US Federal Reserve and Bank of Japan (BOJ), orchestrated a co-ordinated intervention in the currency markets to support the weakening Euro. Since then, the Euro has strengthened considerably reaching a five-month high at the end of the year.

In the UK, interest rates remained stable as inflation remained largely in line with the government's target. Consumer confidence has remained strong and this has helped push consumer credit to record levels. Unemployment fell to its lowest level in twenty-five years, which left many analysts retaining a positive forecast for the UK economy going forward. However, with a slow down in the US economy, growth is predicted to be less rapid than previously assumed.

There have been signs that the Japanese economy has been gradually recovering. The BOJ said that the economy was being led by improvements in corporate profits and rising business investment. Indeed for the first time in ten years, the BOJ abandoned its zero interest rate policy by raising its overnight call rate to 0.25%. However, towards the end of the year markets performed badly and there was a fall in investment sentiment. The markets were affected by the failure of SOGO, the largest department store, and Koyei Life under huge debts. Confidence in the Japanese government also suffered and the Prime Minister survived a motion of no confidence on 20 November.

Economies in the remainder of the Pacific Basin remain volatile. Many of the markets were badly affected by the fall in technology stocks and slow down in the US economy. The volatility of the markets has led many Pacific Basin investors to hold a large proportion of their funds in cash.

4. Stock Markets

Over the twelve months, equity returns were negative in all the major markets in both local currency and sterling terms apart from Europe (ex UK). The FTSE-W World (ex UK) Index returned -4.2% to the sterling investor over the twelve months highlighting this point. However these returns are mainly due to the poor returns in the US during quarter four. The US accounts for approximately 50% of the world index.

Markets have been very volatile over the year largely due to the rises and falls of technology, media and telecom (TMT) stocks. The TMT stocks proved they were not immune to the slow down in global economic growth and fell substantially over the last six months of the year.

UK equities only produced positive returns during the third quarter of the year and then only returned 0.6%. The annual decline of the FTSE 100 Index was only the third in its seventeen year history. The markets were hampered by earnings worries and a ratings decline in the previously highly prized telecom and technology sectors. Investors have become particularly worried over telecom stocks whose companies have continued to strive for competitive advantage by increasing borrowings.

The overall return for the twelve months as measured by the FTSE All-Share Index was -5.9%. The FTSE 100 returned -8.2% whilst the FTSE Small Cap and FTSE 250 had stronger twelve months returns of 5.5% and 4.0% respectively. The best performing sectors during the twelve months were non-cyclical consumer goods (+21.1%), utilities (+16.7%) and financials (+11.2%) whilst the worst were information technology (-44.3%), non-cyclical services (-34.0%) and cyclical consumer goods (-24.0%). The year in particular was associated with the collapse of some internet stocks, or at best a huge decrease in their value. For example, QXL.com fell by 98% during the year.

As stated above, European equities produced the strongest returns over the year in local currency and also in sterling terms. Although the devaluation of Euro continued for most of the year, the Euro rebounded towards the end of the year after intervention from the US Federal Bank, BOJ and ECB. The FTSE-W Europe (ex UK) Index grew by 1.7% in sterling terms and 0.3% in local currency terms. US equities produced positive returns in each of the first three quarters but were badly affected by a reduction in consumer confidence and a number of profit warnings by major US companies in the fourth quarter. The FTSE-AW US Index fell by -8.6% over the fourth quarter leading to a return of -1.1% throughout the year 2000 to a sterling investor. The US market was particularly affected by the tumbling of prices in technology markets and the NASDAQ had its worst year on record, falling by almost 40% over the year.

The FTSE-AW Japan recorded sterling returns of -23.4% and local returns of -20.7%. The poor return was again largely due to market performance in the fourth quarter. The Japanese economy was affected by rising bankruptcy levels and also the abandonment of BOJ's zero interest rate policy, combined with high oil prices and the selling of technology stocks.

The rest of the Pacific region produced slightly higher returns than Japan, returning -14.3% over the year. Korea and Taiwan were both badly affected, but China performed well over the year returning almost 50%.

Property, cash and fixed interest Gilts were the only sectors to achieve positive returns in all four quarters of 2000. The CAPS Property Index returned of 11.9% whilst the LIBID 7 Day Cash Return was 5.6% over the twelve month period.

