

# CONTENTS

<b>1</b>	<b>INTRODUCTION .....</b>	<b>3</b>
<b>2</b>	<b>INVESTMENT .....</b>	<b>4</b>
2.1	INTRODUCTION.....	4
2.2	MARKET OVERVIEW .....	4
2.3	THEMES .....	4
2.4	MARKET SUMMARIES .....	6
2.5	MARKET DATA.....	12
<b>3</b>	<b>STAKEHOLDER PENSIONS .....</b>	<b>13</b>
3.1	INTRODUCTION.....	13
3.2	EXISTING PROBLEMS .....	13
3.3	THE GOVERNMENT'S INTENTIONS WITH STAKEHOLDER.....	14
3.4	THE POSSIBLE IMPACT OF STAKEHOLDER PENSIONS ON THE INSURANCE INDUSTRY.....	15
3.5	FINANCIAL RISKS OF STAKEHOLDER PENSIONS .....	17
3.6	THE AMERICAN EXPERIENCE - THE 401(K) MARKET .....	17
3.7	THE AUSTRALIAN EXPERIENCE - COMPULSORY PENSION SAVINGS .....	20
3.8	THE WAY FORWARD FOR STAKEHOLDER IN THE UK .....	20
3.9	APPENDIX A - THE CONSULTATION PROCESS .....	21
3.10	BIBLIOGRAPHY .....	23
<b>4</b>	<b>PENSIONS .....</b>	<b>24</b>
4.1	MFR REVIEW .....	24
4.2	PENSION MISSELLING REVIEW.....	25
4.3	NEW ACCOUNTING PROPOSALS .....	26
4.4	IMPROVED FLEXIBILITY IN PENSION PROVISION .....	27
4.5	ABILITY TO POSTPONE ANNUITY PURCHASE PAST 75 .....	29
4.6	PENSIONS AND DIVORCE .....	29
4.7	GUARANTEED ANNUITY OPTIONS.....	30
4.8	PENALTIES ON EMPLOYERS AND TRUSTEES .....	30
4.9	THE NEED FOR TRUSTEES TO DISCLOSE POLICY ON ETHICAL INVESTMENT .....	31
4.10	SSAS - INCREASED RESPONSIBILITY FOR PENSIONER TRUSTEES.....	31
4.11	PIA PROJECTION RATE CHANGES.....	32
4.12	BUDGET CHANGES .....	32
4.13	POTENTIAL DEMISE OF CARRY BACK / CARRY FORWARD.....	32
4.14	MARKET INNOVATIONS .....	33
4.15	SIPP GROWTH .....	34
4.16	AMENDMENT TO GUIDANCE NOTES .....	35
4.17	BIBLIOGRAPHY .....	36
<b>5</b>	<b>LIFE INSURANCE.....</b>	<b>37</b>
5.1	NEW BUSINESS .....	37
5.2	FINANCIAL STRENGTH .....	39
5.3	AMENDMENTS TO PART IX OF INSURANCE COMPANY REGULATIONS 1994.....	40
5.4	FUTURE OF WITH-PROFITS BUSINESS.....	41
5.5	GUARANTEED ANNUITY RATES .....	42
5.6	ENDOWMENT MORTGAGES .....	43
5.7	PERSISTENCY .....	44
5.8	GENETIC TESTING .....	46
5.9	LONG TERM CARE .....	47
5.10	SECTOR ACTIVITY .....	48
5.11	AMENDMENTS TO GUIDANCE NOTES.....	50
5.12	BIBLIOGRAPHY .....	51

<b>6</b>	<b>GENERAL INSURANCE.....</b>	<b>52</b>
6.1	THE ECONOMY .....	52
6.2	CLAIMS EXPERIENCE .....	53
6.3	THE INSURANCE CYCLE .....	61
6.4	LEGAL ISSUES .....	61
6.5	CONSOLIDATION, MERGERS & ACQUISITIONS - COMPANIES.....	68
6.6	CONSOLIDATION, MERGERS & ACQUISITIONS - BROKERS .....	69
6.7	DEVELOPMENTS IN RISK ANALYSIS.....	69
6.8	LLOYD'S.....	72
6.9	PROFESSIONAL ISSUES .....	73
6.10	GIRO CONVENTION 1999.....	74
<b>7</b>	<b>OFFSHORE LIFE INSURANCE.....</b>	<b>76</b>
7.1	NEW BUSINESS TRENDS .....	76
7.2	MARKETS.....	76
7.3	OFFSHORE CENTRES.....	77
7.4	PRODUCTS .....	78
7.5	REGULATION .....	79
7.6	INTERNATIONAL SCRUTINY .....	80
7.7	BIBLIOGRAPHY .....	81

# 1 INTRODUCTION

The aim of this paper is to summarise the main areas of change over the last year as they affect the fields of investment, pensions, life insurance, general insurance and offshore life insurance. It is hoped that this will be of particular interest to students, especially those studying for the later exams. A separate section has been given to Stakeholder Pensions to allow a full discussion of the issues which have arisen.

For the record, each section was written as follows:

Investment	Alan Murray
Stakeholder Pensions	John Young
Pensions	Candia Kingston
Life Insurance	Janet Hall
General Insurance	James Widdows, Martin Burke and Emma Pointon
Offshore Life Insurance	Michael Hodges

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

Finally we would like to thank our colleagues for their assistance in the writing of this paper. We must stress that any opinions expressed are those of the authors and not necessarily those of our employers, colleagues or local actuarial societies.

## **2 INVESTMENT**

### **2.1 Introduction**

The structure of this section is as follows:

- A brief overview of the investment market.
- A discussion of a couple of big themes running through the market.
- A brief run through of the main events of each major investment market, intended to give a flavour of that market.
- Tables detailing the returns achieved in various markets in 1999.

### **2.2 Market Overview**

In general 1999 was a year of low inflationary growth. Interest rates were cut across the globe at the start of the year. It was led by the US Federal Reserve, partly to try and avert a credit crunch following the Russian loan defaults and the collapse of hedge fund LTCM, but also to try to stimulate demand globally. This gave most equity markets a positive start to the year. Another supportive factor for equity markets was the high level of M&A activity - companies merging to either gain market share or reduce costs or using excess cash or highly rated shares to buy cheap assets.

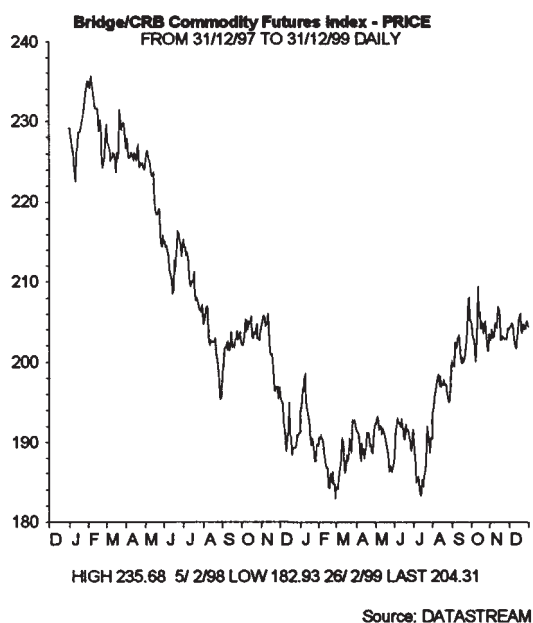
The low level of interest rates had their desired effect and forecasts for global economic growth were increased. This had a positive effect for cyclical stocks, which are more geared into economic activity, and had been out of favour for most of the last two years.

The interest rate cuts, having done their job, were taken back in the second half of the year. There were, however, fears of further rate rises as growth continued to increase and this added volatility to the market. There were also fears about the effect of Y2K but these turned out to be groundless. This was just as well as the much-anticipated post Y2K 'relief rally' actually occurred from mid-November onwards.

### **2.3 Themes**

#### **2.3.1 No Sign of Inflation**

Conventional economic theory suggests that above trend growth and a tight labour market are the perfect situations for inflation. These have been the conditions, especially in the US, for most of 1999 and yet there has been no sign of inflation creeping into the system. One factor that has certainly reduced inflationary pressures is the low level of commodity prices.



The graph opposite shows the level of a basket of commodities over the last two years. Although prices rose strongly in the second half of 1999 driven by the higher oil price, all they have really done is get back to mid 1998 levels which are still low by historical standards.

The impact of rising input prices is lagged by anything up to 18 months so it is doubtful if this will feed through yet to output price inflation unless commodity prices keep rising.

Also helping to keep inflation in check are utility regulators who seem determined to force through price reductions for the consumer.

Businesses are facing greater and greater competition and, without the luxury of inflation, are having to become more and more efficient to keep the bottom line growing. Consumers too remain very price sensitive reflecting the loss of the jobs for life mentality, brought on by companies increased focus on their cost base. These factors may go some way to explaining the lack of impact of the tight labour market on inflation, so far anyway.

Another reason for the lack of inflation is the growth of trade over the Internet. This has increased the globalisation of trade and made it easier for customers, both individuals & businesses, to find the cheapest supplier. There are also big savings to be made on distribution costs by selling over the net. This can help explain the benign inflation situation, especially in the US which is the most advanced 'net economy'. It also lends credence to the very strong improvements in productivity seen in the States.

### 2.3.2 Strength of Tech

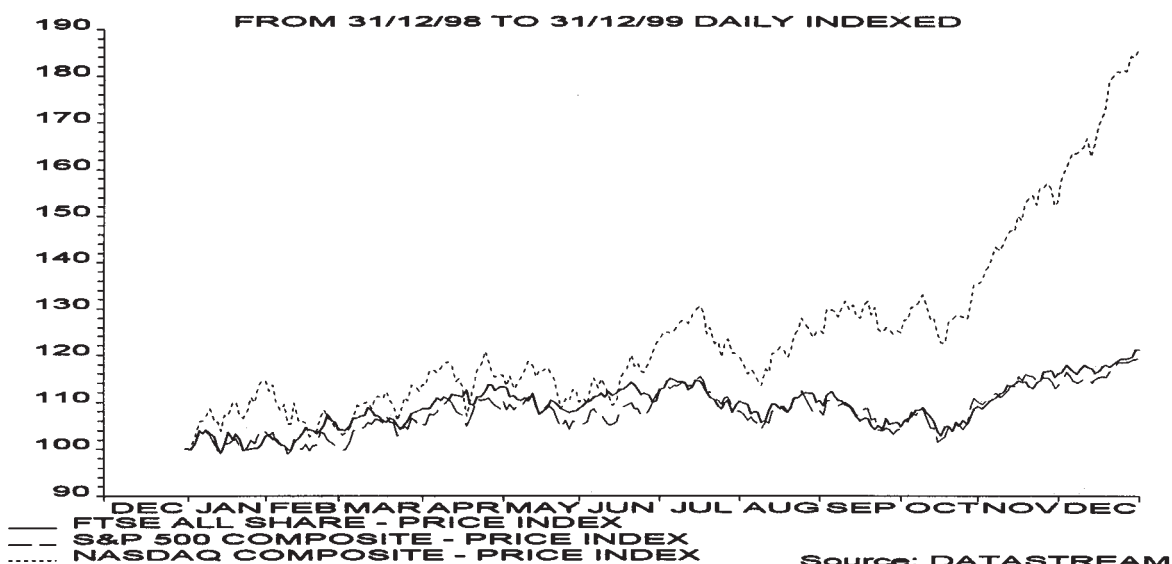
Equity markets have had little breadth this year. That is, much fewer stocks have outperformed the market than have underperformed. In 1999 stocks & sectors which outperformed have tended to be in the high tech growth sectors. This is understandable in a low interest rate environment as these companies are valued discounting future above average growth. The lower the interest rates, the more valuable the future growth.

The other driving force behind the performance of these stocks was the actual growth rates expected. General assumptions about earning growth for the market are around 10%, say. The growth rates assumed for telecoms & Internet related companies can be well in excess of 20%. This significantly above average growth is being rewarded with very high valuations. The effect of this is to polarise the market between the high growth / high valuation stocks and the low growth / low valuation ones.

This is especially true for Internet stocks, where valuations have risen in certain cases to be in multiples of a hundred times sales. This compares with markets as a whole in the range of fifteen to fifty times earnings. Part of this explosion in valuations can be attributed to the exponential

growth in Internet usage, but many of these companies are years away from seeing any profits. Low availability of pure Internet plays which institutions can invest in is certainly also a factor. Arguably these stocks are trading more like commodities and are bought at any price because they are going up!

The graph below shows the strong correlation between the UK FT All Share Index and the US S&P 500, the lower two lines, especially later in the year. The dotted line is NASDAQ, the US High Tech Index, which was probably the most influential index for world markets last year. The strong rise in NASDAQ from mid October onwards is the driving force behind the pick up in both the All Share & S&P, which led to all equity markets having a strong finish to the year.



The increasing importance of high tech stocks in the make up of indices and the global nature of these businesses has led to a general increase in the correlation of all equity markets. In fact the correlation between the S&P 500 and the Japanese broad market index TOPIX, which is traditionally very low, was up at over 70% towards the end of 1999.

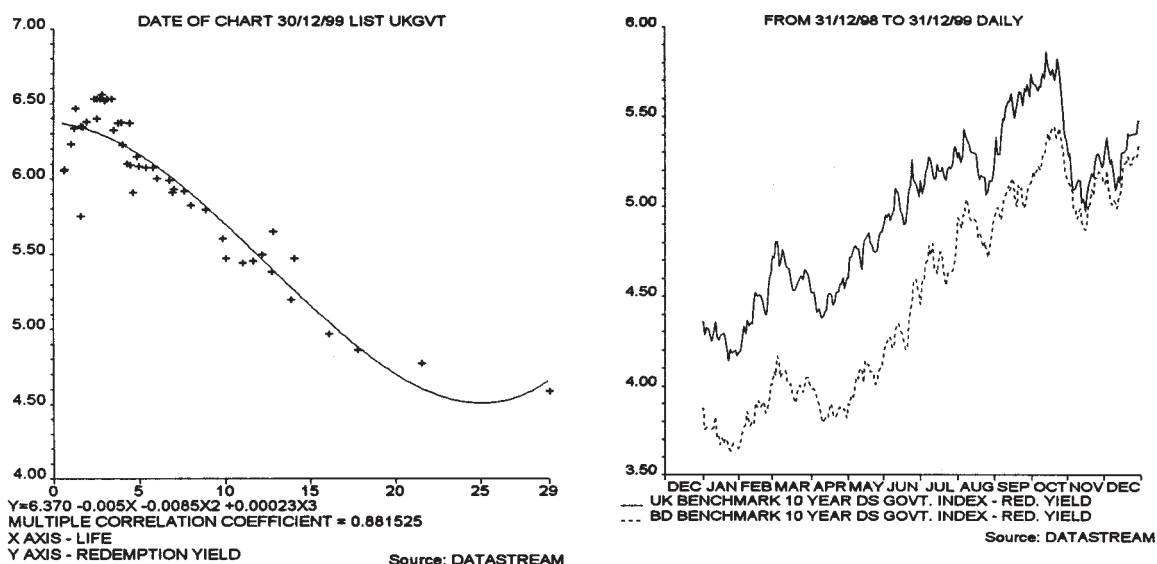
## 2.4 Market Summaries

### 2.4.1 Gilts

After two very strong years sentiment in the gilt market turned negative in 1999. All international bond markets were sluggish and the strengthening domestic economy made any further progress in the market difficult. The performance was hampered by very low levels of liquidity. This reflected the reduced risk tolerance of investment banks (after the LTCM crisis and the general withdrawal of capital from the industry) and the continued strong demand for long gilts against precious little supply. The low level of supply reflected the healthy position of the Government's finances while MFR constraints ensured demand was strong.

The general economic picture was encouraging. GDP looks to be 1.8% for 1999 and forecasts are around 3% for 2000. This is close to Chancellor Brown's initial forecasts which were slated at the time for being overly optimistic. The main concern now is inflation due to the continued tightening of the labour market and strong house price inflation - admittedly centred on London & Edinburgh.

The yield curve remained inverted in 1999, as shown in the left-hand chart below. This reflects the strong demand for long gilts due to MFR and other actuarial constraints. Ignoring the technical position (of demand outstripping supply) the long end of the yield curve is implying that there will be no inflation in the UK economy for the foreseeable future. The short end, by contrast, is suggesting interest rates will have to rise sharply in the short term - presumably to counter higher inflation. This contradiction cannot be explained from a fundamental position. Instead it is the technical factors that are determining the level of yields at both the long and short end of the curve. Ignoring the recent supply & demand problems suggests that long gilts especially are expensive. However the technical situation that has driven the market to this position is still in place and there is no sign of it altering in the short term.



The graph on the right shows the performance of UK gilts versus German bunds. It suggests that there is little upside now for long gilts from the UK's entry into the Euro. Another way to look at it is that the market is already pricing in full entry at some future point. US Treasury Bonds had a disappointing year with concerns over future inflation blackening the fundamental outlook. They were not immune to technical pressures either, as Japanese institutions repatriated significant portions of their T Bond holdings forcing the market lower and the Yen higher.

Index Linked Gilts (ILGs) produced a stronger performance on the year than the conventional gilt market. However they suffered from the same crippling lack of liquidity as strong demand was met with ever reducing issuance. This better performance probably reflects the fact that nothing other than ILGs produces the required exposure to, or protection from, UK inflation. There are alternatives to conventional gilts, such as corporate debt, but no such option for ILGs.

Corporate bonds had a pretty strange year. There was a lot of issuance, taking advantage of the low yields and the large swap spread, but this type of issuance didn't really suit institutional investors. There was no secondary market to speak of as investment banks were loath to use their capital promoting such a market. Any issues that came were priced to go and there was no significant after-market.



Sterling continued to strengthen throughout the year. Manufacturers blamed this on the Monetary Policy Committee (MPC) for being over-zealous in raising rates in the second half of the year. This was cited as attracting foreign money flows into the UK seeking higher nominal returns.

Overall it is unclear whether it was Sterling strength per se or weakness in other currencies, such as the Euro, which accounted for the rise in Sterling. This view is backed up by Sterling being little changed against the US Dollar, and the Dollar weakening significantly against the Japanese Yen.

#### 2.4.2 UK Equity

Another strong performance from UK Equities but as discussed above much of the performance came in the last quarter following the strong rise in NASDAQ. Not surprisingly then the best performing sectors in the market were IT Hardware and Software & Computer Services, up 741% & 158% respectively. Other strong performers were Telecoms (+73%) and Media & Photography (+68%) as investors looked for the next stage beneficiaries from the e-commerce boom. Steel and Mining sectors were also up over 100% because of the rise in commodity prices and the merger of British Steel with Royal Hoogovens of Holland. The major laggards were Water, Tobacco & Electricity - traditionally very defensive sectors.

In common with most equity markets the first half of the year saw buoyant performance as interest rates fell. Inflation remained subdued and growth picked up, but most parts of the economy had little in the way of pricing power. The retail sector was a prime example where, although retail sales were rising by volume, there was no corresponding increase in value. This manifested itself in one of the biggest blue chip retail stocks, Marks & Spencer, having a series of profits-warnings and ending the year the subject of take-over speculation.

M&A was another strong feature of the market, Vodafone/Airtouch, Astra/Zeneca, BTR/Siebe & Wall-Mart/ASDA were the main deals but there was also an increase in the number of smaller transactions. The technical position remained positive with share buy-backs continuing but little in the way of new issuance.

As the market approached the end of the millennium it was expected that volumes would dry up as institutions closed their books earlier than usual due to concerns about the millennium bug. In fact volumes continued to be strong throughout December, mainly put down to private investors chasing Internet stocks.





The chart opposite shows the performance over two years of the FTSE 100, Mid 250 & Small Cap indices. Large cap stocks outperformed strongly in 1998, but during 1999 gave up all of that out-performance as mid and small cap stocks rebounded.

This shows that the market broadened from the polarised position at the end of 1998. Also the pick up in the outlook for the global economy helped the smaller stocks which are generally more cyclical. It also reflects the fact that many Internet companies started the year as small cap stocks.

### 2.4.3 US Equity

Another year of strong growth in the economy, a tight labour market but no inflation. The high tech NASDAQ index produced the best performance with Internet related stocks reaching extremely high valuations. The retail investor in the US is still a strong player in the market especially through their 401k retirement savings schemes. They appear very well trained and treat any setback in the market as a buying opportunity.

The economy continues to produce strong growth and is now well into its ninth year of expansion. There is still no real sign of inflation feeding into the system and the Federal Reserve Chairman Alan Greenspan looks to have done a very good job. He took US rates down by 0.75% at the end of 1998 to avert a potential global credit crunch after Russian loan defaults and the collapse of LTCM. This was given back by the end of 1999 as growth continued above trend. Much of this is put down to productivity gains.

There is concern that the US equity market is in the throes of a speculative bubble that could burst at any moment. The Trade Deficit reached record levels (over 4% of GDP) and this could be exacerbated by the weakening dollar. However a weak dollar would make US exports more attractive and this may help to redress the deficit. The major concern is the savings rate which is at an all time low. The fear is that American consumers are using stockmarket gains to fund purchases. A significant correction in the market could lead to a rush for the exit, as investors seek to liquidate holdings to capitalise any remaining profits.

### 2.4.4 European Equity

Another good year for European equities although they struggled in the first half of the year. They got off to a rip-roaring start with great enthusiasm for the new currency. However this led to a squeeze in the big index stocks which was unwound almost as quickly as it started. In fact the introduction of the Euro has been largely uneventful and the currency has turned out to be rather weak. Over the year the best performing markets were Scandinavia and Greece with France and Germany also posting good gains. Belgium & Ireland were the weakest markets.

