JIA 121 (1994) 597-601

*J.I.A.* **121**, III, 597–601

# CURRENT ISSUES IN LIFE ASSURANCE

## Seminar, 26 April 1994

Almost 200 actuaries attended the Current Issues in Life Assurance seminar held on 26 April 1994 at the Heathrow Park Hotel. The seminar was divided into six sessions, covering a variety of topical subjects. Professor J. J. McCutcheon and Mr L. J. Martin acted as chairmen.

### The New Valuation Regulations

The first session was presented by Mr T. W. Hewitson, who summarised the principal changes being made to the liability valuation regulations. These were to form part of the Insurance Companies Regulations 1994, due to come into force on 1 July 1994. Attention was focused on those changes made since the latest draft set of regulations had been published.

In particular, the following points were highlighted:

(1) There would no longer be any reference to specific reserves for future bonuses. Instead, the Actuary would have to have regard to policyholders' reasonable expectations. There was, however, no intention of requiring a general strengthening of reserves in this area.

(2) The requirement has been reinstated to limit the valuation rate of interest to an overriding maximum of the weighted average of the reduced yields on the existing assets.

(3) The margin taken from the yield on the asset in determining the valuation rate of interest is to be reduced from 7·5% to 2·5%. However, greater attention will be paid to the requirement to reduce the yield so as to exclude any risk premium.

(4) The yield for index-linked securities will be based on the redemption yield, assuming zero inflation, rather than on the running yield, as at present.

(5) The valuation rate of interest for any investment made more than three years after the valuation date may not exceed the lowest of:

   (a) the long-term yield on appropriate Government fixed-interest securities,
   (b) 6·0%, increased by one quarter of the excess of the yield in (a) over 6·0%, and
   (c) 7·5%.

The subsequent discussion centred on the practical implementation of the new regulations. One speaker highlighted a potential abuse of derivatives to circumvent the resilience test requirements. Another asked whether the Appointed Actuary would be required to indicate how he had taken account of policyholders' reasonable expectations in his valuation. The principal speaker replied that no changes were currently envisaged in this area, but that the subject would be reconsidered as part of a wider review of the format of the DTI Returns. Clarification was sought of the type of arbitrary change in the valuation basis that was no longer to be allowed. The example given in reply was a sharp change in the interest rate used to value annuities in payment, with no corresponding change in the redemption yield on fixed-interest securities.

Finally, the principal speaker confirmed that the adjustment made to allow for the effect of taxation would continue to be left to the judgement of the Appointed Actuary.

## Alternatives to the Net Premium Valuation

The second session was introduced by Mr P. D. Needleman and Mr D. J. Lechmere, who updated the audience on the work being conducted by the working party established to examine alternatives to the net premium method of valuation.

The working party had been asked to consider alternative valuation methods used overseas, ensuring that any proposal was consistent with the Third Life Directive. In addition, they were asked to investigate the effect on reserves held under the current regime. The possibility of change had arisen from perceived problems with the net premium method, in particular its passivity, implicit margins and lack of suitability for unitised with-profits business. There was also a requirement for a valuation method which accommodated the demand for an early recognition of profits and gave realistic information on financial strength.

The approach currently favoured by the working party comprises three elements:

(1) A gross premium valuation, reserving for supportable future bonuses and with an allowance for early leavers. The valuation would be on a best estimate basis with planned margins to allow a controlled emergence of profits. Assets would be taken at market value. This reserve would be known as the basic policy liability.
(2) A statutory minimum reserve, again on a best estimate basis, but with a maximum permitted valuation rate of interest and minimum permitted explicit margins for adverse experience in all parameters. The reserve would be subject to a resilience test.
(3) A confidential financial condition report, submitted to the DTI. This would include a further valuation on a more severe basis, known as the capital adequacy reserve, together with details of the life office's surplus distribution philosophy and the results of dynamic solvency testing.

The working party was now giving further consideration to the proposed approach. In particular, the reserve appropriate for terminal bonus was being examined, as was the allowance for renewal expenses for a new life office.

Investigations were also being made into the implications a lower cost of bonus would have on the transfer to shareholders. The intention was to produce a further paper, probably in 1995/96, with an interim update at the 1994 Harrogate convention.

Contributions from the floor included a discussion on whether the capital adequacy reserve should reflect smoothed or unsmoothed asset shares and whether the use of free asset ratios should be abandoned. Concern was also expressed over the practicality of keeping the financial condition report confidential.

## IMPLICATIONS OF THE GOODE REPORT FOR LIFE OFFICES

The third session was presented by Mr J. S. R. Ritchie, who outlined some of the possible implications the Goode Report on occupational pension schemes might have for life offices. He prefaced his talk with the remark that it had been prepared in advance of the announcement of any legislative changes arising from the Goode Report.