5. Bonds

Bond returns increased in comparison to the previous rolling twelve month period with the FTSE A Over 15 Year Gilt Index returning 8.0%, FTSE A ILG (All Stocks) returning 4.3% and JP Morgan Global (ex UK) Overseas Bond Index returning 10.5%.

Over the latest quarter, long-term bond prices have risen most strongly due to a fall in long-term interest rate expectations. Demand for Gilts continues to remain strong despite the expansion of the corporate bond market. The size of the corporate bond market is now approximately 75% of the gilt market which should help increase liquidity and marketability. Corporate bond returns have been volatile over the year relative to gilt returns, but long-dated investment grade stocks have produced outperformance of approximately 2% over the year.

6. Currency

Sterling has depreciated significantly over the twelve months against the US dollar and Japanese Yen whilst depreciating only slightly against the Euro in the fourth quarter. In September, the ECB orchestrated the co-ordinated intervention, together with the US Federal Reserve and BOJ, in the currency markets to support the weakening Euro.

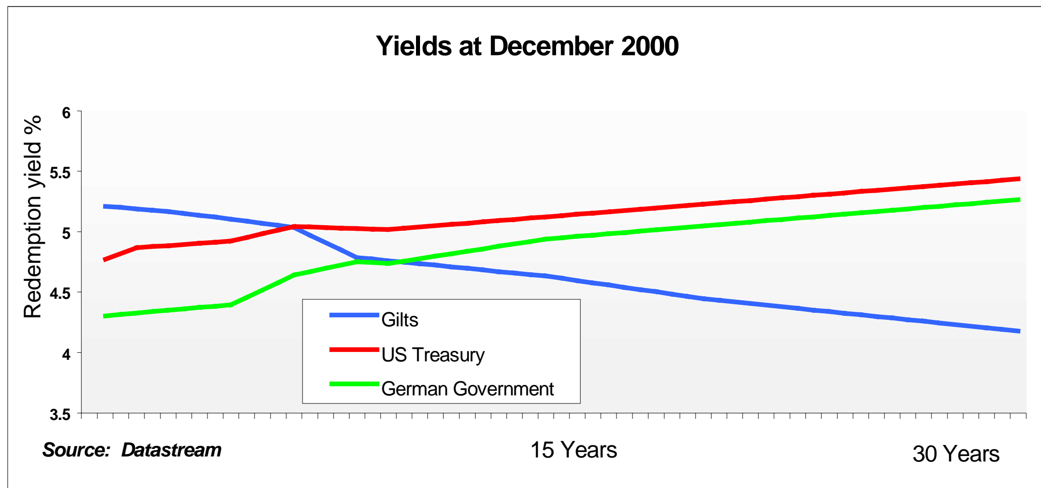
7. Corporate Bonds

Background

Over the last few years bond yields around the world have fallen, reflecting the global outlook that inflation will remain low. The UK market has also been particularly affected by the high level of demand there has been for long-dated Gilts and the lack of supply, leading to the downward sloping UK yield curve, which is the reverse of the US and German yield curves. Government finances are in reasonable shape with little new debt being issued, whilst demand for Gilts has been high.