European economies were weak with manufacturing confidence extremely low. In contrast the consumer was very confident. Interest rates are low, the new European Central Bank inherited 3% rates from the Bundesbank and took them down by 50bp in the first half of the year after the

resignation of the German Finance Minister Oscar Lafontaine. Wage demands are strong and unemployment is falling, although it is still relatively high (10% in Euroland against 4% in the UK). Restructuring is a major theme in Europe as major economies like Germany are still held back by large amounts of cross-shareholdings. There was a pickup in M&A activity in 1999 and an increasing number of hostile take-over bids launched. By buying UK mobile operator Orange, German company Mannesmann opened themselves up to a hostile bid from Vodafone/Airtouch. This is the first time a major German company has been the subject of a hostile bid from a foreign company and if Vodafone is successful it could open the floodgates for other foreigners looking to acquire German assets.

#### **2.4.5 Japanese Equity**

Japanese equities produced their best performance for over ten years as the economy showed signs of eventually recovering. The Bank of Japan's zero-interest rate policy was about as helpful as it could get and the government's pump-priming of the economy also helped GDP into positive territory. Restructuring was also a key theme throughout the year with the most significant happening in the Banking sector where just about every major bank announced its merger with another one.

The main driver for the equity market was buying from foreign investors. From a global view Japan looked an interesting play as it appeared to be going into a recovery phase when western economies were looking to peak. In fact western economies carried on growing but the strong flow of international funds into Japan pushed the market forward. There were also signs that the domestic retail investor was becoming more active, after many years on the sidelines.

Like most other markets it was the high tech sectors that benefited the most, with telecoms especially strong. Mobile phones in Japan have a very high penetration rate and the latest models also give Internet access. Although Japan is two or three years behind the US in Internet usage it was a strong theme for the market and the few companies with exposure to it had very strong performance.

The inflow of funds into Japan was also partly responsible for the strength of the currency. Another major factor was the restructuring of corporate Japan. The labour laws in Japan make it very difficult to reduce the workforce other than by natural wastage, however much faster results can be obtained by closing overseas subsidiaries. This repatriation of assets from overseas helped drive the Yen higher.

#### **2.4.6 Pacific Smaller Markets**

Concern about a devaluation in the Chinese Renminbi surfaced at the start of the year. However as talks about China's entry into the World Trade Organisation got under way the perceived risks diminished. The pick-up in global demand forecasts combined with the strength of the Yen against the Dollar boosted the outlook for Asian exports. Corporate earnings growth was revised up strongly to 70% for 1999 & 20% for 2000. A strong inflow of funds from foreign investors, keen to benefit from this growth pushed the markets on.

Asia is a region with few natural resources, except Australia which is mineral rich and there is some oil & gas in Indonesia. It does however manufacture a significant portion of the world's products. During the Asian crisis inventories of raw materials were run down to very low levels. When activity picked up there was a great deal more demand for these raw materials. For many commodities, such as metals, there is a long lead time required to bring additional production on line, as it generally involves the reopening of moth-balled mines. So any increase to demand

cannot quickly be met by a corresponding increase to supply. For this reason the recovery in Asian economies was a major driver behind the higher commodity prices.

Rising rates in the US forced markets lower as the HK\$ & Renminbi pegs with the US Dollar transmit US monetary policy directly to Asia. However the last quarter rally, led by NASDAQ, countered the effect of this and pushed markets on to a strong close on the year.

#### **2.4.7 Latin America**

A bad start to the year for the region as Brazil devalued in mid January. Familiar concerns surfaced across the whole region with the fear of a contagion effect. Weak metal prices also hampered the market's progress as this is a major factor in most of the countries' economies. However Venezuela did benefit from higher oil prices. Mexico was the least affected market due to its high export ratio to the US where demand continued unabated. 80% of Mexico's exports head north of the border and it is now the US's second largest source of imports.

The pick up in global demand and the bottoming of commodity prices helped the region, however concern about tightening in the US limited these gains. Also a heavier than usual round of political machinations, culminating in a new government in Argentina, added uncertainty to the region. For these reasons foreign investors were not overly enthusiastic about the region and the lack of fund flow held the market back, until the final quarter. There was then a mad rush to get exposure to the region as it was expected to be a big beneficiary of rising commodity prices.

#### **2.4.8 Property**

Property had a pretty steady year. The fundamentals improved with lower interest rates encouraging private investors into the market. The continued raising of Stamp Duty in the budget was unwelcome, although not unexpected. There was a general increase in interest in property as an asset class and many institutions increased their weightings in this area. Overall activity was quiet, however, as investors were selective in their purchases. Off-market transactions and active management of existing properties were favoured.

The office market was strong as development activity remained subdued and tenant demand was robust. The low level of speculative development kept the supply/demand balance in check. This produced good growth in both rental and capital values. In London, City properties were relatively weak but Suburban London offices did particularly well. Also Scotland benefited from the 'Parliament Effect' although there was no discernible increase in tenant demand.

Retailers experienced a mixed year but there was sufficient demand from the successful outlets to keep the market in retail properties firm. Interest moved from prime retail sites to high quality secondary properties. Retail parks appear to have lost their number one ranking in this sector as there was precious little activity in the sub-sector. This may of course just reflect that there was no available stock to acquire.

The UK's industrial economy showed signs of slow growth, but the strength of Sterling was still a major concern. In contrast the market for industrial properties was very strong, with London industrials benefiting most. In particular capital growth was stronger than in the retail or office sector. This reflected the desire of institutional property investors to get exposure to this sector because it is expected to be a big beneficiary of e-commerce. The demand for warehousing space and distribution outlets is expected to be strong from on-line operations.

## 2.5 Market Data

### 2.5.1 Equities

Country	Local Currency Capital Change	Sterling Capital Change	Sterling Total Return
UK	17.1	17.1	20.0
USA	19.2	23.0	24.5
Japan	55.0	76.4	77.8
Germany	30.3	14.8	16.5
France	51.2	33.2	35.9
Hong Kong, China	52.9	57.3	62.4
Australia	10.5	21.6	25.8
Brazil	140.4	67.2	72.9

Region	Local Currency Capital Change	Sterling Capital Change	Sterling Total Return
North America	19.7	23.8	25.4
Europe	27.2	17.6	19.9
Europe x UK	32.8	17.8	19.9
Pacific	49.9	68.8	70.8
Pacific x Japan	32.2	40.5	44.8
Latin America	55.5	59.7	58.0

All indices FTSE World Index Series except Latin America which is MSCI US\$ EMF L.A..

### 2.5.2 Bonds

Country	Local Currency Total Return	Sterling Total Return	Yield
UK	-1.27	-1.27	5.48
USA	-2.58	-0.05	6.36
Japan	5.20	19.97	1.64
Germany	-2.13	-13.47	5.35

All indices Bloomberg/EFFAS Government Bond Indices, Maturities > 1 year. Yields are 10 year Benchmark, local market standards taken from the FT.

### 2.5.3 Property

Sector	Growth in Capital Values	Rental Growth	Total Return
Office	6.50	5.93	14.92
Retail	6.11	5.35	13.04
Industrial	8.65	4.60	17.97

Source - IPD Monthly Monitor.

## **3 STAKEHOLDER PENSIONS**

### **3.1 Introduction**

The introduction of Stakeholder pensions which is due to be completed in April 2001, started in December 1998 when the Department of Social Security (DSS) presented “A new contract in welfare: A PARTNERSHIP IN PENSIONS”. This document outlined:

- The position of pension provision in the UK both now and projected forward to 2025.
- The need to change this model of pension provision, to reduce the burden on the State and to reduce the number of pensioners retiring in poverty.

This initial paper also provided the basic outline for the shape of Stakeholder pensions as listed below:

- A simplified charging structure. Either an annual fund charge or a reduced allocation rate.
- A limit on the permitted level of charges.
- A low minimum level of contributions.
- No penalty on making a Stakeholder pension paid up or on taking a premium holiday.
- No penalty on transferring to another Stakeholder pension.
- A basic minimum level of information.
- Secure governance arrangements.
- Workplace access - employers without a suitable occupational scheme must identify a Stakeholder scheme for employees if they do not already offer an occupational scheme.
- Cost savings achieved by selling via Affinity groups or Trades Unions.
- Contributions limited to the lower of £3,600 pa or 100% of the member's earnings.
- The member can continue contributions for 5 years after they stop working.
- Only one pension can be paid into at any time.

The outline details of this DSS paper were then followed up by a set of six consultation briefs. For those who are interested, an outline of these consultation documents is given in Appendix A.

The final Stakeholder proposals have still to be issued. It is certain that they will require providers to reduce expenses significantly to match the required level of charges. We now consider briefly why the Government felt obliged to introduce this legislation.

### **3.2 Existing problems**

#### **3.2.1 Growing burden of pension provision on the State**

Due to demographic changes in the UK (and the rest of the Western world) the number of people over the State pension age is expected to increase by over one third by the middle of the next century. This increase is partly driven by improvements in mortality and partly due to the “baby boomers” (people born between 1945 and the end of the 60s) retiring. As a result, the ratio of workers to retirees will fall from 3.4 to 1 down to 2.5 to 1. With no alternative strategy, this change will lead to an increasing tax burden on those that still in work since Britain uses a pay as you go funding method.

### **3.2.2 Falling value of State pension provision**

To offset the rising cost of state pension provision, successive Governments have reduced the value of both SERPS and the basic state pension. This has been achieved by linking State pensions to the Retail Price Index (RPI) not National Average Earnings (NAE). It is also due to a deliberate reduction in the rate of SERPS accrual. Consequently, by 2025, half of those people retiring will rely on means tested benefits in their retirement, once again increasing the tax burden on the State.

### **3.2.3 Changing pattern of employment**

The Government claims that fewer people enter work expecting to remain with only one or two employers for life. The resulting increase in work force mobility will make the less flexible Defined Benefit (e.g. Final Salary) pension schemes less attractive for employees since they “lose out” by moving. It would also make defined contribution schemes with high penalties on early exit inappropriate as these penalties would erode an individual’s pension savings. (Actuaries will note that if there is a high turn over of pension scheme membership these penalties are very relevant for the provider!).

## **3.3 The Government’s intentions with Stakeholder**

The groups targeted for Stakeholder pensions include:

- Those earning between £9,000 and £18,500 pa.
- Part time and low paid workers who will vary contributions and take premium holidays as their circumstances allow.
- Carers and disabled who currently have no pension provision.

Stakeholder pensions are intended to provide a low cost, flexible pension package that would appeal to this target group who currently have little or no private pension provision.

The Government hopes that introducing cheaper and more flexible pensions through Stakeholder pensions will encourage people to save for their retirement. This will:

- Save the Government the future cost of pension provision as these people retire.
- Avoid the potentially unpopular option of making pension saving compulsory.

To further encourage the take up of pension provision, the Government has:

- Made it compulsory for employers to “point their employees towards” at least one Stakeholder pension if they do not provide a suitable current pension scheme.
- Encouraged Trades Unions and other affinity groups to provide Stakeholder pensions for their members.
- Capped charges.
- Forbidden any penalties for stopping contributions or switching to a new scheme.

However there may be several weaknesses in this view:

- Pensions have traditionally been sold and not bought. This distinction is an important one. People will buy investment products such as PEPs and now ISAs. They do so for the perceived tax advantages and because they will have access to the money if it is required. However, with a pension, the money is tied up until retirement, and this long time frame and corresponding lack of flexibility is a major reason why pension benefits have needed to be sold.
- For low paid individuals, taking out a Stakeholder pension may not be the best advice. There are means tested benefits, and the new second State Pension, which will be paid to persons with insufficient income on retirement. As a result, a low earner needs to save in the region of £40,000 to £70,000, in today's money, to ensure the pension will exceed the state benefits currently available. The difficulty is that personal income replaces State benefits on a 1 for 1 basis, so if the person's pension does not exceed the means tested level, they have effectively given these savings to the Government for absolutely no benefit to themselves.
- Many companies have considered it uneconomic to sell Stakeholder pensions to individuals. Instead they have targeted the group Stakeholder market. Most recently, the Prudential announced that it would not sell Stakeholder pensions via its direct sales force. This will make it difficult for the Government to achieve its targets for ensuring adequate pension provision for the self-employed.
- During the transition period, there has been a well-documented period of "planning blight". This describes people's delay in taking out any form of pension provision until Stakeholder pensions are introduced. It follows on from uncertainty over the final form for Stakeholder pensions and people delaying pension provision until April 2001. This could have a major impact on the expected value of the individual's pension fund on retirement. For a person with 10 years to retirement delaying pension savings by two years could reduce the pension saved by around 30%.

However, the Government is committed to the introduction of Stakeholder pensions by April 2001, and a few companies have started to offer "Stakeholder compliant contracts". Other companies have modified existing contracts to try and avoid the planning blight issue. Overall both the Government and the Insurance industry are anticipating major changes in the way pensions are sold, but nobody yet knows if this will be a success and how much it will cost the insurance industry.

### **3.4 The possible impact of Stakeholder pensions on the Insurance Industry**

There are various models that have been looked at to try and anticipate how the introduction of Stakeholder pensions will affect the UK Financial services market. The two main models are:

- The American model. This is the "401K market".
- The Australian model which has compulsory pension contributions.

These will be considered in turn, but we look first at the potential changes in both expenses and financial risks that Stakeholder will force onto pension providers in the UK.



### **3.4.1 Impact of Stakeholder on the level of a pension provider's expenses**

A useful starting point is the “Annual Charge Equivalent” (ACE). This represents the fund charge which on its own, would give an insurance company the same total charges over the lifetime of the contract as its existing mix of charges. The calculation of the ACE allows for the actual withdrawal experience of the insurance company, so a company with high withdrawals and high surrender penalties will have a higher Annual Charge Equivalent than a company with the same charges but low withdrawal rates (because the company is taking money out using high TV penalties on early exit). The increased ACE with high rates of withdrawal is consistent with the pension industry having high distribution costs that need to be recovered if a contract leaves early.

Pre-Stakeholder, the lowest ACE for personal pension contracts was Equitable Life with 0.9%. The Industry average was 2.5%, and some Direct Sales companies had ACEs as high as 5%. Since Stakeholder pension charges are currently capped at 1%, this means the overall industry wide charges will need to be more than halved. A consequence is that there will need to be total expense savings of roughly 50% for Stakeholder pensions to be viable.

### **3.4.2 Methods of reducing initial expenses**

Typically half of a pension provider's existing expenses (more if commission is paid) are the cost of selling the policy. Under Stakeholder these expenses will need to be reduced by:

- Selling via the Internet or other vehicles with no commission and little or no advice.
- Selling to group schemes with less individual advice provided. (The Government have proposed “decision trees” and a simplified fact find to help this process.)
- Selling via fee-based IFAs. This simply changes the charge for advice from being implicit in the charges of the contract to one that is explicitly paid by the scheme sponsor.

This is likely to have a significant impact on the IFA market. Smaller IFA's who have traditionally relied on high up front initial commission to provide adequate cashflows will not be able to get this from the proposed Stakeholder charges. This may lead to the pensions market being dominated by large fee charging benefit consultants. If this happens, the small/medium employers who are typical stakeholder targets may find it difficult to get advice.

### **3.4.3 Methods of reducing renewal expenses**

Once again technology will be required to drive down renewal costs.

- All electronic transactions. Use of the Internet to get electronic processing is seen as a major area to explore.
- Reduced flexibility, since this is often a cause for costly manual intervention.

It is expected that using the Internet to automatically answer any member's queries, allow members to change their contributions, switch their funds, investigate the level of their funds and do retirement benefit projections will reduce costs (currently these queries come via an IFA, then go back via the IFA). It is also hoped that this will provide a better service. This has been the case in the US, where this type of access to their pension details has given members a greater sense of control and ownership over their retirement funds.



### **3.5 Financial risks of Stakeholder pensions**

#### **3.5.1 Expense overrun.**

The most obvious risk is for an office's expenses to exceed the reduced level of Stakeholder charges. Many companies will write Stakeholder business short term in the belief they will be able to get their expenses down to the required levels. If they fail in this, the business they have written will represent a financial loss. This is a clear risk since nobody can predict the effect of different untried technologies at present. Companies still have back end manual systems that need to be replaced by fully automatic systems.

#### **3.5.2 Erosion of the Insurer's free assets**

At present, Stakeholder pensions are restricted to a flat 1% fund charge. A fund charge is the most back end charge possible, in other words it takes the longest time to get charges coming out of a contract.

A consequence of this is that the total amount of capital needed to write a block of business with a flat fund charge may be twice as large as the amount of capital needed to write the same business with the charges split between a level reduction in the allocation rate and a fund charge.

#### **3.5.3 Risk of withdrawals from schemes and/or the entry of new providers into the market**

Typically it may take 20 years to break even on Stakeholder policies and any profit will only be made in the last two or three years of this policy being in force. If the average term falls this final charge is never received and a loss arises. Equally, if withdrawals are higher than expected then these charges are not received and a loss is made on the business written.

This risk from higher withdrawals is distinct from the risk of mass scheme lapses. By offering a contract with a flat percentage fund charge, the initial provider increases the risk of new entrants to the market in 5 to 10 years "stealing" Stakeholder business. The new entrant is able to do this since, after 5 years, sufficient funds will have built up for a lower fund charge to generate high enough revenue to cover the renewal and other expenses.

New entrants could include the large US Mutual Funds who have effectively dominated the US 401K pensions market. If existing providers had to cut their charges to avoid this, they would effectively capitalise a loss on the business already written.

An analogy would be a car dealer offering to sell a car with no profit at the moment of sale, instead relying on higher servicing fees in the future. The car owner will simply use a different garage in the future and no recovery of costs will be made.

It should be noted that the risk of mass switching is more significant in the group scheme area of the market when an entire scheme could be persuaded to switch provider. This high risk area is the area that many insurers have targeted since it offers the best opportunity of getting the distribution costs down to the levels required by the Stakeholder charges.

### **3.6 The American experience - the 401(K) market**

The 401(K) market has dominated the US pension industry over the last decade. The weight of money invested in US mutual funds (broadly equivalent to Unit Trusts in the UK) through the 401(K) has been considered one of the main drivers behind the spectacular and sustained growth in the US stockmarket.

At the start of 1999, over \$1000 billion was invested in 401(K) pension plans. This rise has happened from a standing start in 1978 when section 401(K) was added to the US internal revenue code. The British Government are hoping that the introduction of Stakeholder pensions will trigger the same increase in retirement savings in the UK. To decide if this is the case, we first look at the 401(K).

### **3.6.1 What is a 401(K)?**

- It is a defined contribution pension plan.
- It is set up by an employer for their employees. (Similar schemes are available for the self employed.)
- Contributions are made before tax, reducing taxable income
- Employers may match a proportion of employee contributions
- Employee contributions can only be made through payroll deduction. Thus no lump sum contributions are possible.
- The contribution limit is \$10,000 and matching employer contributions are not included in this limit.
- Hardship withdrawals. The money invested is only available after age 59 1/2. A 10% penalty may apply if money is taken out early - except under various circumstances - Disability, medical expenses, early retirement after age 55 etc.
- Loan facility. Up to 50% of the fund may be taken out as a loan. Loans are allowed legally, but restrictions may be placed on the loan facility by the 401(K) sponsoring employer.
- There is no requirement to purchase an annuity.

Key factors which have helped the 401(K) become successful are:

- Fear about the future of US social security, combined with a culture that encourages employees to look after themselves.
- An extended bull market that has encouraged entry into equity savings.
- A simple tax advantaged product.
- Money is not locked in once it is invested in a pensions wrapper. There is access under conditions of hardship, a loan back is possible and there is no compulsory purchase of an annuity.

Relative to the current Stakeholder proposals, the 401(K) has greater flexibility and access to money at times of need. There are also fewer alternative tax efficient investments available. It should be noted that this lack of access to money saved in a pension fund is sometimes viewed as a significant stumbling block to persuading people to take out a pension in the UK.

In addition, in the US there is no underpinning second-tier pension as introduced in the UK. Therefore in the US a person saving for retirement will almost certainly be better off.

### **3.6.2 Would the 401(K) have achieved the UK Government's intentions for Stakeholder?**

Despite its tremendous success, the 401(K) would have failed in several of its key objectives had it been introduced in the UK by the current Government.

- Market penetration.

While 93% of companies with over 5000 employees offer a 401(K) scheme to their employees, this falls to 34% for companies with 100-500 employees. For companies with less than 50 employees, only 11% offer access to a 401(K) scheme.

- Employee participation.

On average only 70% of employees enter a 401(K) scheme offered by their employers.

This poor market penetration in smaller firms (targeted by Stakeholder as they do not offer occupational pensions at the moment) indicates there may be a similar problem for the Stakeholder market. The Government hopes to address this by requiring employers to “point to” a Stakeholder scheme, but already companies with 5 or less employees are excluded (to be reviewed).

### **3.6.3 Lessons from the 401(K) market.**

These lessons are critical for UK insurers wishing to offer Stakeholder pensions.

- Expense savings using technology

US providers have focused on the Internet to reduce both initial expenses and ongoing administration expenses.

Internet sites offer advice on how 401(K) schemes work. They offer on-line illustrations, and the on-line ability for employees to change their contributions, investment choices etc. This reduces the need for any keying or manual processing by the provider. It also encourages people to take out 401(K) schemes since they perceive greater ownership and better service.

- Unbundling of services.

Traditionally, in the US and in the UK, insurers have packaged products to combine marketing, sales, and asset management. However, with the need to reduce costs under Stakeholder, it is possible that these functions will be split between different specialist providers to achieve cost savings.

This unbundling has happened in the US within the 401(K) market. The 401(K) market is dominated through investment in the large mutual fund managers. The US insurers have been the major losers in this change in the marketplace.

### **3.6.4 Are there comparisons between 401(K)'s and the Treasury's Pooled Pension Investment?**

The Treasury introduced the concept of a “Pooled Pension Investment” (PPI) at the start of 1999. The PPI is a pension fund wrapper that provides all the tax benefits of a pension fund investment. Unlike existing Authorised Funds, the PPI can be moved seamlessly between different pensions regimes, i.e. between occupational pensions, personal pensions, and now Stakeholder pensions.

Initially the PPI was compared to the 401(K) as a portable pensions wrapper. However the few details that have emerged show that this is not the case. The PPI is not a product in its own right, it is simply a wrapper that can shelter pension funds within an actual pension product.