The presentation concentrated on the recommendation to allow streamlined regulatory and compensatory procedures for small schemes administered by insurance companies who were prepared to assume responsibility for supervision and for any defaults that might arise. After outlining the features of such a system as suggested by the Association of British Insurers, the speaker went on to discuss the actuarial implications. These included the additional costs that would be incurred, in terms of both the extra administration required and any compensation payments. As a consequence, life offices would have to reprice their products, both for new schemes and, where possible, for existing schemes wishing to adopt streamlined supervision. There may also be reserving implications. In conclusion, the speaker commented that, with around 700,000 schemes and some 6·5 million members, insured occupational pension schemes merited full consideration in their own right, not to be treated as a secondary issue behind large non-insured schemes.

One contributor from the floor commented on the potentially high costs arising from compensation under streamlining that might fall on a life office's with-profits policyholders, given their relatively narrow base. In reply, the principal speaker noted the excessively onerous administration that would result were compensation payments to be spread across all insured schemes. A second contributor suggested that the changes, as proposed, may hasten a switch from occupational to personal pensions.

## LIFE ASSURANCE JOINT COMMITTEE UPDATE

The fourth session was introduced by Mr C. J. Hairs, who updated the audience on the work of the Life Assurance Joint Committee, shortly to be renamed the Life Practice Board.

The joint committee acts as a steering group, overseeing the work of currently thirteen working parties. These comprise three involved with work arising from the Financial Services Act, three concerned with matters relating to prudential supervision, the Joint Actuarial Working Party set up with the Government Actuary's Department and the DTI, and a further six working on miscellaneous topics.

The committee is keen to improve communication with members of the profession, principally through greater use of *The Actuary* magazine.

One speaker from the floor questioned the committee's relatively low profile in the media. The principal speaker accepted this, but pointed out that comments made by committee members often appeared under their own names, rather than as representatives of the profession. A suggestion was made that the joint committee could perhaps extend its role by giving assistance to those actuaries who have to communicate with their Boards of Directors.

## Disclosure Issues

The fifth session was presented by Mr C. D. Pullan, who described the new disclosure regime due to be announced shortly in LAUTRO Rules Bulletin Number 66, and by Mr D. O. Forfar, who discussed the professional guidance required by the changes.

The first speaker outlined the four principal areas that will be covered by the new rules:

(1) Differential pricing will be allowed in the tied sector.
(2) Benefit projections will have to be performed on an own-charges basis, rather than on standard assumptions, as, in general, applies currently.
(3) Surrender values will have to be projected over the long term, at five-year intervals, as well as at each of the first five years of the contract's term.
(4) Commission will have to be disclosed in cash terms at the point of sale. For direct salesforces, some averaging of the rate will be permitted. For companies such as bank subsidiaries, remuneration will, in general, have to be uplifted by 15% to allow for a profit element.

The new rules are to become effective on 1 July 1994, with own-charge projections and client-specific commission disclosure becoming mandatory from 1 January 1995. Client-specific key features documents would be required from 1 July 1995 and client-specific post-sale information from 1 August 1995.

The second speaker discussed the draft guidance that had been prepared in response to the disclosure changes. This comprised a temporary practice note, covering commission and remuneration disclosure, and a guidance note, covering projections and expense disclosure for with-profits business. He highlighted the large amount of work that had been completed over a short timescale.

Contributions from the floor concentrated on the practical implementation of the disclosure changes and on drafting details concerning the guidance. There was general agreement that a further discussion of the temporary practice note and guidance note would be desirable.

## Dynamic Solvency Testing

The final session was introduced by Mr P. J. Nowell, who updated the audience on the work being conducted by the working party established to examine the concept of dynamic solvency testing.

The working party had produced its final report and now saw its task as encouraging the production of a financial condition report including dynamic solvency testing and considering the professional guidance required to produce such a report. The speaker commented that, based on his own experience, difficulties could be encountered reducing the amount of information contained in the report to an intelligible level. In addition, for most life offices, the most important element was likely to be the future return on equity investments.

Some contributors from the floor expressed the view that, given the pace of change in other areas, it was not desirable at this stage to introduce a requirement to produce a financial condition report embracing dynamic solvency testing. Others, in contrast, saw dynamic solvency testing as fundamental to the role of the life office actuary. Comments were also made on whether the financial condition report should automatically be made available to the supervisory authorities and, if so, whether it would be possible to maintain its confidentiality.

There was a discussion on the relative merits of deterministic and stochastic modelling. The latter was seen by some as providing a clearer insight into the possible financial development of a life office, but by others as being insufficiently well developed and difficult to communicate to board members. The principal speaker commented that, whilst the working party suggested the use of a deterministic approach, this did not preclude actuaries who wished to from using stochastic methods.

There was also a request for detailed guidance on the form a financial condition report should take, possibly through the production of a standard version.

The principal speaker concluded by expressing the hope that the use by actuaries of dynamic solvency testing would evolve over time.

P. M. Downey