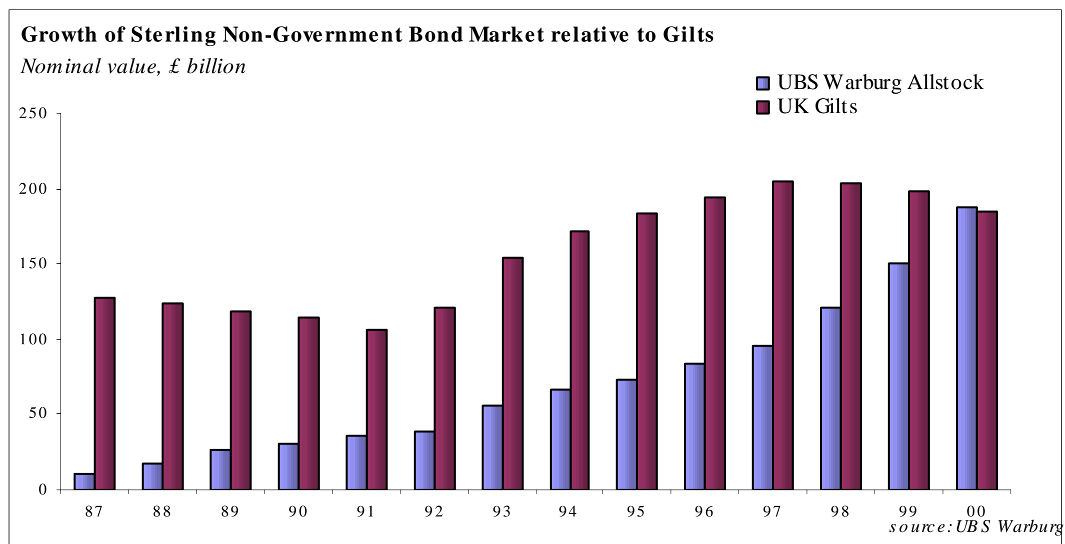
Insurance companies have sought to cover guaranteed annuity rate liabilities and banks need bonds to maintain solvency ratios. Moreover, an increasing proportion of UK pension schemes are seeking to reduce risk. The main drivers for this risk reduction are increasing maturity, more onerous levels of guaranteed benefits (with a corresponding reduction in the scope to fund for discretionary benefits), greater transparency of pension fund costs and, in some cases due to the introduction of the Minimum Funding Requirement (the MFR).

The yield curve as at 30 September 2000 for Gilts relative to US Treasuries and German Bunds
is shown overleaf. This highlights the extent of the technical squeeze on the longer dated end of the UK market, where yields are currently much lower than their US and German counterparts.



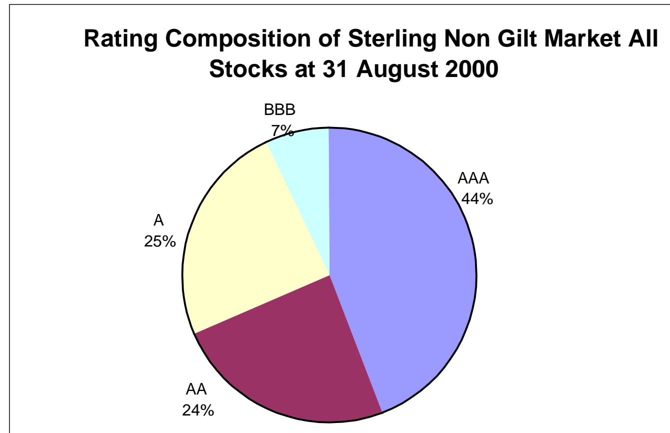
CORPORATE BOND AVAILABILITY

The corporate bond market now rivals the size of the entire Gilt market, as illustrated below:



Institutional investors invariably focus on higher quality corporate bonds, often restricting investment to the "Investment Grade" universe, i.e. those bonds of credit quality BBB or above.

The chart overleaf shows the breakdown of the Merrill Lynch corporate bond index by credit rating. It demonstrates the significant weighting towards higher quality stock. Note that the recently published FRS 17 accounting standard for UK pension funds has stipulated that the yield on a suitably dated "AA" corporate bond be used as the discount rate for valuing pension fund liabilities when accounting for pension costs.



CORPORATE DEBT – FEATURES

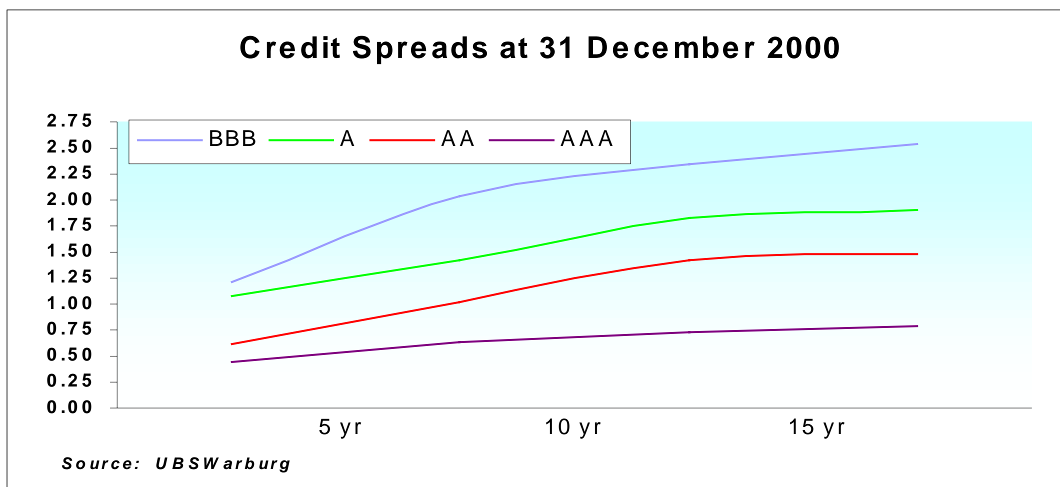
Corporate debt is similar in principle to Government debt. The price of corporate debt varies, like Government debt, as interest rates change and (unlike Government debt) as credit spreads widen or contract.