### **3.7 The Australian experience - compulsory pension savings**

This is the option the UK Government chose not to adopt. They would rather encourage people to save for retirement than enforce savings.

The Australian pensions market has changed steadily since 1983, driven by frequently changing legislation.

The first step towards a Stakeholder type of situation came in 1985 when the Australian Unions agreed a 3% superannuation contribution rather than a 4% pay rise. This pension contribution was paid directly by all union employees into “Industry Funds”. However experience showed saving for retirement was still not wide enough and with little additional savings on top of the 3%, the amounts invested in the Industry Funds were too low to give an adequate retirement fund.

Thus in 1992, a compulsory contribution, starting at 3% rising to 9% by 2002 was introduced for all workers earning above a low threshold.

Some lessons from Australia might be:

- There may be a need for compulsion. Even after a low cost scheme with a 3% initial contribution to get then started, people did not voluntarily save enough for retirement.
- Insurers offered loss leaders on administration to try and secure the profitable investment mandate. However these companies often lost the investment mandate to Industry Funds and were left with loss making administration.
- Difficulties were seen to arise in running multi-employer schemes, in particular premium collection and reconciliation.
- Industry Funds were initially set up to serve a particular Union or work force. However the largest have typically allowed any employer or self employed person to join. These large Industry Funds have managed to negotiate cheaper administration. They have also proved a major competitor to established life offices.
- There will be some unbundling of administration. Two administrators dominate the Industry Fund market. Both began as life offices.

### **3.8 The way forward for Stakeholder in the UK**

There is little doubt that Stakeholder pensions will be introduced in April 2001. The effect that this will have on the pensions industry is still uncertain. When the final details about Stakeholder are known, some of these uncertainties will reduce and possibly disappear.

At present it is very much in the government’s interest to make Stakeholder work (or appear to work!). The insurance companies will go along with this as long as they can see a potential profit. There are various scenarios that could emerge, affecting both the distribution channels and the shape of the providers’ market place.

#### **3.8.1 Distribution**

Sales and distribution costs need to fall. Offering lower levels of initial commission on Stakeholder pensions may well force smaller IFAs away from the pensions market. This would leave the pensions market dominated by larger fee charging benefit consultants. This would give Stakeholder coverage to employees, since their employers would need to point towards a Stakeholder scheme and offer payroll deduction facilities to this scheme. However large benefit

consultants may choose not to deal with smaller employers, leaving their employees and the self employer without adequate advice.

For self-employed people, carers and others not covered by employer schemes, the Benefit consultants might reach them using affinity group Stakeholders. Alternatively, these individuals could find out about and take out Stakeholder pensions via the Internet. Depending on the disclosure and advice requirements, this might be achieved through a direct sales mail shot campaign as seen for simpler investment products and also through use of tele sales using a callcentre.

### **3.8.2 Providers**

Providers will need to cut costs dramatically using new technology. They will also need to retrain scheme sponsors to use this technology. To achieve cost reductions, there may be a significant unbundling of the market to specialist fund managers, distributors and administrators.

If the required cost savings are not possible this way there may be a prolonged price war to achieve dominant market share. Providers would sell a loss making contract to generate market share and force other providers out of the market. If there were only four or five providers left, they may have enough Stakeholder funds under management to recover the losses incurred previously. In addition the sensitivity to withdrawals would reduce since the funds would simply move between these providers.

This would radically affect the shape of the current market and force many existing insurers into other markets or to merge with the dominant survivors. It would also leave the surviving insurers in a weakened financial state, as they would have invested large amounts of capital into this bid to outlast their rivals. There is a clear risk in this route of overseas insurers entering the market after such a period to “poach” mature funds that have built up at a lower fund charge.

Overall there is too much uncertainty to know which way the Stakeholder market will emerge. It will be fascinating to see this happen over the next few years, and it is likely to be of keen interest in future current topics papers.

## **3.9 Appendix A - The consultation process**

### **3.9.1 Paper 1 - Minimum Standards**

This paper specifies the maximum charges that can be made on a Stakeholder contract. It came out on 2nd June 1999.

- A maximum charge of 1% of the fund can be made.
- This must cover “all normal operating costs”.
- The minimum contribution is £10 for regular or single contributions. (Now raised to £20 in a later briefing.)
- There is no minimum frequency at which contributions are made.
- There can be no extra charges made for transfers out of a Stakeholder pension scheme.

### **3.9.2 Paper 2 - Employer access**

This paper specifies the level of employee access that must be provided to a Stakeholder scheme. It came out on 29th June 1999.

- An employer must “point to” a designated Stakeholder pension scheme if other adequate pension arrangements are not in place. (There is now a five-year exemption for employers with 5 or fewer employees.)
- Payroll deduction by the employer would only be required to the designated Stakeholder scheme.
- An occupational scheme exempts the employer from a need to provide access to a Stakeholder scheme provided the waiting period to join the scheme is less than 6 months.
- Employers with a Group Personal Pension (GPP) scheme would be exempt provided the GPP meets certain requirements. These requirements are to be more fully specified at a later date.

### **3.9.3 Paper 3 - Clearing house arrangements**

This paper covers the possible mechanism by which payments could be made from the employer to the Stakeholder pension providers. It came out on 12th July 1999.

- Do not have any clearing house arrangement. In this case, payments would be made from the employer directly to a single nominated Stakeholder scheme.
- Develop a new dedicated clearing house for Stakeholder pensions payments.
- Use current clearing house arrangements such as BACS to provide the payment from the employer to the nominated scheme. In this case small firms with no experience would need to develop the needed payroll deduction facilities.

### **3.9.4 Paper 4 - Regulation, Advice and Information**

Along with the first paper on the maximum charges allowed under Stakeholder pensions, this is the most controversial paper. The reason is that the issue of advice is inevitably linked to costs. Under Stakeholder, costs must be kept to a minimum and there is little room for any tailored advice. This came out on 2nd August 1999.

- Regulation of the scheme will be carried out by OPRA
- Regulation of both advice and sales will be by the FSA.
- Information must be provided to prospective members including Key Features, “generic advice” about the scheme suitability to different groups of people and an indication of the need for further advice.
- Decision trees might be used to reduce the cost of advice.
- Separate charges for advice should not undermine the transparency of the Stakeholder costs.
- Employers designating a Stakeholder scheme will not be “introducers”. This means they are not responsible under the FSA rules for giving advice.

### **3.9.5 Paper 5 - Governance**

This paper considers the possible governance arrangements for a Stakeholder pension.

It came out on 2nd August 1999.

- A Trust - based scheme. This is the system used for “occupational pension schemes” at the moment. Scheme trustees are appointed to look after the interest of a scheme’s members. This could be expensive for very small schemes, and would need to be met from the 1% fund charge. It might be suitable for affinity group or employer sponsored schemes.
- “Secure Stakeholder Management”. This would apply when a Stakeholder scheme is set up by a Financial Services company. A “Stakeholder pension manager” will be appointed to look after the interests of the scheme’s members. The manager then assumes a number of the responsibilities that would otherwise fall on scheme trustees.

### **3.9.6 Paper 6 - The Tax Regime**

This simplified the original proposals significantly. A major aim was to reduce the level of advice that would otherwise have been required just to go over the different tax regimes for Occupational pensions, personal pensions and Stakeholder pensions. The paper came out on 16th September 1999.

- Concurrent membership of several defined contribution (DC) schemes is allowed provided the overall contribution limit is not exceeded. This includes all contributions from the employer and the individual. It does not include the contracting out rebate.
- Contributions to DC schemes can be the higher of £3,600 or the current personal pension limits. This ensures Stakeholder pensions will affect all areas of the pensions market.
- All contributions to DC schemes will be paid net of basic rate tax.
- Carry forward / carry back will be removed. This was a system where a person could look back 7 years to check if they had made their permitted level of pension contributions in these years. If not they could make up for that in the current tax year. They could then choose if this counted for this year or the previous year’s tax relief.
- Occupational money purchase schemes can opt into this new DC regime as a one off decision.
- There is no lower age for starting contributions to a pension.

Further comments were invited from the Insurance industry on:

- The ability of a member of a defined benefit scheme to pay in a Stakeholder pension. This would remove the need for AVCs.
- How to treat “rider benefits” such as life assurance under this new regime, in that before there was an obvious link to earnings.

### **3.10 Bibliography**

- Current Topics paper 1999
- Press cuttings
- FSA press releases
- A new contract in welfare: a partnership in pensions - DSS



## **4 PENSIONS**

### **4.1 MFR Review**

The Pensions Board was asked by the government at the beginning of 1999 to undertake a fundamental review of MFR. The aim of the review is not to suggest minor amendments to regulations but to undertake a complete review. This means that a range of solutions will be considered, from investigating ways of improving the present MFR regime to major change such as a central discontinuance fund.

A number of working parties have been set up, each one of which is looking at a particular solution. The working parties cover:

- modification of status quo - as a benchmark for testing other solutions
- solvency test based on risk-free assumptions
- modification of the previous case to allow for expected equity returns
- solvency test based on prospective benefits on an ongoing valuation basis
- central discontinuance fund
- solvency insurance to guarantee certain benefit levels on winding-up
- legal issues on winding-up

#### **4.1.1 Central discontinuance fund**

One of the most important of the above is the central discontinuance fund. A central discontinuance fund would take over the assets and liabilities of defined benefit schemes winding up where the sponsoring employer had gone out of business and could therefore provide no further support.

A paper on this was presented in October 1999 by the relevant working party. The paper concludes that “a system which avoids cross-subsidies is to be preferred.... Employers should stand behind the promises made to members while they are solvent and should not look to either the government or other employers to bail them out should they become insolvent.” In most cases a central discontinuance fund would need to rely on levies, either from other employers operating defined benefit schemes or from the Government.

#### **4.1.2 Factors affecting the MFR review**

Important factors affecting the MFR review include:

- concerns about the viability of traditional asset valuation techniques used by pensions actuaries, based on discounting future equity dividend income, following the abolition of ACT relief in the 1997 budget, and the increase in share buybacks and other forms of rewarding shareholders
- a move towards market value based valuation techniques, in particular for accounting purposes both internationally and in the UK
- strong pressure, from the NAPF in particular but also from other sources, for the replacement of MFR by a long-term funding standard coupled with a central discontinuance fund

The review is expected to report back in March 2000. Following this the DSS will need to



consider the matter and consult widely on any proposed legislative changes. If primary legislation needs to be changed as a result, the earliest date would probably be 2001.

Interestingly, the Faculty and Institute have been asked to keep the findings of the MFR review quiet until it is published in March. The debt management office, which runs the Government's debt, has said that any information given to the market will have an impact on gilt prices if information is leaked early.

## **4.2 Pension misselling review**

### **4.2.1 Phase 1 of personal pension misselling review**

Phase 1 covered the so called 'priority cases'. The latest data shows that 690,000 cases have been reviewed, that 384,000 investors have been offered and have accepted redress, and that the amount accepted has been in excess of £2.6 billion.

### **4.2.2 Phase 2 of personal pension misselling review**

Last year's current topics paper discussed the details of Phase 2 of the review of personal pensions misselling. Phase 2 covers the 'non-priority cases' which did not fall under phase 1:

- those who were aged 35 and under when they opted out of, or did not join, their occupational pension scheme
- men who were under 50 and women who were under 45 when they transferred out of their occupational pension scheme into a personal pension
- those who were aged 30 or over when they bought a rebate-only policy

Under the FSA, a campaign was launched in the media in January 1999, inviting calls from people who thought that they may have been the victim of misselling. The campaign was funded by a direct £10.5 million levy on the industry. Firms also had to mail potential victims with information and an invitation to review. This mailing exercise had to be completed in total by the end of April 1999. A telephone helpline was set up by the FSA between January and May 1999, which took 114,000 calls.

Firms were given until the end of June 2002 to complete the compensation of the estimated 1.03m people caught up in the phase 2 review. The FSA calculated that there were 50% more phase 2 cases than phase 1.

### **4.2.3 FSAVC misselling review**

In October 1998, the FSA identified that there may have been a problem with the sales of some free standing additional voluntary contribution (FSAVC) policies as well as personal pension policies.

In August 1999 the FSA and PIA produced a joint consultation paper setting out proposals for a review of up to 110,000 FSAVCs to check whether misselling had indeed taken place. The regulators estimate that redress could be between £122 million and £241 million.

It is proposed that all firms that have sold FSAVCs should review four particular categories of sale:

- employees whose occupational in-house scheme provided for an employer contribution to match that made by an employee to an in-house AVC

- employees whose occupational scheme provided for an enhanced employer contribution into the in-house AVC or to the main pension scheme (but not to an FSAVC)
- members of the Armed Forces Pension Scheme where any pension top-up can easily lead to over-funding
- certain sales of regular premium pensions to employees in a “waiting period” to join an occupational pension scheme with the intention of converting the personal pension into an FSAVC

The review will cover all FSAVC business sold between 29 April 1988 and 15 August 1999.

The FSA and PIA propose that a direct approach by providers to FSAVC policyholders in the four selected categories should be the most productive approach.

Priority cases, which should be reviewed within six months of being identified, are defined as those where the client has died or has taken benefits under the FSAVC scheme. The proposals expect the review to be finished by November 2000.

### **4.3 New accounting proposals**

In 1999, the Accounting Standard Board (ASB) issued a financial reporting exposure draft (FRED 20) concerning the reporting of pension assets, liabilities and expenses in the employer's financial statements. If approved, FRED 20 will become a financial reporting standard (FRS) and will supersede the current standard SSAP 24.

Whereas SSAP 24 was concerned with the profit and loss account effect of pension provision, FRED 20 looks first to the balance sheet and then uses the profit and loss account to move from year to year. This is consistent with modern accounting theory, and comes from an accounting rather than an actuarial background.

FRED 20 has three key features:

- it places emphasis on market values and market yields at the close of business on the balance sheet date, rather than on longer term averages
- it assesses liabilities by reference to bond yields (on the grounds that such assets are a close match to the liabilities) rather than the expected returns on the assets actually held by schemes
- it shifts the emphasis of reporting from the annual cost to the balance sheet position (treating all pension assets and liabilities as being directly attributable to the sponsoring employer)

In January 2000 the actuarial profession issued a draft response to the proposed introduction of FRED 20.

It is stated that the proposed new standard increases the quality of the information available to shareholders, and should make the calculation and disclosure of pension costs more transparent. It is also agreed that the more objective use of market valuation methodology is more suitable for modern accounting.

However, the profession has also stated a concern that the changes proposed by the FRED may have practical consequences beyond that envisaged by the ASB. SSAP 24 has led to a generally smooth long term reporting of cost, consistent with long term provision of pensions. It appears

that the proposed standard will lead to more volatile expenses and a more volatile balance sheet than present for employers operating defined benefit pension schemes.

The more volatile situation could lead to a change in investment strategy, or even a change in the method of pension provision, with schemes moving from defined benefit to defined contribution in order to stabilise their accounting costs. It is even suggested that the new standard could have an unknown effect on stockmarkets, particularly in the UK.

#### **4.4 Improved flexibility in pension provision**

In 1998 a consultation paper was issued which covered proposed improvements to the flexibility of occupational pension schemes. Three of these proposals were covered in more detail in PSO Update No 54, issued in June 1999.

The first would allow deferral of annuity purchase for approved money purchase schemes and buy-out contracts. During deferral pensions would be paid through income drawdown.

The second improvement would relax the rule that AVCs must be taken at the same time as the main scheme benefits.

The third improvement proposed was that main scheme benefits could be taken at any age from 50 to 75 without the employee needing to retire. However there are ‘problems of interaction with social security law’ which are currently being examined, so nothing concrete on this proposal has yet been issued.

The first and second proposals are discussed below. It is up to each scheme to decide whether to offer these facilities to members.

##### **4.4.1 Deferral of annuity purchase**

Where a scheme chooses to allow this facility, the scheme member or survivor can choose to avail. No further employee contributions would normally be permissible.

The facility may be used by the following types of scheme:

- employers’ insured schemes providing only money purchase benefits
- small self-administered schemes providing only money purchase benefits
- large self-administered schemes providing only money purchase benefits
- money purchase AVC arrangements
- buy-out policies providing money purchase benefits
- FSAVC schemes

###### **4.4.1.1 SSASs**

It is already possible for a SSAS to defer the purchase of an annuity up to age 75. In the meantime a pension can be paid from scheme funds. This new facility adds flexibility as the amount of pension taken can be less than the full amount, as decided by the member or survivor. Each SSAS can choose whether to adopt the new method or continue with the existing one.

###### **4.4.1.2 Method of calculation**

Government Actuary’s Department (GAD) single life tables must be used to calculate the amount of pension payable as drawdown. When pension benefits first become payable, income drawdown may apply to the sum of pension benefits, or an annuity may be purchased with some of the benefits and income drawdown applied to the remainder. Pension benefits should be calculated separately for member and survivor, with the same method applied to each.

The income drawdown amount must be between 35% and 100% of what a full annuity would have been, subject to the overriding Inland Revenue maximum for a member or survivor at any point in time.

Once income drawdown has begun, it may not be stopped, although it can be varied each year within the above-specified range.

#### **4.4.1.3 Three year reviews**

The funds underlying the pension must be reviewed on every third anniversary of the commencement of drawdown for a member or survivor, until the pension is fully secured by annuity purchase. Reviews may take place more frequently at the discretion of the scheme.

#### **4.4.1.4 Buying the annuity**

Once drawdown has begun, the member or survivor may ask the scheme trustees to phase the purchase of annuities to secure part of the overall pension. A full annuity must be bought no later than the member's 75th birthday. For a survivor a full annuity must be bought no later than the date of the deceased member's 75th birthday or the survivor's 75th birthday, whichever is earlier.

#### **4.4.2 Flexible use of AVCs**

Until this year, benefits funded by AVCs had to be taken at the same time as benefits from the main scheme employer / employee contributions. This is no longer the case. AVC benefits may now commence at any time between ages 50 and 75 (or before 50 in the case of incapacity). This is regardless of whether the member has retired or has left pensionable service.

This facility may be used for benefits arising from:

- AVCs paid to the employer's main scheme
- AVCs paid to a separate scheme of the employer
- AVCs in the employer's scheme which were originally paid to secure added years of pensionable service
- FSAVCs

An employee can treat AVC benefits from the employer's main scheme separately from FSAVCs. It is not possible to take separately only a part of the benefits from one source. Membership of an FSAVC covering more than one job counts as different sources.

A member remaining in employment may continue to pay AVC contributions up to the 15% limit even after taking AVC benefits.

Where AVC benefits are being taken before benefits from the employer's main scheme, the AVC benefits must be taken as a pension in the form of income drawdown. Purchase of an annuity or pension commutation is not allowed.

Where AVC benefits are being taken at the same time as benefits from the employer's main scheme, income drawdown or annuity purchase may be used for each part separately.

#### **4.5 Ability to postpone annuity purchase past 75**

Currently, all pension holders are required to have purchased an annuity with their accrued pension fund by the age of 75. There is political pressure to raise the age deadline, or even eliminate it altogether.

This debate results from the continuing scenario of low annuity rates, with no prospect of gilt yields rising in the foreseeable future. A second argument has been posed for raising the age deadline: once a pension fund is swapped for an annuity, money in the fund is lost on death of the policyholder. Investors who have built up significant pension funds resent not being able to pass any savings on to their heirs. The latter argument is unlikely to cause much impact. Tax relief on pension plans is given to encourage people to build up a pot of money to finance a retirement income, rather than to save cash which can be passed on to heirs.

Changing the rules will however do nothing for the majority of retiring people, who are unable to afford income drawdown or phased retirement schemes to draw an income directly from their pension schemes to live on until an annuity is finally purchased.

More people could be affected if the age limit was changed for the new Stakeholder vehicle. An opposition amendment in the House of Lords was passed in October 1999, proposing that the upper age limit for annuity purchase should be abolished for the new Stakeholder pension. This should open up the market for new choices, which could generate higher retirement income than can be had from low-risk gilts.

#### **4.6 Pensions and divorce**

The Welfare Reform and Pensions Bill cleared Parliament in November 1999. The bill gives divorcing couples greater flexibility when dividing up their assets, and will make it easier for them to split any pensions.

Pension 'sharing' is not expected to come into force until the end of 2000 at the earliest. Until then, divorcing couples must continue to use 'offsetting' or 'earmarking' as a means of accounting for pension rights in financial settlements on divorce or judicial separation.

'Offsetting' is where the value of pension rights are offset against other matrimonial property, for example a couple's main residence. The main problem with offsetting is that before 1995 it was often difficult to obtain accurate information about the value of the member spouse's pension.

The 1995 Pensions Act introduced provisions for courts to ' earmark' the member spouse's pension so that payment of some or all of this pension could be made to the non-member spouse on the member's retirement. Earmarking however precludes a clean break between the divorcing couple, as the non-member spouse remains linked to the member spouse until retirement. Furthermore, if the non-member spouse remarries, rights to the pension are forfeited.

The new bill introduces the concept of 'pension credits' and 'pension debits', so that some agreement may be made on the division of the pension following divorce. Effectively both spouses may become members of the scheme. The former non-member can then choose to leave the deferred pension in the scheme or transfer it to another occupational or personal pension scheme. Where this spouse has no existing pension arrangements, or where the original scheme is unfunded (for instance, a public-sector scheme) benefits must be left in the original scheme.

The pension is valued on the 'cash equivalent transfer value' (CETV) basis, as though the member were leaving the scheme at the time of the divorce. The CETV method does not take into account potential salary and promotion increases before retirement, any surplus or deficit in the scheme, potential discretionary increases, death benefits or guaranteed annuity options (the latter in personal pensions).

Any administrative costs incurred by pension sharing will be passed on to the divorcing couple, either directly or via reduced pension benefits. Pension sharing is not retrospective. There is also no compulsion on divorcing couples to use pension sharing. Earmarking or offsetting may be more appropriate for some.

#### **4.7 Guaranteed annuity options**

For policies dating from the 1970s and 1980s the rate of conversion between cash and pension at retirement was often guaranteed. With long term gilt yields at historically low levels, and dramatic improvements in mortality over the last twenty years, there has been a sharp fall in annuity rates over the past five years. Guaranteed annuity options given under pension contracts in the past have thus come to have considerable value. Guaranteed annuity options hit the headlines in 1999 with widespread coverage of the Equitable Life case.

Because of their large exposure to guaranteed annuity options (approximately 90,000 holders), Equitable Life offered their policyholders with maturing pension plans an open market option with full terminal bonus or the annuity guarantee with a reduced terminal bonus. The effect of the cuts in terminal bonus was to make the guaranteed annuity options more or less worthless.

The High Court ruled in a crucial test case in September 1999 that Equitable Life was not contractually bound to make the full terminal bonus. The vice chancellor said that the directors of the firm were within their rights in cutting the terminal bonuses to guaranteed options holders although the directors were criticised for failing to do enough to communicate the change of bonus policy.

In January 2000 this ruling was overturned when the Court of Appeal ruled against Equitable's treatment of policyholders. The court ruled, by a 2-1 majority, that the directors acted unlawfully in reducing terminal bonuses. The directors were ruled to have acted wrongly, given the details of the policies. The appeal judges rejected Equitable's argument that it was trying to be fair to all its members. The company was allowed to appeal to the House of Lords, which acts as the highest court.

The impact of the judgement is yet to be seen. The company may now be forced into a merger or takeover to raise sufficient funds, in so doing losing its mutual status.

The actuarial profession issued a statement on guaranteed annuity options in March 1999, urging insurers to explain their position so that each policyholder should have a clear idea of how the existence of these guarantees may affect them.

Note that guaranteed annuities are also covered in the Life Assurance section.

#### **4.8 Penalties on employers and trustees**

Late payment of employees' pension contributions became a criminal offence under the 1995 Pensions Act. In September 1999 the first prison sentence was imposed on an employer resulting from an OPRA prosecution. A company director was jailed for six months.

As a result of the number of cases OPRA has had to look at concerning late payments, it is about to toughen its approach. From April 2001 late payments will become a civil rather than a criminal breach, which will enable OPRA to hear many more cases, and to impose financial penalties on employers through its own civil procedures.

Pension scheme trustees are also liable to civil penalties from the pensions authority and criminal penalties in the courts for breaches of the Pensions Act. OPRA can fine or penalise



trustees by disqualifying them from acting as trustees for civil breaches of the Act. Where a criminal offence has occurred, it is up to the pensions authority to decide whether to prosecute or not. To date, 50 people have been fined a total of £100,000 with fines ranging in size from £100 to £12,200.

#### **4.9 The need for trustees to disclose policy on ethical investment**

At the start of July, the Government introduced a new requirement for pension funds. A clause was added to the 1995 Pensions Act, stating that from July 2000 pension scheme trustees must disclose “the extent to which social, environmental, or ethical considerations are taken into account in the selection, retention and realisation of investments”. The new regulation will not require trustees to adopt an ethical stance, but it has been made clear that they will have to state that they have no ethical policy if that is the case, although they will not need to justify that position.

The new requirement was brought in largely as a result of consumer pressure. A survey carried out by the Ethical Investment Research Service in February 1999 found that 73% of the UK adult population would like to have pension funds run on ethical lines. Perhaps more surprisingly, almost a third of those questioned would have been prepared to accept some reduction in their pension benefits as a result (The Independent 10/3/99).

The issue of whether returns may be sacrificed in order to provide more ethical funds may make it difficult for trustees to meet their responsibility to act in the best interest of all members. Competing interpretations of this responsibility cause debate over whether any considerations apart from strictly financial ones should be used by scheme trustees to decide on investment policy. Although trustees are voluntary and unpaid they can be held legally and financially liable if a scheme fails to meet its obligations to members and they can be shown to have been negligent.

#### **4.10 SSAS - increased responsibility for pensioner trustees**

The next major change for small self-administered schemes (SSASs) will be the eventual introduction of a much wider role for the pensioner trustee. SSAS trustees are chosen by the SSAS company and usually include all the members of the scheme. For every SSAS scheme there must also be a pensioner trustee, who is a person or company approved by the Inland Revenue.

The pensioner trustee provides advice to ensure that the scheme meets all the Revenue rules. Fuelled by several high-profile tax avoidance cases, the 1998 Budget outlined proposed changes to stop the practice. The PSO propose to substantially strengthen the role of the pensioner trustee in order to limit the opportunities for abuse in SSAS schemes. PSO Update No. 41 says that “the abuses encountered usually involve the removal of the pensioner trustee without replacement, or undertaking transactions without the pensioner trustee’s knowledge.”

The main requirement that has been enacted is that the pensioner trustee cannot be removed unless an immediate replacement is found. If another pensioner trustee is not found within 60 days of notice, the scheme must be wound up.

Other proposals yet to be enacted include the pensioner trustee becoming a co-owner of scheme assets and being a co-signatory to cheque signing. The former would prevent the other trustees selling scheme assets without the pensioner trustee knowing. There are certain problems with this proposal, for example existing assets, and the fact that there are assets where the pensioner trustee cannot be registered as an owner (for example, where a loan is made by the trustees to the company).

#### 4.11 PIA projection rate changes

In order to reflect prospective investment returns in a low inflation / low growth environment, PIA projection rates changed as of 1 July 1999. The new growth rates are shown in the table below.

		<b>Lower</b>	<b>Middle</b>	<b>Higher</b>
Pensions (in deferment), PEPs, ISAs	New	5%	7%	9%
	<i>Current</i>	6%	9%	12%

		<b>Lower</b>	<b>Middle</b>	<b>Higher</b>
Non-pensions / life collective investment schemes (non-PEP / ISA)	New	4%	6%	8%
	<i>Current</i>	5%	7.5%	10%

		<b>Lower</b>	<b>Middle</b>	<b>Higher</b>
Retail Prices Index inflation assumption	New	0.5%	2.5%	4.5%
	<i>Current</i>	1.5%	4.5%	7.5%

		<b>Lower</b>	<b>Middle</b>	<b>Higher</b>
Average earnings increase assumption	New	2%	4%	6%
	<i>Current</i>	3%	6%	9%

#### 4.12 Budget changes

Chancellor Gordon Brown's pre-Budget report in November 1999 extended the 10p starting rate tax on savings to pensioners. The change applies to bank and building society interest as well as annuity income from purchase life assurance annuities, but not ordinary pension annuities.

In a bid to boost the number of people who invest in the company they work for, the chancellor also introduced an extension of employee share ownership through tax incentives. Workers will be able to buy shares worth up to £1,500 each year from their pre-tax salary. The company can match this purchase with another allocation of free shares worth up to £3,000 (up to two free shares for each one they buy). All shares must be held for five years before they are exempt from income and capital gains tax. This was taken as a blow to pension savings as workers may invest in shares in their own company rather than put more aside for their pension.

#### 4.13 Potential demise of carry back / carry forward

A proposal was launched by the government to abolish the carry back / carry forward provisions on personal pensions. The provisions are due to disappear in April 2001 when the Stakeholder pension is introduced.

Carry back and carry forward allow investors to use up unused relief for up to seven previous years. Which of the two to use depends on the tax position of the investor.



Carry back allows the investor to use up unused relief from the previous year, by treating contributions made in this tax year as if they were paid the previous year. So, a higher rate taxpayer in the previous tax year who has since become a standard rate taxpayer can make extra contributions that will receive tax relief at the higher rate. The existing year's allowance can then be saved for use in future years.

Carry back is also useful for people with no earnings in a year, as in this case the rules allow contributions to be backdated by two years.

Carry forward allows the investor to use up unused relief from the previous six years. This facility is particularly useful for those who find themselves with extra cash. The relief can be claimed at the investor's current tax rate - so if the investor becomes a higher rate taxpayer in the current tax year, relief can be claimed at the higher rate not only on contributions made now but in respect of the previous six years. Carry forward can only be used if the maximum pension contributions for the current tax year has been made.

The complexity of the rules was one of the justifications put forward for the provisions' abolition.

The Inland Revenue has hinted that it may have second thoughts about abolishing carry back / carry forward, despite arguing that less than 3 per cent of personal pension holders make use of the arrangement. It is still reviewing responses to the Stakeholder proposals, and will not decide until later in 2000.

#### **4.14 Market innovations**

The fall in annuity rates has been the topic of much debate this past year. The cause of these low rates is simply demand and supply.

On the supply side, a combination of a buoyant economy generating robust tax revenues, with continuing curbs on government expenditure has produced a budget surplus in the UK. The supply of gilts has accordingly been reduced, particularly at the long end.

By contrast, demand for long gilts remains high. The Minimum Funding Requirement states that defined benefit funds must calculate the present value of future liabilities by discounting by the long gilt yield. The proportion of money invested in the gilt market by pension funds has therefore risen from the historical average of one third to more than a half of all new cash invested since the MFR was introduced in 1997.

This has led to a situation in direct contrast with that prevailing in other leading bond markets, where yields on long-dated UK gilts are substantially lower than those of shorts.

Income paid by pensioners' annuities, which are backed by insurance companies' gilt holdings, has fallen to the lowest level in decades.

Poor annuity rates have had the positive results of innovations in the market place, where a series of new style products have been launched. Retirement income paid by conventional annuities is either fixed for life or goes up at a pre-arranged rate. Income from investment-backed annuities, on the other hand, is linked to investment performance.

With profits annuities work in the same way as any other with profits investment: the amount of the annuity is linked to the payment of an annual bonus which is in turn dependent on the investment performance within the fund. With profits annuities have been on the market place for some years, but the drawback has been the lack of certainty year to year, because they can fluctuate in value.

New entrants into the market are offering minimum income guarantees. One particular product guarantees a minimum income even if stock markets crash. Investors have to select an assumed bonus rate (ABR) of between zero and 5 per cent each year. The lower the bonus rate, the lower the initial income, but the greater the chance of a rising income in the future. Payments are guaranteed never to fall below what you would have received from a zero per cent ABR.

Somewhat further up the risk scale comes the unit-linked annuity, with its value linked directly to the stockmarket. Income level is specified in terms of a number of units rather than a cash amount. Investors can typically select an assumed rate of investment growth, and can invest in a number of different funds. One new product is a derivative-backed, unit-linked annuity which provides a 100 per cent capital guarantee and guaranteed income on a quarterly basis. The guarantee is provided by investing 3 per cent of the fund in derivatives for stock market exposure and currency hedging, while the balance is kept in cash.

The most risky of the modern breed of annuities are self-invested annuities. These are currently only offered by one company. They offer a SIPP-style portfolio of investments which must raise the required income. However, a standard annuity must still be purchased at age 75.

#### **4.15 SIPP growth**

The self invested personal pension (SIPP) celebrated its tenth birthday in 1999. In that time it has grown from being a niche to a mainstream product. It has recently been estimated that there are now 50,000 SIPP policyholders owning assets valued at over £6 billion.

Part of the reason for the growth in the SIPP's popularity was the introduction of income drawdown in 1995. Put simply, income drawdown allows a pension holder to defer buying an annuity until the age of 75. In the meantime, the whole of the pension fund can be invested to provide an income between limits specified by the Government Actuary's Department (the GAD limits). This is done so that the allowable income closely reflects the level of payments that would have been received from the equivalent annuity.

According to recent research, 25% of all maturing pension funds eligible for annuity purchase are now invested into drawdown arrangements. Once benefits begin to be drawn from a pension fund you cannot change the provider of the contract regardless of the ensuing investment performance. This makes having a SIPP wrapper - allowing you to move your investments - vital to protecting your retirement income.

The opportunity to improve performance, usually in conjunction with a stockbroker, was also a key driver of SIPP growth. In contrast to this, an investment strategy specifically designed to meet the objectives of an individual tends to be far more attractive than the traditional pooled approach. The investment freedom available under a SIPP also allows younger investors to be more adventurous with their investments than those close to retirement. The most favoured investment choices are currently equities (including securities quoted on foreign exchanges such as NASDAQ), AIM stocks, investment and unit trusts and commercial property.

#### 4.16 Amendment to Guidance Notes

Revisions were made to GN3, GN13, GN27, GN29 and GN31. GN16 and GN17 are also being reviewed. An exposure draft for a new Guidance Note has also been circulated (Exposure Draft No 37).

**GN3:** Certain certificates for contracting out. The last version of GN3 was issued in July 1997. At the time, the Pensions Board was in discussion with the DSS regarding the need to provide a certificate for schemes that commenced wind-up before 6 April 1997, so it was clear that a further amendment would be needed. The latest version covers this certificate, and has been restructured. It also notes that the responsibility for the Contributions Agency was transferred to the Inland Revenue from the Department of Social Security with effect from 1 April 1999.

**GN13:** Actuarial statements required in connection with the statements of financial accounting standards. Technical amendments were made concerning reference to the Minimum Funding Requirement, reference to the International Accounting Standard IAS 19 and Advice on FAS 132.

**GN27:** Retirement benefit schemes - Minimum Funding Requirement. References to the FTSE Actuaries Fixed-Interest 15-year Medium Coupon Index are changed to FTSE Actuaries' Government securities 15-year Yield Index. The changes apply to:

- MFR valuations which are signed on or after 1 June 1999
- minimum cash equivalents calculated as or after 1 June 1999
- deficiency calculations under GN19 where the applicable time is on or after 1 June 1999

**GN29:** Occupational pension schemes - actuaries advising the trustees or a participating employer. Several requirements have been added in relation to schemes which are, or have been, contracted out on a salary-related or mixed-benefits basis and still retain salary-related contracted-out liabilities and where there has been a change of scheme actuary.

**GN31:** Actuaries to appropriate personal pension schemes. The main reason for this revision of **GN31** is the transfer of functions to the Inland Revenue from the Contributions Agency and the Department of Health and Social Security for Northern Ireland.

**Exposure Draft No 37:** Illustration of defined contribution pension benefits. The new GN gives guidance to actuaries when they are giving illustrations of the benefits which might be received from a defined contribution scheme, with particular emphasis on members who are considering transferring from a defined benefit scheme. It also gives guidance on the information which should accompany these illustrations.

#### **4.17 Bibliography**

- Current Topics paper 1999
- Press cuttings
- ABI press releases and updates
- Various government consultation papers
- The Actuary
- Manual of Actuarial Practice
- Annuity Guarantees - actuarial profession position statement
- SSAP 24 Review - actuarial profession position statement
- Draft Response to Financial Reporting Exposure Draft 20 - actuarial profession position statement
- Small Self-administered Personal and Company Pension Arrangements - Henry Stewart Conference literature February 1999
- A Central Discontinuance Fund for Pension Schemes - paper presented to the Staple Inn Actuarial Society October 1999
- Improved Flexibility in Pension Provision - PSO Update No 54

## 5 LIFE INSURANCE

### 5.1 New Business

#### 5.1.1 Current Sales Volumes

New business figures produced by the Association of British Insurers (ABI) for the last five years (1999 only available up to end of quarter 3 at time of writing) indicate the following trends:

<b>Total Individual Life and Pensions Business</b>			
	<b>New Regular Premiums £m</b>	<b>New Single Premiums £m</b>	<b>Equivalent Annual Premiums £m</b>
1994	2,592	13,753	3,967
1995	2,145	12,107	3,356
1996	2,451	17,605	4,212
1997	2,707	19,572	4,664
1998 Q1	797	5,266	1,324
1998 Q2	833	5,465	1,380
1998 Q3	776	5,627	1,339
1998 Q4	806	5,946	1,401
1999 Q1	776	6,757	1,452
1999 Q2	844	6,994	1,543
1999 Q3	779	7,063	1,485

Notes:

- Equivalent Annual Premium =  $AP + SP/10$
- Due to a change in the new business data collected it is not possible to compare the results from 1998 Q1 with those of previous years.

Based on total premiums, new business for the first three quarters of 1999 increased by 24% over the same period in the previous year. However, this overall increase disguises the fact that personal pension sales have fallen compared with 1998, with regular premium sales down 9%. The main reason for this decline is the uncertainty over the impact of Stakeholder pensions on pension advice. Stakeholder pensions are not expected to be available until 2001 but regulators have warned that advisers must take their introduction into account now. The reduction in pension sales may also be due to the current low annuity rates which make personal pensions less attractive and a lack of confidence arising from the mis-selling scandal.

In contrast, total new life assurance business for the first three quarters of 1999 increased by 32% over the same period in 1998 with single premiums up by 34% and regular premiums up by 9%. Single premium with-profits bonds account for much of the increase in life sales.

Insurance ISA sales have been disappointing with only 80,000 new policies compared with over 655,000 cash and equity ISAs sold by insurance companies. The lack of demand for insurance ISAs has been blamed on two factors - that ISAs in general are confusing and that insurance ISA

annual contributions are capped at £1,000. This compares unfavourably with equity ISAs where the annual cap is £7,000 this year and £5,000 in future. Consequently, there have been calls for ISAs to be simplified and for the insurance annual limit to be raised to £5,000 to create a level playing field with equity ISAs.

### 5.1.2 Distribution Channels

The following table shows the distribution of individual life and pensions business by sales channel over the past 5 years.

<b>Total Individual Life and Pension EAP Split by Distribution Channel %</b>					
	<b>IFAs</b>	<b>Bancassurers</b>	<b>Direct Sales Force</b>	<b>Tied Agents</b>	<b>Other</b>
1994	39	18	35	6	3
1995	44	14	35	5	2
1996	47	14	32	5	2
1997	50	13	29	5	2
1998	52	11	29	5	3
1999 Q1	53	10	29	4	3
1999 Q2	54	11	28	5	3
1999 Q3	56	11	25	5	3

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 evident over recent years, continued during 1999. In particular, Stakeholder confusion helped IFAs to an unprecedented dominance in pension sales. Their share of new regular premium individual pension business increased to 62.4% in 1999 quarter 3 from 53.7% in the same period the previous year and they continued to monopolise sales of single premium individual pensions, accounting for 84% of the business sold during quarter 3. In contrast, ISA sales have been dominated by direct sales forces - 75% of regular premium ISAs and 60% of single premium ISAs sold during 1999 quarter 3 were through direct sales forces compared with 11% and 17% respectively through IFAs.

In recent years life offices have been disbanding their sales forces due to the high costs of operation. Royal & Sun Alliance sold its direct sales force in 1999 to concentrate on sales through IFAs. Other offices with sales forces are restructuring their core distribution channel to boost sales efficiency as well as establishing IFA sales.

### 5.1.3 Polarisation of Investment Advice

In 1998 the Office of Fair Trading (OFT) began a review of the impact of polarisation to assess whether polarisation rules

- have achieved the objectives for which they were designed i.e. to ensure that the status of intermediaries was clearly identified and that responsibility for advice given by tied agents was clearly that of their host offices,
- have enhanced consumer understanding,
- have had any significant effect on competition in the market.

The OFT's long awaited report was published in August 1999. It concluded that the polarisation rules distort competition and prevent retail innovation. However it felt that these effects are outweighed, in the case of life assurance and personal pension products, by competition between providers operating in the independent sector.

As a result the OFT recommended that the polarisation rules should apply only for advice given on life and pensions products because they are complex. For simpler, more transparent investment products such as unit trusts and OEICs, the rules should not apply. Instead company representatives should be able to develop multi ties so that they can advise on and sell the products of several providers. These multi tied agents would be directly authorised by the Financial Services Authority (FSA) and all advisers would be required to disclose any arrangements or ties that they might have with providers before giving advice.

Other recommendations included a clear separation of the selection of products for best advice panels from the negotiation of commission and an equalisation of the tax treatment of fee and commission based advice.

The OFT recommendations were not as radical as some had feared - there had been suggestions that only fee based advisers would be given the right to describe themselves as 'independent'. However, there is some concern about the proposal for multi ties. Their introduction could be confusing for consumers and perhaps even mislead them into thinking that they are receiving independent advice when they are not.

## **5.2 Financial Strength**

### **5.2.1 Free Asset Ratios**

The issue of financial strength received much press comment in the months following publication of the FSA Returns. In 1998 free asset ratios deteriorated for the majority of companies. The average free asset ratio in 1998 was 11.6%, compared to 13.8% in 1997 (Source: Money Marketing).

The 1998 year end was exceptional due to long term interest rates which reached their lowest level in almost 30 years. At 31 December 1998 long-term interest rates had fallen to 4.5 per cent from 6.4 per cent at the end of 1997. The effect of this fall was to increase the liabilities, including the reserves to cover the cost of providing guaranteed annuities. In addition, many companies were forced to increase provisions for phase two of the pensions review. Consequently the free asset ratio of many companies was reduced.

At the end of 1998 six companies included future profits as a capital item, compared with two at the end of 1997. Some companies have specific reasons for using the future profits item but others used it to offset the fall in free assets in order to maintain a prudent margin above their minimum solvency level.

During 1999 long-term gilt yields increased to over 5.25% before falling to 5% at the end of the year. The result should be a reduction in liabilities at the end of 1999, including some release of the end 1998 reserves for guaranteed annuities. In addition, the FTSE All Share ended 1999 on an all-time high, increasing over 20% from the start of the year. Strong equity market performance together with the rise in gilt yields should enable companies to improve their free asset ratios from the end 1998 levels.



### **5.2.2 Relaxation in the Resilience Test**

Last year's Current Topics paper gave details of a temporary modification to the second resilience test and in particular to the fall in equity values to be assumed in certain investment scenarios.

The Government Actuary's Department (GAD) wrote to appointed actuaries at the end of September 1999 setting out a revision to last year's guidance which it considered appropriate to apply when assessing the ongoing financial condition of life insurers at the end of 1999. GAD believes that this amendment should ensure greater consistency between the assumed fall in equities and the level of gilt yields.

As with last year's guidance, the change only affects the second resilience test: a 10% fall in fixed interest yields combined with a fall in equity values of 25%. It is proposed that the test should comprise a combination of

- a 10% fall in fixed interest yields,
- a fall in the value of equities of the greater of
  - 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 10% fall in fixed interest yields, and
  - 10%.