Credit spread represents the additional yield over Gilts, which is paid in compensation for the extra risk of corporate debt. Corporate debt commands a higher yield as:

(i) the risk of default is higher than with Government debt, and
the liquidity of issues is generally lower.

At present, the valuation of corporate debt is not suffering the technical squeeze associated with Gilts to the same degree. This is perhaps best illustrated by the Government auction of mobile phone licences during 2000: Telecommunication companies bid to pay the Government £22 billion. In order to pay for these licences, the telecommunication companies need to raise debt (albeit most will not be through the Sterling debt market). At the same time the Government is reducing its borrowing requirement by the same amount. The net effect is a continued contraction of the Gilt market. Indeed, changes in the way companies seek finance have already led to significant growth in the sterling corporate debt market.

The difference between the yield on conventional Gilts and corporate bonds, i.e. the credit spread, is illustrated in the graph overleaf:



The yield on corporate bonds has historically been more than sufficient to compensate for the default risk. In part this has reflected a liquidity premium. However, the scarcity premium currently being paid for UK sovereign debt (by insurance companies and banks, as well as pension funds), coupled with the lack of Gilt supply led to a widening of investment grade credit spreads over the last twelve months. There was a contraction in the spread premium towards the latter part of 2000, but the spread on AAA long-dated debt is still around 80 basis points (0.80%), even though some of these stocks are effectively government-backed.

ASSOCIATED RISKS

There are of course risks associated with investment in corporate bonds, in particular the risk that the credit spread can widen further, the risk of default, and issues relating to liquidity.

Whilst over the longer term corporates have generally outperformed conventional Gilts, there have been periods when this has not been the case. This arises because the yield premium on corporates varies over time. For longer dated debt with a BBB rating the yield premium has varied between 1% and 3% over the 1990s. When the yield premium is rising corporate debt performs poorly relative to conventional Gilts.

In addition there is the risk of an individual issuer of debt defaulting, as mentioned above, and there is liquidity risk. Corporate bonds are less liquid than their conventional counterparts and are more expensive and difficult to trade, although the higher grade stock does not suffer greatly from this.

8. PRIVATE EQUITY

DEFINITION OF PRIVATE EQUITY

The unquoted equity market is well developed in the US and UK/Europe. The generic term used to refer to the sector is private equity. This market covers different stages of investment from early stage/start up investments, through development capital and expansion financing for companies, to funding management buy outs (or buy ins) from larger, often listed companies. Venture capital is a sub-sector of the private equity market and refers to investments in the early stage/start up end of the market.

The topicality of this issue was assured when Paul Myners was asked by the Government to review institutional investment in the UK to assess, amongst other issues, why the UK institutional pension funds had very little investment in this sector.

THE PRIVATE EQUITY MARKET IN EUROPE

Although much smaller than the US, the European Private Equity market has been growing significantly over the last few years. Figures from the European Private Equity and Venture Capital Association show that in 1999, $24bn was invested in private equity, the lions share ($11bn) in the UK (62% up on 1998 figures). The figures for 2000 are estimated to continue this strong growth.