A working party is currently reviewing the guidance on resilience testing. It is expected that the resilience tests will be changed after the amendments have been made to the valuation regulations.

### **5.3 Amendments to Part IX of Insurance Company Regulations 1994**

In November 1998 HM Treasury issued a consultation document outlining proposed changes to the insurance company regulations. The changes cover four main areas:

- Clarification of the effect of policyholders' reasonable expectations when considering the provision that may be required when valuing an option
- To allow a gross premium valuation for non profit business
- To reduce the maximum yield for investment to be made more than three years after the valuation date
- To establish a sound and consistent standard for the valuation of unitised with profit business.

(Further details were given in last year's Current Topics paper together with a summary of the responses made by the industry and profession.)

The overall effect of these proposed changes may be to increase the reserves offices need to hold, particularly those writing substantial volumes of unitised with-profits business, thus reducing free asset ratios.



It was widely expected that the amended regulations would be introduced to be effective before the end of 1999. However, recognising that companies may be unable to comply with the regulations within this timescale due to system freezes in the run-up to 2000, the FSA decided to postpone the introduction of the amended regulations until the early part of 2000.

The FSA also confirmed that the changes to the regulations should be broadly the same as those consulted upon at the end of 1998.

#### **5.4 Future of With-Profits Business**

With-profits business has been the mainstay of UK insurance companies and still accounts for nearly half of new premium income for both life and pension sales. One of the reasons why with-profits products continue to attract such a substantial proportion of the industry's new business is their relative simplicity - people can pay contributions without having to make further investment decisions - making them suitable for a large number of people. A further reason is the security provided by the key elements of with-profits products, namely the guaranteed benefits, the pooling of investment risks and the smoothing of investment returns. Moreover, in recent years with-profits policies have tended to out-perform alternative investments.

Despite the attractions of with-profits for many policyholders, the concept is under greater scrutiny than ever before. The main criticism is that most with-profits companies do not give policyholders information about investment returns, asset shares or how investment returns have been smoothed. There is a suspicion that by withholding this information it is easy for companies to manipulate payouts, for example, transfer values reduced in order to boost maturity values or payouts reduced below assets shares in order to build up or replenish reserves. Without the information policyholders have no idea how their investments are progressing or whether the payouts to them are fair.

Within the actuarial profession it is recognised that if with-profits products are to survive there must be more detailed disclosure but there are differing views on how this can be achieved. So far, the FSA has compromised by 'encouraging' companies to disclose investment returns, but with little response.

Observations on with-profits investments made by the Department of Social Security (DSS) in one of its consultation briefs, 'Stakeholder Pensions: Minimum Standards - The Government's Proposals', have focussed attention on the future form of with-profits investment. These included the comment that with-profits guarantees may be attractive to many potential members of Stakeholder schemes, in particular that 'the value of a member's fund cannot fall'. However, the DSS expressed concern that company discretion in the allocation of investment returns makes for uncertainty in payouts, allows for the possibility of investment returns not actually being credited to policyholders, and involves arbitrary market value adjustments. They envisage with-profits policies with all investment returns being allocated to policyholders, with none going to a separate reserve, and may make this a requirement of with-profits Stakeholder pensions.

It seems that the Government values the pooled investment risks and guarantees in with-profits policies, but is wary of the smoothing of returns. Smoothing is the main merit of the with-profits concept and for it to work effectively, actuaries need to have discretion. It would be very disappointing if Stakeholder pensions simply became pooled investment products directly exposed to market fluctuations, but with guarantees that restrict investment freedom.

## 5.5 Guaranteed Annuity Rates

During 1999 much attention was focused on guaranteed annuity rates due to their effect on life office financial strength and the High Court judgement in the Equitable Life case.

With gilt yields reaching historically low levels at the end of 1998, life offices had to hold higher reserves to meet the cost of guaranteed annuity rates. Standard & Poors estimated that UK life companies had to put aside around £14 bn at the end of 1998 to meet the cost of these guarantees.

The impact of guaranteed annuities on free asset ratios varied widely between offices, depending not only on the volume of guaranteed annuity business that they had written but also on the generosity of the guarantees. The effect was exacerbated by the reserving guidelines issued by GAD under which companies had to assume that the majority of guaranteed annuity options are taken up. Some companies had put in place stop loss and other reinsurance arrangements to mitigate the impact on solvency.

In September the High Court judgement on Equitable Life endorsed the company's stance on guaranteed annuity rate policies. Equitable Life had brought the case to court in order to establish the legality of allocating bonus to those with guaranteed annuity rate policies at a lower rate than that at which it awarded bonus to other policyholders.

The court ruled that the Equitable Life directors had acted lawfully. The company's Articles of Association permit the directors to apportion bonuses "on such principles and by such methods as they may from time to time determine". In the court's opinion this allowed a "very wide choice of action, well wide enough...to justify an apportionment expressed to be conditional on the form of benefits to be taken by a policyholder". The judgement was important for all offices, not just Equitable Life, because a successful challenge to the rights of directors to set discretionary bonuses would have had wide-ranging implications.

Policyholders' reasonable expectations (PRE) were examined in some detail. The High Court stated that policyholders did not have a reasonable expectation that the same rate of final bonus would be paid to all policyholders and, in any case, a reasonable expectation does not become a contractual right. PRE is only one of the factors to be taken into account by the directors. It was for them to decide on its importance relative to all the other factors.

It was always the directors' intention to use final bonus to enable each policyholder to receive benefits with a value that equated to the notional asset share. Where an annuity based on guaranteed rates would have a value in excess of the asset share, and thus involve a cost to Equitable Life, the directors were, in the exercise of their discretion, entitled to reduce the final bonus awarded to those who opted for benefits based on guaranteed annuity rates.

The court gave the policyholders leave to take the case to the Court of Appeal which recently ruled against Equitable Life. The company has appealed to the House of Lords so the issue of guaranteed annuities is set to remain a focus of attention.

## 5.6 Endowment Mortgages

Endowment mortgages received more press coverage than ever before during 1999. During the summer a spate of national newspaper reports and political statements were highly critical of endowments. Some journalists even began talking of a “mis-selling scandal”. The negative comments arose from the results of reviews of endowment policies carried out by insurers.

In the late 1980s and early 1990s premiums for endowments were based on the assumption of future growth rates in the range 7% to 10.5% p.a., with some salesmen using growth rates at the upper end of this range in order to reduce premiums. In the current low-inflation, low-interest environment the FSA argues that projecting future returns of anything above 8% is misleading. In recognition of this, the FSA cut the rates to be used in projections, in July 1999, to 4% p.a. and 8% p.a., with a new central projection rate of 6% growth a year.

The new 6% projection rate doesn't just apply to the sale of new endowments. In September the ABI put in place a new code of practice in which all those policies sold at the old, higher projection rates would have to be reviewed using the new rates. Over the following months, policyholders were advised of the results of these reviews, and in some cases the review showed that the proceeds of the endowment policy would not be sufficient to repay the mortgage.

Poor past performance does not explain the problem with endowment policies and the recommendation, in some cases, of a contribution increase. Rather it is the expectation for future investment returns that is the issue - these returns are likely to be significantly lower than was assumed when the premiums were calculated at the outset of the plan.

Other commentators attributed the problem with endowments to high commissions which encouraged mortgage lenders to sell endowments rather than repayment mortgages.

In May 1999 a working party was set up by the Faculty and Institute of Actuaries to consider under what circumstances a new endowment mortgage might reasonably be regarded as “best advice” as opposed to a new repayment mortgage. The working party published a report in November in which it concluded that endowments, due to their high costs and inflexible terms, were no longer the best way to pay off a mortgage. Instead it advocated the repayment method as “the most straightforward and low-risk method of repaying a mortgage”.

The report sets out five principles for evaluating an endowment mortgage against a repayment mortgage. These include the recommendation that assumed growth rates should not normally be greater than the FSA mid-rate of 6% p.a. and that the customer's attitude to risk/reward and personal financial circumstances should be taken into account.

The key conclusion of the report is that, in order to justify an endowment mortgage rather than a repayment mortgage, there has to be a reasonable likelihood that, based on long term financial assumptions, the customer will be no worse off than with a repayment mortgage. The report sets out the maximum reductions in yield (RIYs) - for both maturities and surrenders and including and excluding critical illness cover - which would make an endowment mortgage worthwhile. Comparing these with current market RIYs, the working party concluded that:

- Shorter term endowment mortgages (i.e. 10 years and possibly 15 years) are unlikely to be justifiable as providing good value.

- Longer term endowment mortgages can be justifiable as providing good value if a sufficiently competitive endowment contract is used; the greater the level/cost of the protection cover required (based on age, sex, smoker status and need for critical illness) the higher the level of charges which can be deemed to be competitive.
- Longer term endowment mortgages are unlikely to be justifiable on early redemption grounds particularly if the charges are heavily front end loaded.

The number of new endowment mortgages has slumped dramatically over the last five years. Time will tell what effect this report will have on future endowment sales although it is widely expected that the number of new endowment policies will be greatly reduced. At least one company has reduced the RIYs on its endowment policies in an attempt to boost IFA confidence. Others, including Pearl Assurance, NatWest Life, Halifax and Nationwide Building Society, have stopped selling endowment policies.

Following the allegations of endowment mortgage mis-selling, the FSA investigated past endowment sales practices to establish whether a full-scale review was needed. In late December it announced that despite evidence of bad advice, there were no grounds for an industry-wide review of past endowment mortgage business. The FSA believes that, 'on average, holders of mortgage endowments have enjoyed returns which mean they have fared at least as well as they would have with a repayment mortgage'. It also called for improved communications with policyholders.

Following the FSA's announcement, insurers agreed a ten-point action plan for future sales and existing endowment policies. For future sales, the plan adopts the principles for good advice proposed by the working party. As part of the plan, insurers wrote to existing endowment policyholders in January giving general information about endowment policies and indicating when they will receive revised projections for their policies. The letters were accompanied by an FSA factsheet which outlined the options if an endowment policy is unlikely to repay the mortgage and stressed the importance of not cashing in policies early. The ABI is working with the FSA to develop a standard set of wording and list of information to be used in re-projections of expected investment performance due to be issued to policyholders from April 2000.

## **5.7 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 fifth survey were published in October 1999. The report extended the information published in previous reports with one, two, three and four year duration persistency rates for business sold in 1997, 1996, 1995 and 1994 respectively.

The one-year duration persistency rate for regular premium policies sold in 1997 showed no improvement. (A higher persistency rate means that there are fewer lapses.)

#### **Lapse Rates for Regular Premium Policies (All Sales Channels)**

<b>Policies started in</b>	<b>1994</b>	<b>1995</b>	<b>1996</b>	<b>1997</b>
Lapses in year 1 (%)	10.9	10.3	9.3	9.3
Lapses in year 2 (%)	7.4	7.4	8.5	
Lapses in year 3 (%)	6.2	6.9		
Lapses in year 4 (%)	5.4			

These figures show that, for every 1000 policies taken out in 1997, 93 lapsed during the first year, the number being unchanged from 1996.

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 1994 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 will be 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.

For single premium business written in 1997, the one-year persistency rate fell slightly, reversing the trend of slow improvement in previous years.

#### **Lapse Rates for Single Premium Policies (All Sales Channels)**

<b>Policies started in</b>	<b>1994</b>	<b>1995</b>	<b>1996</b>	<b>1997</b>
Lapses in year 1 (%)	2.3	1.7	1.4	1.5
Lapses in year 2 (%)	3.2	2.3	2.0	
Lapses in year 3 (%)	3.6	2.6		
Lapses in year 4 (%)	4.0			

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 rate 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 1996 are:

	<b>Company Representatives</b>	<b>Industrial Business</b>	<b>IFAs</b>	<b>Direct Offer</b>
Lapses in year 1 (%)	9.2	12.5	7.4	8.0
Lapses in year 2 (%)	8.4	10.4	7.2	8.2

Possible explanations for these differences in persistency rates are:

- IFAs tend to advise those on higher 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.

## **5.8 Genetic Testing**

This is an issue which continues to be widely debated both inside and outside the insurance industry. For the industry, the debate is important if its freedom to underwrite is to be protected and it is concerned to ensure that an equitable approach is taken to underwriting potential and existing policyholders.

The industry believes that it is inequitable to allow the normal rate of premium to an individual with a known extra risk if that risk has a genetic basis. It would not be fair to those rated for other reasons, for example, diabetes or high blood pressure, and it would not be fair to those without extra risk who were accepted at normal rates.

The industry is also concerned about the potential for anti-selection by potential policyholders who do not disclose the positive results of a genetic test in order to obtain standard premium rates or substantial sums assured.

Outside the industry, the issues have centred on a concern that there would be discrimination which would create a 'genetic underclass', that incorrect conclusions might be drawn from genetic test results and that insurance companies' access to genetic information might discourage people from having tests.

The ABI Code of Practice on the use and handling of genetic test information came into effect on 1 January 1998 with the aim of developing industry-wide standards on underwriting and confidentiality. The Code has recently been updated to the following:

- ABI members will not ask for genetic tests to be taken for insurance purposes nor will they use the results to define preferred lives.
- They will not ask for access to previously taken genetic test results for life policies associated with house-purchase mortgages up to a sum assured of £100,000.
- Results from previously taken genetic tests will be taken into account in the underwriting of policies outside the above concession but the following caveats will apply:

Test results from an individual will not be used in the assessment of other family members.



Only reliable test results will be taken into account and then only when they are relevant to the risk being insured. Any extra premiums will be calculated in a fair way.

- Each company must have a written confidentiality policy in respect of genetic information and this must be adhered to.
- There will be a central point of contact (the nominated genetics underwriter) in each company to deal with genetics issues.
- Companies must recognise the Genetics and Insurance Committee's (GAIC) role in evaluating the validity of genetic test results.

The GAIC was established by the Government in 1999 with a remit to publish criteria for the evaluation of specific genetic tests, their application to particular conditions and their reliability and relevance to particular types of insurance. GAIC will be assisted in this task by the UK Forum for Genetics and Insurance which was formed in 1999 'to analyse the implications of advances in genetic knowledge for insurance in all its forms and to serve the public interest by reporting on its findings'. The Faculty and Institute of Actuaries are represented in this UK forum.

With advances in genetics it is possible that the risk of anti-selection may become greater and that extending the moratorium on genetic test results could cause financial problems for insurance companies. However, at the same time it should become possible to draw more robust conclusions about insurability from the results of genetic tests.

## **5.9 Long Term Care**

In December 1997 a Royal Commission was established:

- To examine the short and long term options for a sustainable system of funding long-term care for elderly people, both in their own homes and in other settings, and
- To recommend how, and in what circumstances, the cost of such care should be apportioned between public funds and individuals.

The Commission's report entitled 'With Respect to Old Age' was published in March 1999. The key recommendations of the report were

- The split of long-term care between personal care, living and housing costs. Personal care would be free, subject to assessment of need, whereas living/housing costs would be subject to a means test. The Commission takes personal care to mean 'the care that directly involves touching a person's body, which is distinct both from treatment/therapy and from indirect care such as home help or provision of meals'. There will need to be considerable debate before the elements of personal care and living/housing costs can be agreed, not to mention who is responsible for the costs incurred in measures which potentially reduce the need for personal care.
- The formation of a National Care Commission (NCC). The Commission envisaged a wide ranging role for the NCC, including monitoring of demographic and spending trends, establishing national benchmarks for care services, delivery of transparency and accountability in the care system and representing the interests of consumers.



Two of the Commissioners were concerned about the long-term care cost estimates used in the main report. They question whether the estimates make assumptions about future informal care provision and expectations of future wage increases of care workers which are too optimistic. They also believe that the projected costs are flawed because there is no allowance for the impact on demand of providing something free or that there will continue to be a public expectation for improvements in the quality of care. They argue that these factors substantially increase the cost of the free personal care recommendation and make the proposal of the main report unworkable. Therefore, in a 'Note of Dissent', they propose modifying the existing means test instead of providing free personal care.

The Commission proposes general taxation as the most appropriate means of meeting the costs of its recommendations. While general taxation may be effective, it maintains the 'status quo' and does nothing to reduce dependency on future governments and taxpayers to fund the long-term care costs of the elderly. It does nothing to stimulate personal responsibility.

While there is some uncertainty about what the actual long-term care cost will be, it is expected that the extra cost will impact at just the time when the demographic changes in the UK start to bite, implying a significant burden for the then working population. For this reason, the concept of 'pre-funding' would be preferable to general taxation.

The dissenting Commissioners recommend a public-private partnership in the provision of care and do not rule out a more substantial role for the private sector. They identify insurance and equity release products as suitable options for some individuals. They also recommend that the government review the tax treatment of pensions, with a view to removing obstacles to the use of pensions to fund policies providing for long-term care.

The Royal Commission has not presented the government with a unanimous way forward. Perhaps most worrying for the government is the proposal to continue funding long-term care via general taxation. It seems reasonable to assume that the government would welcome some alternatives to the Commission's proposed funding methods.

Overall, the Royal Commission did not feel there was a significant role for the insurance industry. Even the 'Note of Dissent', while more positive, was not wholly supportive. However, insurance has a role to play in long-term care provision - long-term care policies can meet the needs of those wishing to protect themselves from self-financing living/housing costs and better standards of personal care. The insurance industry must promote its experience and skills in developing innovative products if it is to play a central role in the government's future long-term care strategy.

## **5.10 Sector Activity**

The momentum in the insurance industry towards mergers, demutualisations and take-overs continued during 1999.

### **5.10.1 Scottish Widows and Lloyds TSB**

In June 1999 Scottish Widows announced that it was to demutualise following a proposed £7bn take-over by Lloyds TSB. The transaction, which was later reduced to £6.7bn, was approved by Scottish Widows' policyholders in late December.

Details of the deal are as follows:

- Lloyds is to pay Scottish Widows' policyholders £5.4bn in cash windfalls.
- Every eligible Scottish Widows policyholder will receive a cash payment of £500.
- £4.6bn is to be paid to 900,000 with-profits policyholders based on the value and duration of their policies, averaging an extra £5,100 each with some policyholders getting substantially more.
- £1.3bn is to be set aside for unforeseen contingencies arising from existing business and will be distributed to eligible policyholders over time in the form of bonuses rather than as cash.
- Annual cost savings of £60m are projected by the third year.

The take-over of Scottish Widows by Lloyds TSB, which sees Scottish Widows demutualising from a position of strength, will create the UK's second-biggest life, pension and unit trust provider, with £80bn of assets under management.

Scottish Widows has stated that the driving force behind this deal was the need to be a strong competitor in the Stakeholder pension market. There had been suggestions that Scottish Widows had been pushed toward a sale because it was having difficulties in meeting payouts on guaranteed annuity policies but this was denied. In 1999 Scottish Widows slashed bonus rates which angered some policyholders and led to the setting up of the Scottish Widows Action Group. The biggest contingency likely to reduce the extra £1.3bn pay-out is guaranteed annuities.

Lloyds TSB is now a major player in the IFA market, as well as selling life and pension products through its branch network. To date Lloyds has had only limited success with life and pensions sales but it is hoping for better results with the Scottish Widows brand.

### **5.10.2 Legal & General and NatWest**

Soon after the announcement of the Lloyds TSB take-over of Scottish Widows, NatWest announced plans for a £10.75bn take-over of Legal & General. The merged company would have had a market capitalisation of £30bn making it the third-biggest financial services organisation in the UK behind Lloyds TSB and HSBC.

For Legal & General the deal was based on a desire to broaden its distribution networks and to be able to sell through NatWest's banking outlets. Unlike Lloyds TSB, NatWest was not planning to use the Legal & General name - Legal & General would hold on to its IFA brand while producing products for NatWest's branch network under the bank's name.

In September Bank of Scotland launched a hostile bid for NatWest which forced NatWest and Legal & General to abandon their plans.

### **5.10.3 Britannic Assurance and Britannia Building Society**

Britannic Assurance, a home service insurer, signalled its ambition to become a major provider in the IFA marketplace and took tentative steps into this market with the launch of a with-profits bond in early 1999.

Britannic Assurance was one of the strongest life insurers and had for some time sought to expand. Having been unsuccessful in bids to purchase London & Manchester and NPI, Britannic agreed to buy Britannia Life and 75 per cent of Britannia Asset Management in a £346m deal in August 1999.

There were three key parts to the deal:

- Britannic Assurance paid £150m for a 75% stake in Britannia Asset Management, which was renamed Britannic Asset Management. This was the key to the deal and gave Britannic Assurance a firm foothold in the fund management sector, enabling it to use Britannic Asset Management's positive profile in the IFA market to develop this part of its distribution.
- An agreement which allows Britannic Assurance to distribute its life, pension and investment products exclusively through Britannia Building Society's branch network over the next 10 years.
- £196m was taken from Britannic Assurance's with-profits fund to buy Britannia Life. Britannia Building Society had been trying to sell the life company for a couple of years. Britannia Life was closed to new business at the end of 1997 after suffering a £9m loss amid fierce competition and falling margins, but not before Britannia Building Society had injected £100m to keep the life arm afloat. The Britannia Life with-profits fund will remain stand alone rather than being merged with the Britannic with-profits fund. Britannic has also secured indemnities for personal pension, endowment and FSAVC mis-selling liabilities.

Britannic's capital has not been significantly reduced by this deal and the company is keen to make further acquisitions.

### **5.10.4 Guardian and AEGON**

Following AXA Sun Life's purchase of Guardian Royal Exchange (GRE) in early 1999, AEGON paid £759m to acquire GRE's life business. The main GRE life, pensions and unit trust businesses were much smaller than those of AXA Sun Life and were concentrated on markets, such as the protection market, that were not perceived by AXA Sun Life to be its primary market. The Guardian operations were a good strategic fit for AEGON, with Guardian Employee Benefits' product range complementing Scottish Equitable's substantial group personal pension market share and Guardian Financial Services giving exposure to the individual protection market.