RATIONALE FOR INVESTING IN THE SECTOR

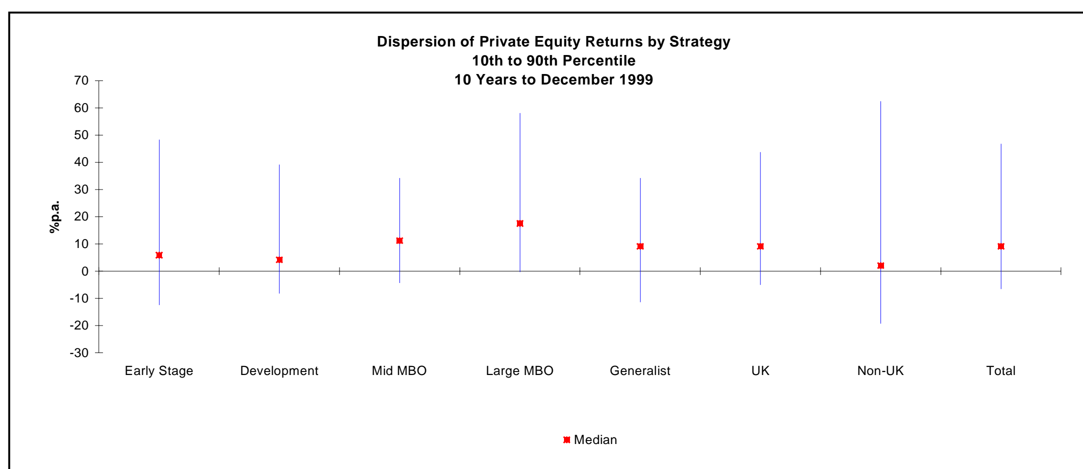
The rationale for investing in private equity is the expectation of achieving returns above those available from the quoted market. The expectation of investors in private equity of earning above quoted market returns is based on two factors:

A premium for illiquidity;
Capturing the returns that arise from companies entering a phase of rapid growth.

RISK AND RETURN CHARACTERISTICS

The greatest "risk" of investing in private equity is not so much that the underlying investments are in small companies that will fail more readily than a quoted company (though some undoubtedly do, particularly in early stage/start up funds). It is the risk of investments being committed to the funds of managers, who do not have the skills to build, develop and successfully realise a portfolio of companies.

Over the ten years to the end of December 1999 the performance of all funds raised in the UK ranged from -7% p.a. to +47% p.a., compared with the FTSE All Share return over the same period of 14.9% p.a. Over shorter time periods, the range between 10th and 90th percentile manager tends to be even greater. A chart outlining this is shown below.



Manager (or fund) selection is therefore the key risk facing investors.

METHODS OF INVESTMENT

There are many ways to diversify exposure in the area of private equity. The first area of diversification is the stage of investment, ranging from Early and Development stages to funds specialising in MBO investment. The European market has traditionally focused on the MBO side (53% of investment in 1999), but there are signs that this is slowly changing, with more being invested in early stage ventures.

In addition to allocating commitment across the different stages of investment, further diversification can be achieved in three ways: by geography, by manager and by time of investment.

PERFORMANCE MEASUREMENT

Private equity funds do not fit neatly into the traditional quarterly performance measurement format. The nature of the closed end partnership means that calculations of returns in the early years of a fund's life are fairly meaningless and do not help in determining how well the fund is likely to perform. Indeed initial set up costs and the use of conservative valuation methods means that the returns are normally negative in the early years, improving as investments are realised in latter years of the fund's life (hence the returns from private equity funds are sometimes referred to as following a J-curve). The true performance of the fund will only be known at the end of the life, when the last distribution has been returned to investors. For this reason private equity funds are usually measured on a cash-on-cash basis, referred to as an internal rate of return (IIR), because it reflects the value of all cash-flows in and out of the fund.

Assessment of the private equity allocation should be judged separately and over a much longer period of time (over the first 3 – 4 years there will be little to report on beyond investment activity of both the fund of fund manager and within the underlying funds). Over the longer term comparison of the performance of the private equity allocation should be made with the returns in the relevant industry survey (e.g. WM/BVCA Survey for UK raised funds) and with the returns which have been achieved in the relevant quoted market. Short-term measurement should always be treated with caution.

Performance targets are normally defined as an outperformance target against the respective quoted index, i.e. the FTSE All Share in the UK. A typical target would be between +3% to +5% per annum over the long-term. Some managers will define an absolute target measure, such as 'in excess of 15% per annum over the long-term'.

PRIVATE EQUITY SUMMARY

The expectation of investors in private equity of earning above quoted market returns is based on an illiquidity premium and the scope to capture returns from companies entering a phase of rapid growth.

The very long term, highly illiquid nature of the investment makes private equity less appropriate for many institutional investors, although political pressure may lead to more funds committing a small portion of their assets to this sector.

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