## **5.11 Amendments to Guidance Notes**

GN8 : Additional Guidance for Appointed Actuaries and Appropriate Actuaries

A working party was established to prepare a revision of GN8 that would take account of the amendments to the Insurance Company Regulations 1994 proposed by the Treasury in November 1998. This revision to GN8 has been held up by the delay in introduction of the revised valuation regulations.

## **5.12 Bibliography**

- Current Topics paper 1999
- Press Cuttings
- ABI Circulars
- The Actuary Magazine
- Long-Term Insurance : New Business Results and Sources of New Business Results - Quarter 3 1999 published by the ABI
- GAD Letters
- Report of the Endowment Mortgages Working Party
- FSA's Fifth Survey of the Persistency of Life and Pensions Policies

## 6 GENERAL INSURANCE

### 6.1 The Economy

At the beginning of 1999 the UK was teetering on the brink of recession, with manufacturing in recession and the slowdown spreading to the services sector. Fears at that time have failed to materialise and the UK economy is now expanding rapidly, driven by strong domestic demand. The economy is expected to have grown by around 1.8% in 1999 with forecasts of around 3% growth in 2000.

Headline RPI inflation dropped to a 30-year low of 1.1% in August and September. Interest rates fell to a low of 5% in June. The Bank of England's monetary policy committee demonstrated its determination to keep ahead of inflation by raising interest rates in September and November, prompted by a buoyant housing market and fears of wage pressures. The National Average Earnings Index has increased at an annual rate of around 4% to 5% through the year. In December, however, house prices rose by 2.6%, their second biggest monthly rise since the summer of 1988. Further interest rate rises are now expected in 2000.

A stable, low inflation environment reduces the risk that the growth in claims costs will outstrip the inflation assumptions used by insurers in pricing their business and setting their reserves. Low interest rates and the boom in the housing market are also good for insurers in that there will be reducing claim numbers and costs on Mortgage Indemnity policies.

When people move home they are increasingly likely to look around the market for their household insurance rather than continue with their current insurer. This is bad for insurers as the cost of acquiring new business is greater than that of renewing policies. Increased house buying is held to lead to more subsidence claims as surveys identify problems.

The number of people unemployed and claiming benefits fell to a 20 year low in 1999. The number of people classed as economically active hit an all time high in the latter part of the year. It is thought that the economy is now below its natural rate of unemployment. This could lead to further inflationary pressures in 2000.

A buoyant economy, and in particular low unemployment, is good for insurers for a number of reasons:

- People in employment are more likely to purchase insurance
- Some claim causes, e.g. theft, fraud and arson are correlated to the unemployment rate
- There will be an increased level in the purchase of cars and the number of holidays taken; this will result in more insurance being purchased.

Manufacturing output rose in the latter half of the year. The rise in the exports of traded goods in the 3rd quarter was the biggest quarterly increase for 20 years.

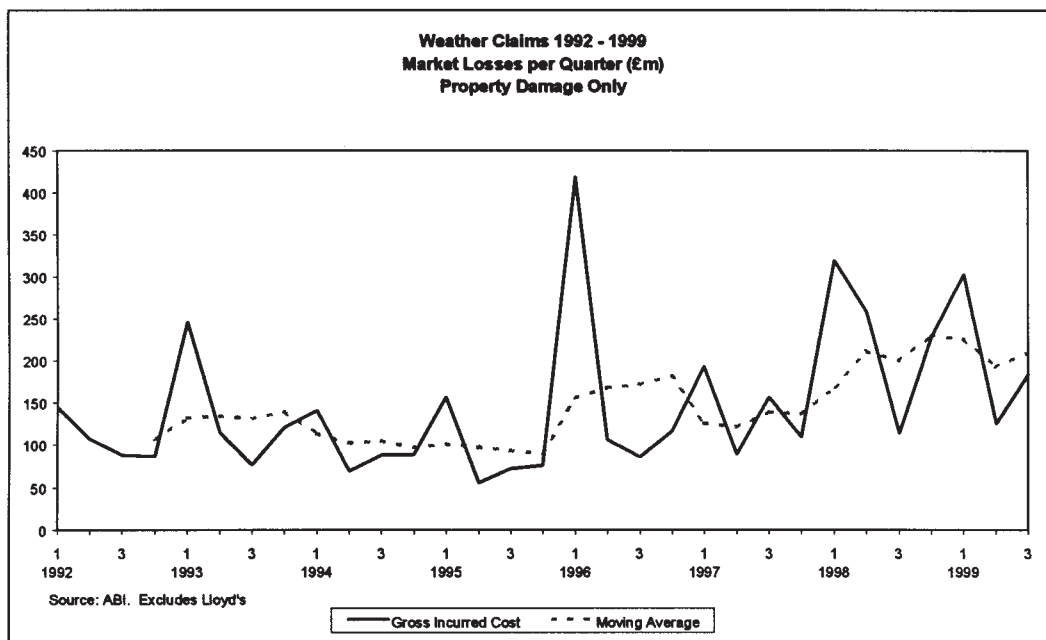
High levels of manufacturing output can lead to higher claims costs for insurers. Machinery and employees are worked harder and corners are cut to increase output, which can lead to a greater number of accidents. The cost of business interruption claims will be higher as, for a given period of time, the volume of business lost will be greater.

## 6.2 Claims Experience

This section contains graphs and commentary on the major claim causes. It uses ABI statistics, which 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 in 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 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.

None of the figures used to compile the graphs have been restated to current levels.

### 6.2.1 Weather



The severely cold weather between Christmas 1995 and the year-end gave rise to the highest claims peak, but on the graph this is plotted against 1996 Q1. Some of the cost is due to claims for damage from pipes bursting when the thaw set in. This happened over a period when many homes and premises were empty, thereby making the situation much worse. The spike shows that the cost was around £300m, which, while severe, was nowhere near the £2bn cost of the storms in January 1990.

The overall trend in the graph has been upwards since the end of 1995. The moving average has doubled within the past five years. Over the same period the RPI has increased by around 11%.

There were no major UK weather events in 1996 and 1997 but 1998 saw particularly bad

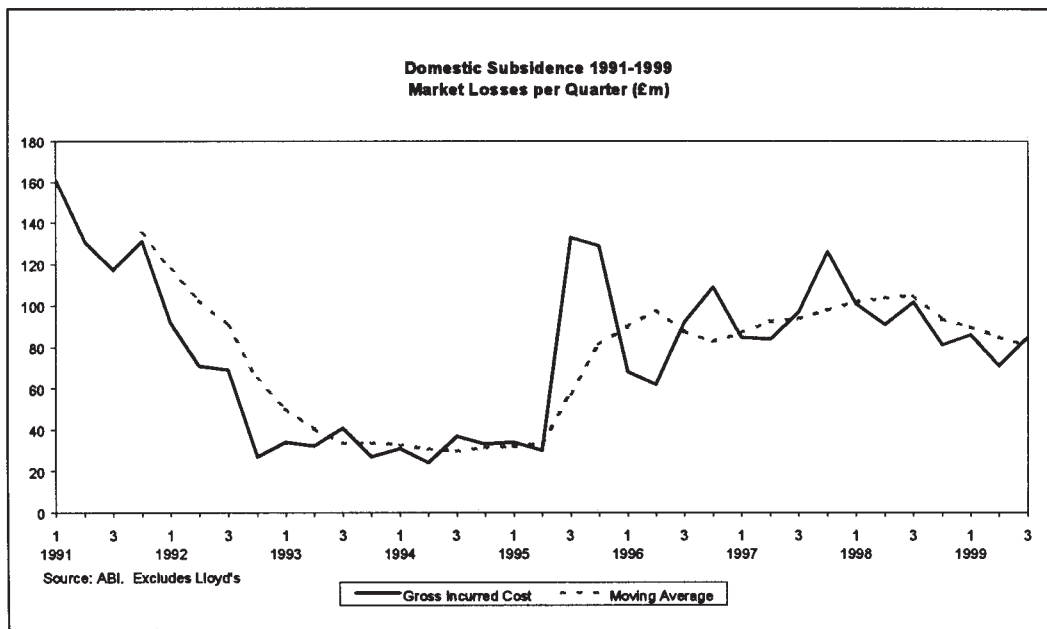
weather with major events in three out of the four quarters. This consisted of heavy storms and flooding in January, severe flooding over the Easter weekend and violent storms over one weekend in October.

Storms battered Northern Ireland and Scotland over the Boxing Day weekend of 1998. 1999 started with storms battering North-West Britain again. Although neither one of these events was very serious in themselves, together their cost was quite high.

1999 ended with some severe weather in December. This consisted of snow in the Midlands near the start of the month and flooding along the south coast nearer Christmas. Overall, the costs are expected to be typical for a winter month.

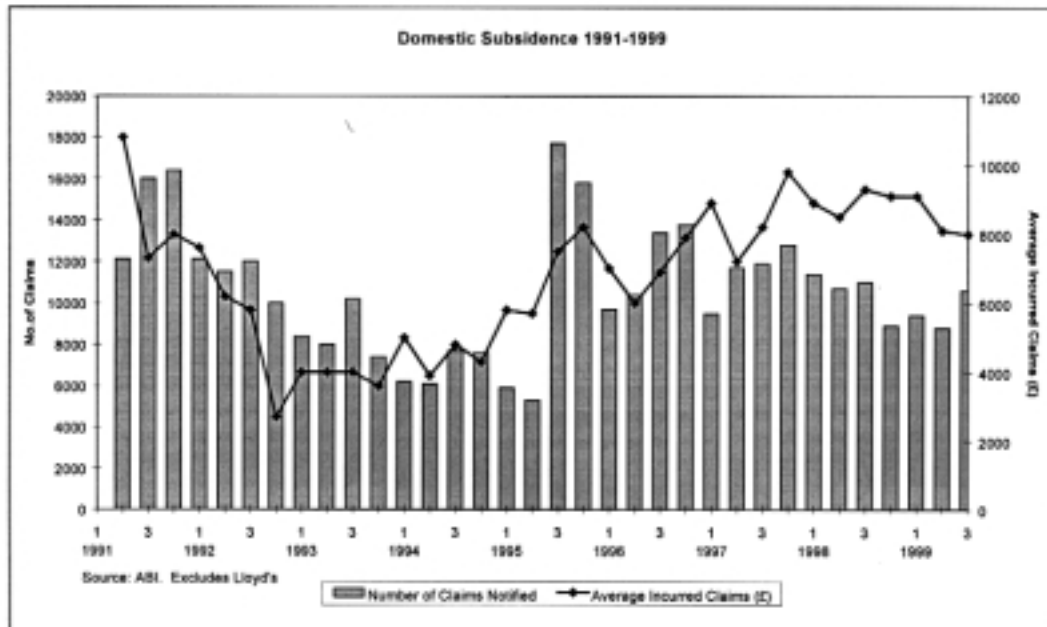
Western Europe, in particular France, was hit twice by hurricane strength winds on the 26th and 28th of December. The weather caused extensive damage, including one quarter of the high-tension electricity grid and up to 60% of roofs in some parts of Paris requiring repairs. Estimates of the insured loss have been up to £4bn pounds. The severity of the windstorms is certainly on a par with the 1987 and 1990 storms in the UK. For such storms to track through France is even more unlikely than tracking through Southern England. The French storms appear to confirm an expected increase in the incidence of multi-billion pound windstorm damage events in the UK.

### 6.2.2 Subsidence



Following a relatively consistent level of total claims cost during the second half of the 1990s, market losses began to fall during the second half of 1998, and have continued to do so during 1999. The losses are still at a much higher level than between 1993 and 1995.





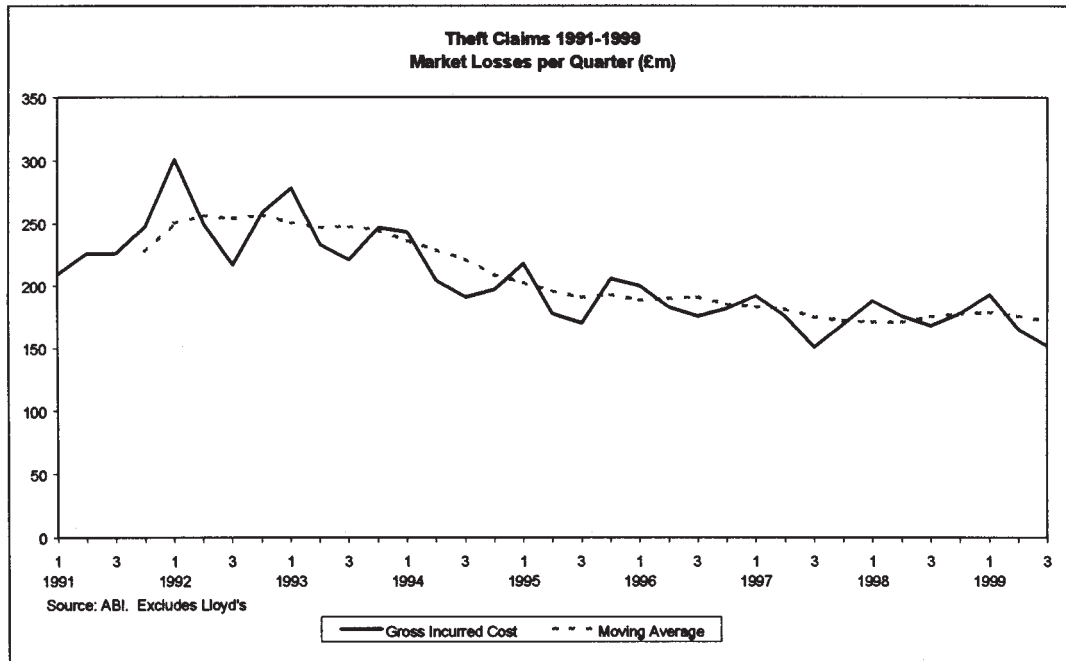
The number and average cost of subsidence claims are closely linked to the level of drought. 1995 was a particularly dry year, which partly explains the high cost of claims that year. 1998 and 1999 have been reasonably wet years. However there can be a significant delay between the period of drought and the subsidence being discovered and reported to the insurer.

It is difficult to estimate the cost of subsidence claims in their early stages. For instance, the high cost of claims in 1995 and 1996 is due partly to insurers strengthening claim reserves after taking an overly optimistic view of claims costs in the preceding years.

As mentioned in the section on the economy there has been a boom in the housing market. There had been a fear that this would lead to a higher number of claims as houses were surveyed in connection with sales. The graph shows a decrease in the number of notifications over the late 1990s so this problem does not appear to be too severe.

Average claims costs have doubled over the period from 1993 to 1999. Over the same period the house rebuilding cost index has increased by about 25%.

### 6.2.3 Theft

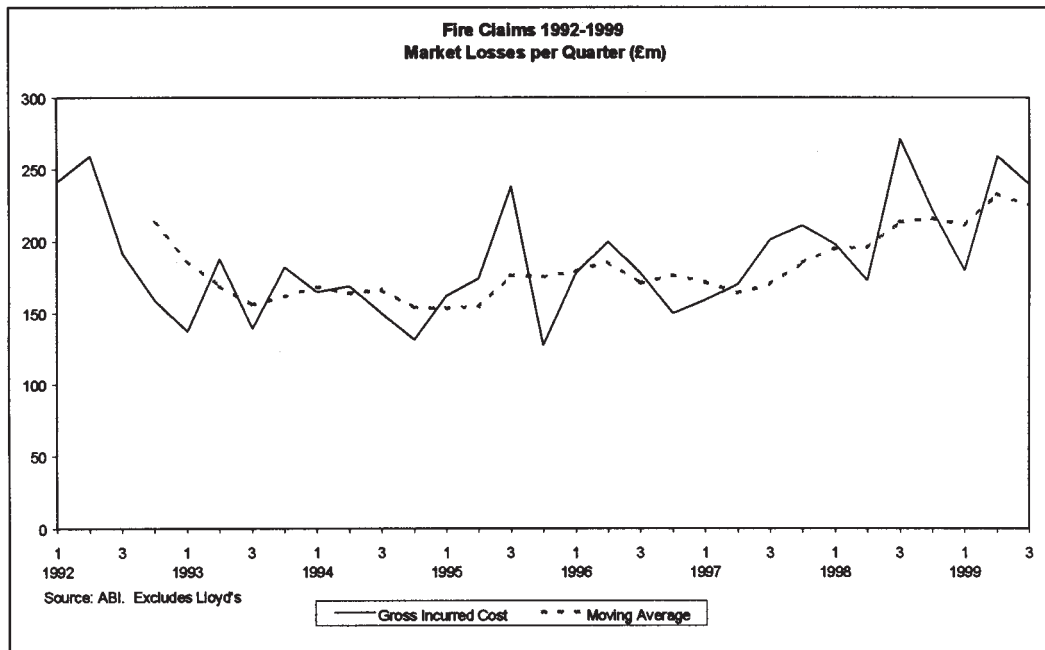


There has been a steady decline in the overall cost of theft claims over the last eight years. The number of theft claims is correlated with the level of unemployment, which has been decreasing since early 1993.

Improvements in anti-fraud measures over the last few years, especially the computerised pooling of information on claims and claimants, will also be helping to reduce theft claims.

There is a seasonal pattern to the figures. The losses in the first quarter are generally higher than those in the fourth quarter. In turn these are generally higher than the second quarter figures with the third quarter losses generally being lowest each year.

## 6.2.4 Fire

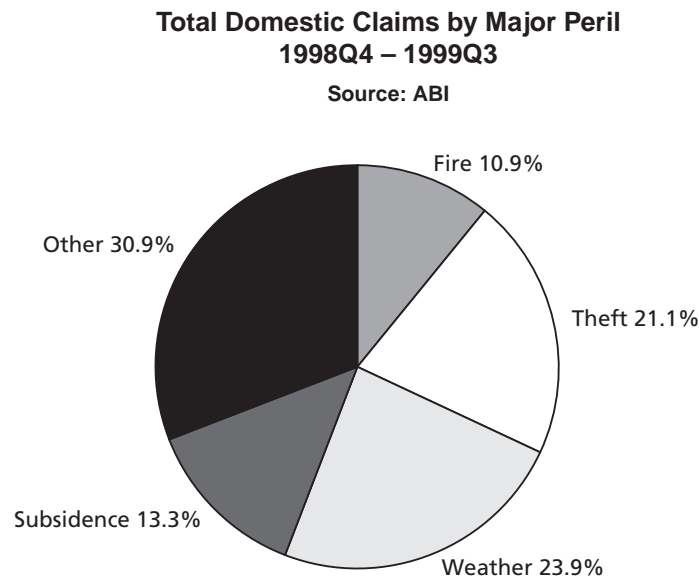


The figures displayed relate only to property damage resulting from fire. Most commercial property claims (such as fire or weather claims) also incorporate claims for business interruption. There is a steadily increasing trend in the cost of fire-related claims.

Occasionally fires lead to very large claims, hence the erratic nature of the gross incurred cost. For example a fire in Covent Garden, London in September 1999 is expected to cost around £20m (although some of this is for business interruption claims). A claim of this magnitude can represent about 10% of the claims cost in a quarter.

The erratic nature of the incurred cost reflects an underlying distribution of apparently huge variance. This looks like an area where extreme value statistics could be of benefit. A very crude application to the above data suggests a return period of approximately 20 years for a quarterly claims total in excess of £350m and a return period of over 250 years for a quarterly claims total in excess of £500m.

### 6.2.5 Total Domestic Claims by Peril



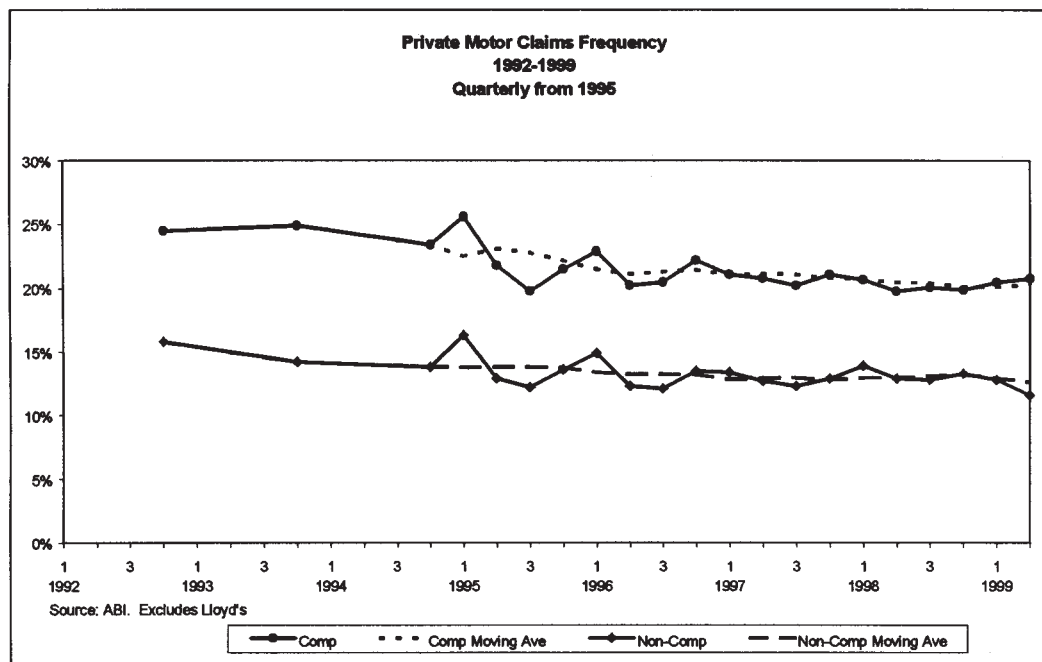
This chart shows the split of household claims by peril for the last year (1998Q4-1999Q3). This has been included to help put the previous sections into context, at least for household claims.

The majority of claims are classified as arising from 'other' perils, which account for 30.9% of the total cost of household claims. Most of these claims are in respect of accidental damage and 'all risks' where the proximate cause is not necessarily captured.

The proportion of the claims cost attributable to weather will be the most variable element. The fourth quarter of 1998 had some bad weather but 1999 has been a good year for weather claims. Therefore the weather cost shown here (23.9%) is, if anything, on the low side.

### 6.2.6 Motor

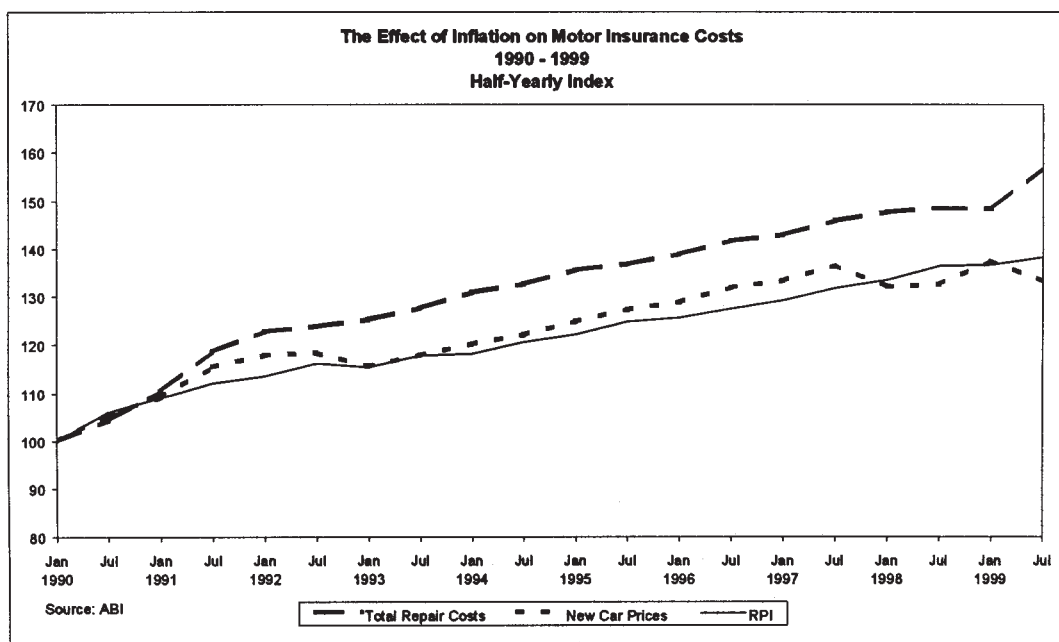
The long tail of the third party bodily injury element of motor claims makes measurement of trends difficult over short periods of time. For this reason the cost is traditionally split into two components: the incidence or frequency of the claims and their average cost. The frequency can be measured readily because of the understandably quick reporting of motor claims after the accident.



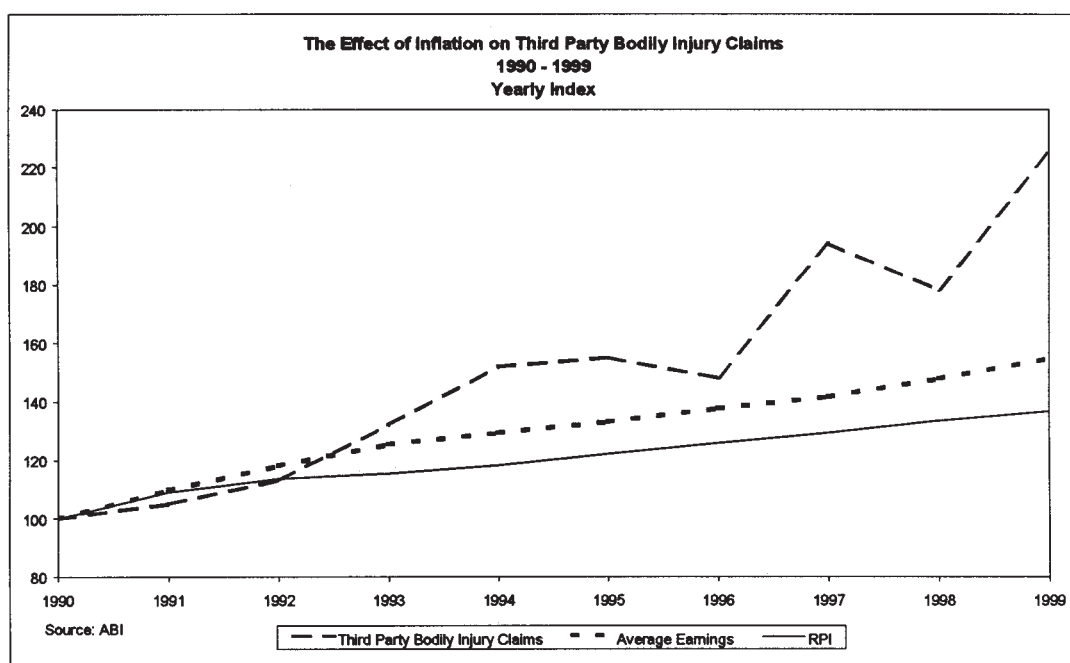
There is great similarity in the trends in the claim frequencies of comprehensive and non-comprehensive policies, although comprehensive policies claim more frequently since the cover is wider. The 1990s have seen a remarkable downward trend in claims frequency.

Seasonality can also be observed from the graph. Claims in the first quarter of the year, when the weather is generally at its worst, are usually significantly higher than during the rest of the year. Over the latter half of the decade the seasonal variation also appears to have reduced.

The cost of motor claims is often considered in two parts, vehicle damage and bodily injury, because of their differing characteristics.



The graph shows a high level of consistency between the level of inflation in vehicle repair costs and retail price inflation.



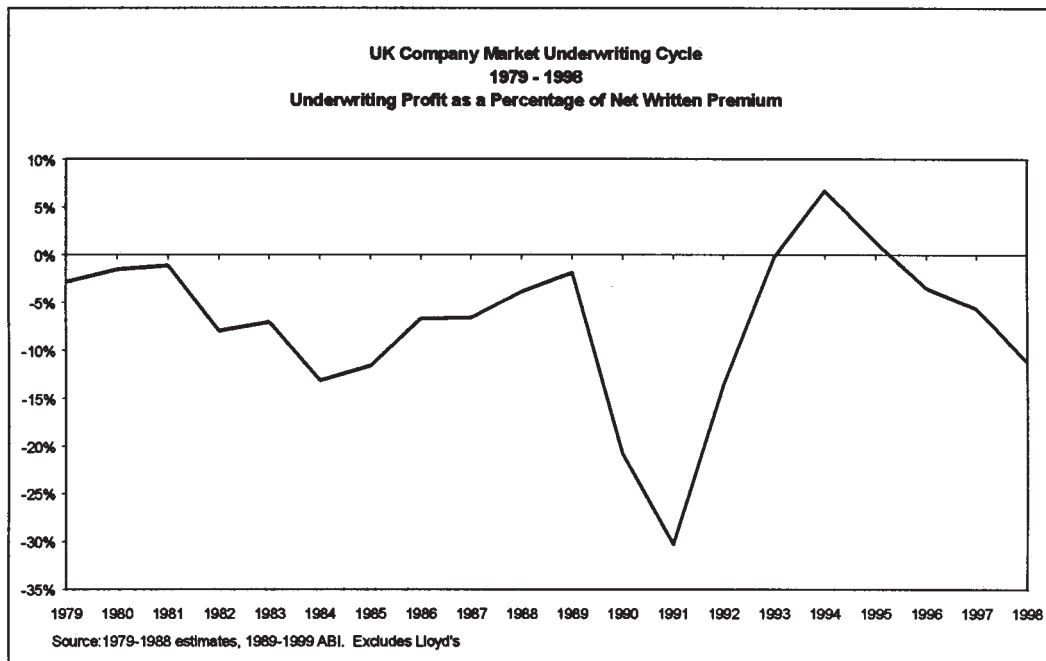
The picture is very different for bodily injury claims. A better comparison for bodily injury claims is the average earnings index, because a major part of injury claims relate to loss of earnings.

The graph shows that the cost of third party bodily injury claims has increased much more rapidly than average earnings. This has been accompanied by an increase in the frequency of bodily injury claims. Some of the reasons for these changes are discussed in the following pages.

Over recent years the proportion of claims costs which relates to bodily injury has risen, now making up roughly one third of the cost of motor claims. Over both property damage and bodily injury claims, typical estimates are that average claims are rising at about 6% pa. As the overall frequency has been dropping the overall costs have been rising by less than this.

1998 saw large underwriting losses for motor insurance across the industry. The operating ratio (incurred claims divided by earned premium plus expenses divided by written premium) was around 125%. 1998 was expected to be the bottom of the cycle as insurers started to implement rate rises in 1999, particularly in the latter half of the year. This should lead to a modest improvement in the results but the difference will not be fully felt until the increases work through to the earned premium in 2000.

### 6.3 The Insurance Cycle



The graph shows the underwriting result for the company market. Profitability has continued to drop during 1998. This is in part due to 1998 being a particularly bad year for weather claims, as mentioned earlier, whilst claims costs in some classes, especially liability, have increased much more quickly than inflation. The other major factor is the level of competition in the market that has kept prices low.

Hopefully 1999 will be an improvement on 1998. Weather costs have been moderate, and rate rises have been implemented, particularly in motor classes.

### 6.4 Legal Issues

The legal environment influences claims experience on many fronts. The main legislative issues currently affecting insurers are outlined below. The impact of individual issues may not be great, but taken as a whole they add to the costs experienced by insurers.



#### 6.4.1 Road Traffic (NHS Charges) Act

Under the Road Traffic Act 1988, hospitals are entitled to claim back in-patient and outpatient costs up to specified maxima. The Government has been recommending that hospitals recover these costs, as highlighted in 'Current Topics 1998'.

In an attempt to achieve the Government's stated aim of full NHS charges recovery, the NHS Charges Act introduces changes in respect of the recovery of NHS hospital charges arising from road traffic accidents. The administrative arrangements for the collection of NHS charges are to be centralised and will be recovered by the Compensation Recovery Unit (CRU). The changes will increase motor account personal injury claim costs.

Charges are recoverable only where there has been a compensation payment for an injury or death as a result of a road traffic accident and the traffic casualty has received treatment at a NHS hospital in respect of their injuries.

The amount to be charged will depend on whether the accident occurred before or after 2nd July 1997. If the settlement date is after 5/4/99 the new charges are as follows:

Accident	Charges
Pre 2/7/97	In-patient: daily rate of £435 up to maximum of £3,000. Out-patient: a flat charge of £295, regardless of treatment.
After 2/7/97	In-patient: daily rate of £435 up to maximum of £10,000. Out-patient: a flat charge of £354, regardless of treatment.

Insurers must advise the CRU of all claims where a person receives NHS hospital treatment as a result of the use of a motor vehicle on the road. The new arrangements apply to Motor Insurer's Board uninsured or unreported claims only for accidents on or after 5/4/99.

#### 6.4.2 Access to Justice Bill

This Bill replaces the Legal Aid Board with a new Legal Services Commission. It restricts the range of cases currently funded by Legal Aid, simplifies the civil court procedures, and speeds them up. The Bill received Royal Assent on 27th July 1999.

Conditional Fees Arrangements (CFAs) are popularly known as No Win, No Fee. In a CFA, the solicitor agrees to be paid only if he succeeds in recovering damages. If the solicitor is successful, he is entitled to a success fee, which is normally agreed with the claimant as a percentage of the normal fees charged. Claimants normally take out insurance to cover the defendant's costs if they lose.

In the Access to Justice Bill, there are two provisions in particular that concern insurers. In relation to CFAs, the Bill proposes:

- Making the success fee recoverable from the losing party (normally the defendant's liability insurers)
- Making the insurance premium recoverable from the losing party (normally the defendant's liability insurers).

If a CFA is operating in relation to a particular claim, then insurers will be notified. They will be told the percentage success fee and the insurance premium paid. The court will have discretion to decide whether the success fee should be recoverable.

The effects on costs, following the changes to CFAs, are difficult to gauge, but an increase is possible. Following the Bill gaining Assent, solicitors are more likely to turn down speculative claims that have little or no chance of success.

#### **6.4.3 Law Commission Report 257 - “Damages For Personal Injury: Non-Pecuniary Loss”**

This report recommends reform in two areas, namely the law governing the assessment of damages for non-pecuniary loss (i.e. damages for pain, suffering and loss of amenity) in personal injury cases and the role of juries in the assessment of damages generally.

The report recommends that:

1. Damages should be increased by at least 50%, but not more than 100% where the current award for non-pecuniary loss would be over £3,000
2. Damages should be augmented by a series of tapered increases of less than 50% where the current award for non-pecuniary loss would be in the range between £2,000 and £3,000.

The Report recommends that the proposed increases would best be implemented by higher courts exercising their powers to issue guidelines in a case or series of cases. However, if the above recommendations have not affected the level of awards in personal injury cases within a reasonable period of time, e.g. 3 years, then legislation should be enacted to achieve this.

The Report is addressed to the Lord Chancellor, who has not yet made a decision on whether to implement its recommendations.

The cost of these reforms to the insurance industry is difficult to gauge. Modelling was carried out by PriceWaterhouseCoopers, for the ABI, based on claims data collected two to three years ago. This suggests insurers should increase premiums on Motor and Employers’ Liability by 5% and 18% respectively to offset the increase in claims costs. This assumes the maximum possible increases suggested by the Law Commission are applied.

In February 2000 a special week-long hearing, in front of 5 judges at the Court of Appeal, will listen to arguments for increasing payments over the full range of personal injury categories. The main area of compensation examined will be injury in terms of pain, limitations on bodily capacity and inability to enjoy leisure activities.

The decision of the Court is a common law one, if any framework is updated it has to take immediate effect. There is the potential for a substantial hit to the insurance industry as a consequence.

#### **6.4.4 Woolf Reforms 1999**

A new era for civil justice in England and Wales began on 26th April 1999. The key areas covered in the Woolf reforms are:

- Unified rules for the High Court and county court, simplifying procedures and removing the anomalies created by local practice
- A higher small claims limit for most cases, increasing the number of people able to bring their disputes to court without fear of high legal costs
- A new Fast Track for straightforward claims valued above the small claims limit and up to £15,000, with standardised procedures and timetables
- A new Multi-track for more complex or higher value claims, where directions and timetables would be case-specific
- New rules dealing with disclosure and experts
- Pre-action protocols and claimant offers, both designed to encourage settlement at the earliest opportunity
- Across the landscape, the concept of proportionality: that the time and cost invested in a case should be proportionate to the value of the claim and the issues at stake.

A review on the effects of the reforms, in the form of a conference attended by Designated Civil Judges and Court Service Managers, took place on the 16th July. The meeting reported very few appeals, generally fewer interim applications and more co-operation between parties.

It is difficult to assess the effect of the reforms at the moment. The influencing factor will be the risk-aversion of the solicitors concerned in deciding whether to adopt a case or not. It is likely that solicitors will be more risk-averse than the Legal Aid Board, but the lure of the success fee may balance out any natural aversion to avoid certain cases.

Even when the first batch of trials under the new regime is complete, there will be some difficulty in assessing effects, due to the existence of significant numbers of transitional cases in the system. Transitional cases are those being brought forward in order to avoid the stay that will be imposed if there has been no interaction with the court within twelve months of 26th April 1999. Thus it will be at least 18 months after the reforms were introduced before the true Civil Justice Reform landscape emerges.

Current indications are that the number of new cases being brought has dropped noticeably and lawyers are prepared to negotiate earlier. The reforms may therefore lead to reduced costs for insurers through lower legal expenses.

#### **6.4.5 Year 2000 issues**

In advance of the event, speculation had been rife concerning the possible effects of the roll over to the year 2000. This discussion will not re-tread old ground concerning possible scenarios following the date change, we would rather seek to encapsulate the post-change environment.

In these early days since the event it is impossible to call catastrophe or hoax, although the press seemed to pick up on the lack of disastrous tidings immediately after the new year:

*“Relief world-wide as millennium bug fails to bite” - FT 3rd January 2000*

In the article Robin Guenier, head of Taskforce 2000, was quoted as saying “It is a promising start but too early to say what the outcome will be”. The most relieving detail was that positive reports were coming out of the large eastern nuclear powers, Russia, Ukraine and China.

On 4th January, the editorial in the FT asked “*What 2K?*”. The editorial questions the large spend on preventative measures, but strikes a continuing note of caution in asking whether we know if disaster has been averted or not.

By the end of the first working week, the FT was investigating “*The Hidden Benefits of Y2K*”.

Major Y2K-associated claims do not appear to have arisen, however the issue of remediation costs (those costs associated with preventative action taken to guard against the Millennium Bug) may yet turn out to be significant to insurers with US exposure. US property business usually contains a “Sue and Labor” clause which provides cover for expenses of preventing imminent loss or damage. It is this clause which is at the centre of several US cases regarding Y2K.

In the U.K. no specific Y2K legislation exists, so the claims environment would appear to be much less risky. However, at the current time, despite initial positive experience, the prudent view would be to hold back on drawing a line under the event for some time to come.

#### **6.4.6 Recovery of Hire Charges from Motor Vehicle Insurance**

A credit hire company supplies replacement vehicles to claimants following a road accident. The hire charges are not paid by the claimant: instead, the motorist’s cause of action against the person at fault is pursued by the hire company in the motorist’s name, and the credit hire fees are included in the damages recoverable from that person.

Recent growth in the use of credit hire firms by claimants has resulted in higher third party costs to motor insurers. Firstly, the cost of hiring replacement vehicles from a credit hirer may be much higher than the cost of using an ordinary car hire company. Secondly, credit hire firms may encourage the claimant to claim for minor bodily injuries, such as whiplash.

The decision of the Court of Appeal in *Dimond v. Lovell* considered the legal implications of the use of credit hirers by claimants. *Dimond v. Lovell* raises issues as to the status of credit hire agreements and as to the right of credit hire companies to recover their charges from insurers by way of damages.

Credit Hire agreements fall within the strict regulatory controls of the Consumer Credit Act 1974 unless they include provisions making them exempt. Agreements are therefore unenforceable if they do not include a stated cost figure at the time of making the agreement. In this case the Consumer Credit (Agreements) Regulations were not complied with. Thus the credit hire agreement supplying a vehicle had been ‘improperly executed’.

In principle, damages for the hire of a replacement vehicle are recoverable as a recognised form of loss where the need for a replacement vehicle can be shown. However the claimant is under duty to mitigate any loss, and the Court of Appeal recognised that if a claimant has acted unreasonably in incurring hire charges, the full cost is not recoverable from the wrongdoer.

The three judges of the Court of Appeal differed in their views of this case. Sir Richard Scott V-C and Lord Justice Thorpe agreed that it was reasonable for *Dimond* to rely on the advice of her broker, assuming the broker would have knowledge of the market.

Lord Justice Judge was more sceptical, emphasising that in every case it was necessary to assess whether it was reasonable for the claimant to take advantage of credit hiring services.

The viability of credit hirers depends on how the Court of Appeal's decision operates in practice. The majority view is relatively lenient and places little emphasis on shopping around. The opposing view implies that a claimant will only be able to justify the use of credit hirers if there is an urgent need for repairs and there is little opportunity for shopping around. Further clarification will be required from the courts in due course.

#### **6.4.7 Ogden**

The Ogden tables were produced by a working party of actuaries and lawyers, chaired by Sir Michael Ogden. They give multipliers, for each age and sex of claimant, at various discount rates, to be used in determining compensatory lump sum damages in personal injury cases.

In the introduction to the first set of Ogden tables the working party argued that the most appropriate way to invest a compensatory lump sum would be in Index Linked Government Stocks (ILGS). The Ogden working party was of the opinion that a claimant should not bear the investment risk inherent in stock market returns.

In October 1996 the Court of Appeals, in reference to the cases of *Wells v. Wells*, *Thomas v. Brighton Health Authority* and *Page v. Sheerness Steel Co. Ltd.*, concluded that a claimant who receives a large damage award is likely to receive investment advice. Hence, a strategy of investing 100% in ILGS was overly risk averse. This led the Court to recommend a set of multipliers with a 4.5% discount rate.

The House of Lords passed its judgement on the appeal to the above decision in July 1998. The Lords overturned the Appeal Court's verdict, recommending that the claimant should not have to bear any investment risk. Thus a discount rate of 3%, using the latest edition of the Ogden tables, was suggested, reverting to the idea of investment in ILGS.

The 1996 Damages Act gives the Lord Chancellor the power to prescribe a discount rate when using multipliers. However no decision has been taken in this regard.

In April 1999, the Ogden working party convened once more. When the working party met the yield on ILGS was 1.72%, and had been consistently below 2% since December 1998. The meeting concluded thus: 'the Working Party would prefer the Lord Chancellor to set the rate pursuant to the power conferred on him by the Damages Act 1996 Section 1'.

The effect of moving to a 2% discount rate can be seen in the following table (figures from 3rd edition of the Actuarial Tables for use in Personal Injury and Fatal Accident Cases):

For a 30-year-old male, with retirement age 60 (using prudent mortality assumptions):

	<b>Ogden @ 3% Discount</b>	<b>Ogden @ 2% Discount</b>
Multiplier	19.49	22.12

The change amounts to a 13.5% increase in the cost of "loss of earnings" compensation.

#### **6.4.8 Financial Services and Markets Bill**

The Financial Services and Markets Bill has been pending for some time.

Since the Government announced its proposals to introduce legislation to reform the regulation of financial services in May 1997, steps have been taken to transfer responsibility for regulation to the Financial Services Authority.

In July 1998, the Treasury published a paper entitled 'Financial Services and Markets Bill: A Consultation Document' which explained its policy and included a draft of the Bill.

By November 1999, the FSA had issued 35 consultation papers and feedback statements covering a range of topics. This has been part of its wide ranging consultation on the way it proposes to use its powers.

The Bill provides a framework within which a single regulator for the financial services industry, the FSA, will operate. From the insurance perspective, the Bill makes provision, amongst other things, for:

- The Insurance Ombudsman's duties falling under the remit of the FSA Ombudsman
- Staff training and competency standards will apply to insurers
- The definition of the scope of regulated activities
- The Society of Lloyd's to become an authorised body
- The FSA to direct the affairs of the Society of Lloyd's, its members, managing agents and members' agents
- Powers of the FSA to authorise, regulate, investigate and discipline authorised persons.

The Bill is intended to co-ordinate and modernise financial regulatory arrangements which are currently established under various enactments, including the Insurance Companies Act 1982 and the Financial Services Act 1986.

As yet, only consultation papers have been published covering the above areas. The final content of the Bill is unknown at this stage. However, the overall effect of the Bill is not expected to be as significant for general insurers as other developments, such as:

- The repeal of the Insurance Brokers Registration Act, heralding the arrival of the General Insurance Standards Council
- The Competition Act, regulating anti-competitive behaviours in the insurance market
- The Data Protection Act, making consent a requirement for insurers to use the information they hold about a policy for marketing or other purposes.

## 6.5 Consolidation, Mergers & Acquisitions - Companies

Since the last Current Topics paper in 1998, market consolidation has been a noticeable theme in the UK marketplace.

The main mergers of note were that of Commercial Union with General Accident to form CGU, and Eagle Star with Zurich. Take-over activity has been much more evident

In 1998		Acquired	
	Norwich Union		ITT London & Edinburgh
	Allianz (Cornhill)		AGF
	Groupama (Lombard)		GAN
	Norwich Union		Renewal rights to St Pauls (Personal lines)
	NIG		Hibernian's UK business

In 1999		Acquired	
	AXA		Guardian
	Bishopsgate (Fortis)		Northern Star
	Ecclesiastical		Ansvar
	Norwich Union		Royal London portfolio
	Liverpool Victoria		Landmark
	Management		Admiral
	QBE		Iron Trades
	Direct Line		Green Flag
	Churchill		Renewal rights to United Friendly business

### 6.5.1 Reasons for consolidation

There are several possible drivers for the recent wave of consolidation:

- One of the overriding forces behind consolidation is achieving economies of scale and expense savings. Areas where cost savings arise include reinsurance, IT, property, marketing and bulk buying from suppliers of goods and services. The focus on savings reflects an increased emphasis on shareholder value driving much of the consolidation taking place
- Insurers seem to be aiming to gain a certain critical mass in order to establish themselves not just in the UK, but on the international stage. This may allow them to adopt a defensive posture against overseas bidders
- Merger and acquisition is a tool in building a real value brand
- Consolidation will raise the company's profile and capital base, leading to greater partnership opportunities
- Consolidation gives companies more data, allowing greater market segmentation and targeted pricing



- Consolidation may also be seen as a method of fanning the corporate ego. The quest for titles such as “Market No. 1” can sometimes overrule the business case behind any merger or acquisition.

### **6.5.2 Moves Into Insurance**

Brands from outside the insurance sphere have impressed themselves onto the market in recent months and years. Large companies with a customer database to match are moving into insurance in an attempt to maximise the value of those customers.

The main markets of interest have been non-motor products, but companies are beginning to move into the remaining personal lines.

Companies making acquisitions to position themselves as insurance-capable include Ford and Centrica, purchasing Kwik-Fit and the AA respectively.

## **6.6 Consolidation, Mergers & Acquisitions - Brokers**

Brokers have been an area of intense consolidation activity for several years now. By 1998 there were just 5 main brokers: Marsh, Willis Corroon, Lambert Fenchurch, Jardine Lloyd Thompson, and Aon.

This consolidation has happened following:

- Changes in distribution channels used to buy general insurance. Direct sellers, over the telephone and prospectively over the Internet, have changed the market place unequivocally. Most brokers now have a tele-broking arm
- The commoditisation of insurance in the mind of the consumer has led to increased competition
- Customer loyalty for personal lines cover has also reduced significantly, leading to a shortening customer lifetime over which acquisition costs may be recouped.

### **6.6.1 The Future**

It would certainly appear that mergers and acquisitions will continue to be a fixture of the insurance landscape in the future. Exactly how such activity will manifest itself is the question on everybody’s lips (and one this paper does not attempt to answer).

The outlook is for “Broker merger boom to continue” according to Post Magazine 7th January 2000. The article referred to a study by Insurance Merger and Acquisition Specialists predicting that the level of investment needed for brokers to continue to compete in a changing technological environment will inevitably lead to more mergers.

## **6.7 Developments in Risk Analysis**

This section was kindly contributed by James Orr, the Tsunami Project Director. Tsunami is a government sponsored initiative to increase the application of scientific research results to general insurance.

### 6.7.1 Extreme Value Statistics

With the increased reliance on excess of loss reinsurance and higher deductibles common in commercial business, the focus of analysis is turning from normal observed values (eg in pricing motor business) towards extreme values. Extreme Value Statistics techniques were originally developed by engineers to look at failure rates, such as over-topping of flood barriers or fibres breaking in a rope.

Two useful results should be mentioned:

The Generalised Extreme Value distribution describes, under loose conditions, how maximum observations (say, within a year or within subgroups) will be distributed. The probability function is described using three parameters, representing location, scale and shape. The shape parameter describes whether the tail of the distribution will be finite (if it is negative) or infinite (non-negative).

The Generalised Pareto Distribution describes, under assumptions that can be tested using a plot of the mean value of observations above a threshold, how points in excess of a certain value will behave. The probability function is again described using three parameters, representing scale, shape and the threshold. This distribution is particularly useful in pricing excess of loss reinsurance contracts or contracts with high deductibles.

### 6.7.2 Bayesian Statistics

Bayesian statistics allows the blending of *prior* judgements, for instance expert opinions, with observed data to arrive at *posterior* estimates of a distribution.

Recent advances in computing power and the ease of simulation have enabled the use of Markov Chain Monte Carlo (MCMC) techniques. These can be used to estimate *posterior* distributions in circumstances where the likelihood surface of all possible parameter values is too complex to use more traditional optimisation techniques. In addition, by using an MCMC to search the space of likely parameter values, estimates of the uncertainty attaching to those parameter values can be made.

Bayesian statistics can also be used to create “Bayesian Networks”. These are similar in form to neural networks, but are based on joint distributions that describe the relationship between variables at each node. These networks can be constructed through an interview process, with an expert, in order to understand the interaction between key descriptor variables. A network of these key factors (say, age and sex of driver, linked to year of passing test, linked to size of car engine) can be set up and *prior* distributions established.

The *prior* distributions can then be updated using emerging experience, in a similar fashion to “learning” in a neural network. However, the major advantage of a Bayesian Network is that the joint distribution at each node can be viewed and a probabilistic meaning attached to it.

### 6.7.3 Catastrophe Models

A significant number of insurance and reinsurance operations now rely on catastrophe models to assess the risks they face from natural perils, such as windstorm, flood and earthquakes. These models have three key elements:

Exposure -	a description of the properties that are exposed to loss that may lead to an insurance claim, for example, a brick-built bungalow worth £60,000
Hazard -	to which the properties are exposed, described in terms of both probability and severity
Vulnerability -	of that property to a given hazard (say, one metre of water, will destroy 25% of the property's value).

By simulating the passage of a large number of different hazard events over the property portfolio of an insurer, a loss distribution for that portfolio from a particular hazard can be estimated.

Close attention should be paid to the potential impacts of climate change on observed extreme weather events and changes in building practices and regulations.

### 6.7.4 Medium-Range Weather Forecasting

Significant progress has been made in recent years in the production of medium-range weather forecasts, which estimate conditions over a number of months or even years in advance. Again, computing power has played a role, but the main driver for this has been the collation of high quality meteorological data that describes the world's climate going back a number of decades.

In recent years, insurance against "Weather Risks" has become increasingly popular. For instance, energy companies have bought "Weather Risks" contracts to provide protection against a mild winter, when demand for fuel will be less than expected. Such a contract would be based on the sum over winter months of the daily average temperature falling below a threshold value, called "Heating Degree Days". If the number of Heating Degree Days is less than a particular value, temperatures will have been higher than expected, the energy company will have had less income and a payment is made under the contract.

Although these are not pure insurance contracts, as payment is not linked directly to an incurred loss, they can be expected to increase the interest in and demand for medium-range weather forecasts. If these forecasts should become sufficiently reliable, then insurers may use them to make judgements on the risks that they will face in the coming year(s), as a basis for pricing and reinsurance decisions.

### 6.7.5 Integrated Risk Management

In looking at risk assessment from an insurance perspective, it is important to be aware of developments in the risk management community. The main professional body, AIRMIC, has produced a booklet on "Integrated Risk Management", which sets out how a company (in any industry) can look at the risks that affect its results and even its future survival. This process involves the identification of critical risk factors, to create a risk register. This may include reputational, environmental, currency or even weather risk.

These key risks are then analysed, perhaps through interviewing experts on the impact of those factors, and quantified in terms of both probability and potential impact. This information can then inform the risk management strategy of the company, say through choosing mitigation, transfer (insurance) or retention options. Of course, “Integrated Risk Management” may also be applied to insurance and reinsurance operations.

The importance to the general insurance industry of these developments is that the risk register and accompanying risk assessments will define the agenda of many insurance buyers (that is, the risk managers). Some of the risks that they identify (such as reputational risk) are not commonly insured. The challenge will lie in understanding these risks and developing products that provide protection at an acceptable price to customers and at an acceptable cost to insurers.

## **6.8 Lloyd’s**

Over the last decade Lloyd’s saw major change. It underwent a huge restructuring, setting up Equitas to reinsure all of the 1992 and prior liabilities of Lloyd’s syndicates. This allowed a line to be drawn under the past losses and a fresh start to be made.

Traditionally in Lloyd’s, capital was raised from individual members, called ‘names’, who used their personal wealth to back the insurance contracts. Their liability was unlimited. In 1994 Lloyd’s allowed corporate members for the first time. That year they provided £1.6bn or 15% of total capacity. By 1999 this had grown to around £9.5bn or 73% of the capacity. The number of names has dropped from a peak of 34,000 in 1988 to around 6,000 now.

Corporate members have been attracted by record profits in some of the years since Equitas was set up. However, the last few years have not been so rosy and some corporate members have started to withdraw from the market. Seven syndicates were put into run-off at the end of 1999. 91% of their capital came from corporate investors.

There have been predictions of losses of £68m for 1997 and £500m for 1998 and a minimum of £346m for 1999. The position is not expected to be much better in 2000 as there is too much spare capacity in the market.

Lloyd’s has a Central Fund which operates as a safety net for the whole market. Each syndicate makes contributions to it and if they trade particularly badly they can draw on its funds. In effect the poorer performing syndicates are subsidised by the more profitable ones. This system came under pressure as the capital supplied by corporate members increased. Corporate capital providers are in competition with each other and have no reason for wanting to bail out a fellow corporate member. As a result of this, in April, Lloyd’s decided that the fund would be reinsured. Six leading reinsurers agreed to provide cover.

Another traditional feature of the Lloyd’s market is the ‘annual venture’. This is the system whereby investors commit capital for one year at a time. Three years after the start of each underwriting year the year is closed. The outstanding losses are assessed and reinsured, usually to the next underwriting year. This has been a good system in the past as it has allowed profits or losses to be crystallised and investors to leave Lloyd’s. However, it is costly and prevents underwriting for the long term. Providers of corporate capital are more interested in having a longer term investment and the ‘annual venture’ is expected to come under significant pressure over the coming years.

## **6.9 Professional Issues**

### **6.9.1 Position Statements**

The Institute and Faculty, from time to time, produce position statements. These aim to enable its officers, members of its Council and senior members of staff to respond to questions from the profession, the public and the media about important topical issues and developments.

The statements may be used as a background for public pronouncements. They are not formal guidance, neither are they a definitive expression of the views of the profession as a whole on the subject.

One such paper issued this year was titled ‘Availability of Personal Lines General Insurance’. This paper considered whether, for individuals deemed to be subject to a higher risk of loss, certain personal lines products were not available at an affordable price, eg houses at a high risk of flooding.

There is a danger of this happening because, as computers keep growing more powerful, insurers are using increasingly sophisticated premium rating tables. There is an issue of whether a minimum level of insurance cover should be available at a reasonable price as a human right.

The paper concludes that, at the moment, availability of insurance does not seem to be a problem but there is some evidence that affordability is an issue. It recommends that working parties be regularly set up to monitor the situation.

A paper the previous year made the case for introducing a statutory requirement that every company transacting general insurance business should have an Appointed Actuary with defined responsibilities for reporting on that business.

The responsibilities of the Appointed Actuary would probably be limited to start with but with the aim of moving to a situation where an annual report on the financial condition of the company would be prepared. This would form part of the company’s annual supervisory return.

Position Statements can be downloaded from the Institute website.

### **6.9.2 GN18 Actuarial reporting for general insurance companies writing US-regulated business.**

A revised issue of this guidance note applies from the end of 1999. It has been modified to make it consistent with GN20 and GN33 and to include new areas of reporting which relate mainly to trust fund reporting.

### **6.9.3 GN20 Actuarial reporting under the Lloyd’s valuation of liabilities rules**

GN20 was completely revised in December 1997. It reflects the requirement on Lloyd’s syndicates writing general insurance business to provide the Council of Lloyd’s with an actuarial opinion on their world-wide reserves.

As from 31st December 1998 the scope of the opinion was extended to include bad debt references including, in particular, reinsurance bad debts and unallocated claims-handling expenses. It has also taken on board a number of additional points including reinsurance exposure, year 2000 issues and other date-related risks.

In order to assist actuaries in dealing with the new developments, three papers have been prepared: Unallocated Loss Adjustment Expense Provisions; Reinsurance Bad Debt Provisions;

Millennium and other Date-Related Risks. These papers are being issued in association with GN20, under cover of an advisory note. The advisory note does not represent formal guidance from the Faculty and Institute of Actuaries and does not form part of the guidance note, although it is referred to in it.

#### 6.9.4 GN33 Lloyd's US opinions

A reviewed and updated GN33 took effect from 1st December 1999. It incorporates the specimen opinion wordings found previously in the advisory note. In addition the US opinions advisory note is being updated to take account of circumstances existing at the 1999 year-end.

#### 6.10 GIRO Convention 1999

The 25th Anniversary GIRO convention was held in Brighton in October. Around 350 people attended.

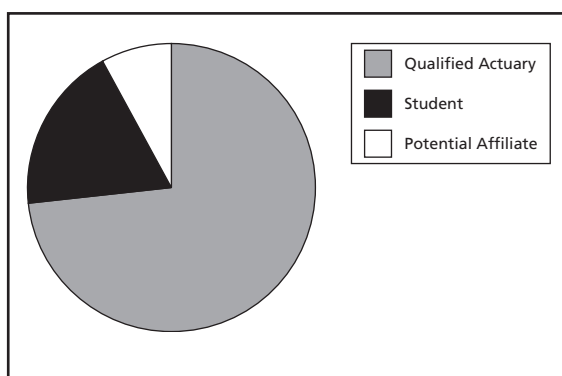
The convention consisted of a mixture of plenary sessions and a choice of workshops. GIRO depends on the participants forming working parties to look into current issues and do research. Many of the sessions were presenting the output of working parties from over the previous year. In fact, around one third of those attending contributed in some way to the material being presented.

There were also a number of guest speakers. These included Thomas Mack (Chain Ladder & Bornhuetter Ferguson - Some Practical Aspects), Tom Bolt (Developments in the Reinsurance Market) and Michael Tillett QC (Legal Developments).

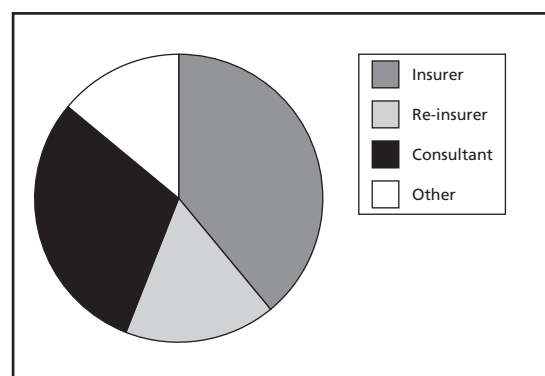
The final morning included a surprise session at which delegates used hand held units to vote on various questions and issues. The results appeared on a screen a few seconds after voting had happened.

The questions covered a mixture of population statistics, insurance issues and fun topics. Some doubt was cast on the reliability of the results when they showed that 13% of delegates did not know what sex they were! The following pie charts give a sample of the questions and answers.

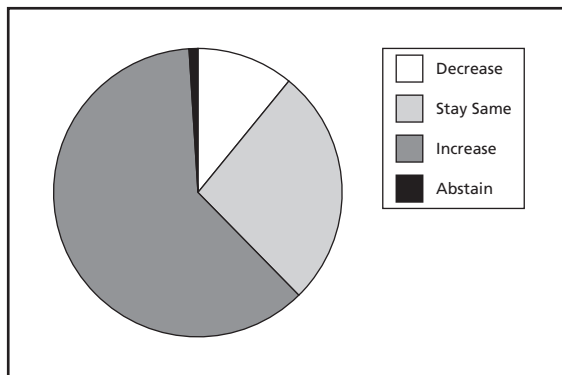
**Are you a ...?**



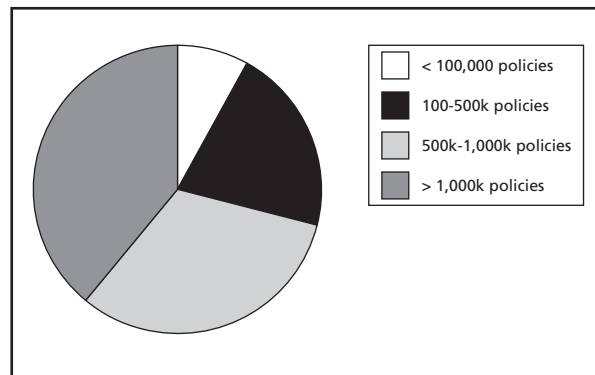
**Do you work for a ...?**



**Will the volume of business through direct writers in the next 5 years ...?**



**What volume of GI business will be done over the Internet by 2005?**



35% of delegates thought that the actuarial exams were too easy and 83% said that they would attend GIRO if it were held at Disneyland Paris!

Two books of papers were produced for the conference; they can be borrowed from the Institute or Faculty Library. The topics covered in them are:

- Practical 'Modern' Bayesian Statistics in Actuarial Science
- General Insurance and the Public Interest Working Party
- Bodily Injury Claims Working Party
- Vehicle Postcode Zoning Working Party
- Reinsurance Pricing Working Party
- Capital Allocation Working Party
- Alternative Risk Transfer Working Party
- Reserving for the Unknown Working Party
- Reserving for the Year 2000 Working Party
- Practical Tips for Efficient Generalised Linear Modelling Using SAS Under NT
- Woolf Reforms
- An Introduction to Personal Lines Premium Rating Techniques
- Pricing for Bodily Injury Claims Within a UK Private Motor Account
- Weather Derivatives/Insurance
- Integration of Insurance & Capital Market Products
- Mortgage Payment Protection Insurance
- Catastrophe Modelling
- How To Buy an Insurance or Reinsurance Company.

It is hoped that material from the other workshops will be posted on the Institute website in due course.



## 7 OFFSHORE LIFE INSURANCE

### 7.1 New Business Trends

The table below shows new business premium income for offshore life assurance companies as measured by the Association of International Life Offices (AILO).

<b>New Business Premiums (£m)</b>									
	<b>1991</b>	<b>1992</b>	<b>1993</b>	<b>1994</b>	<b>1995</b>	<b>1996</b>	<b>1997</b>	<b>1998</b>	<b>1999 (est)</b>
Regular Premiums	43	54	96	102	114	147	187	155	173
Single Premiums	512	710	1,231	1,739	1,405	2,118	2,974	3,314	3,387

Equivalent Annual Premiums have grown by 76% between 1994 and 1998. This compares favourably with onshore growth of 37% as measured by the Association of British Insurers statistics quoted in the Life Insurance section of this paper.

Growth in sales of single premium products has been particularly strong throughout the 1990s. This trend is similar to that in the UK with strong demand for guaranteed products and with-profit bonds and a general movement towards more flexible savings vehicles. Money has been pushed into equity-backed investments by investors looking to improve on low bank interest rates. Single premium, personal portfolio bonds have also seen strong growth.

Provisional figures for 1999 indicate that the rapid growth seen in the mid-1990s has weakened.

Regular premium growth has been affected by a number of companies withdrawing from Latin American and Asian markets in recent years.

### 7.2 Markets

#### 7.2.1 Regional Trends

Little recent information on origins of business is available for publication.

Europe, and the UK in particular, generates the majority of business, after which the Far East and Middle East are the most significant markets.

#### 7.2.2 UK Residents

A substantial proportion of the offshore market represents sales to UK clients.

One feature of offshore jurisdictions is tax-free, or low tax, roll-up of investments and this allows offshore bonds to form a key tax-planning role. For the UK investor, offshore bonds do not produce taxable income until a chargeable event takes place: essentially on surrender, death or if withdrawals in any policy year exceed 5% of the original contribution.

Ongoing tax liabilities can be deferred for many years and this allows investors flexibility to pay tax when it is most convenient. This may be valuable in, for example, retirement planning if the bondholder expects to move to a lower tax bracket in later life.

Tax-free roll-up may prove particularly attractive to those earning in excess of the UK pensions earnings cap. In addition, offshore bonds allow flexibility in the form in which proceeds may be taken at retirement which has become desirable in the current low annuity rate environment.

Offshore bonds also have advantages as investments for trustees, providing a tax-efficient, easy-to-administer tool in managing inheritance tax. Similarly a bond may be held in trust, gifted to a prospective student and used to plan for university fees.

The relatively low limits set on ISA investments, changes to ACT treatment of pension fund dividend income and increased administrative burden imposed by self-assessment all add to the relative attractiveness of offshore bonds. Despite their potentially important role in tax planning, recent research has indicated that more than two thirds of UK IFAs do no form of offshore business. One of the challenges facing the offshore life insurance industry is to increase this level of awareness.

### **7.2.3 Expatriates**

The offshore insurance market has its origins in the expatriate market, which continues to be a significant source of business, although it may lack the potential for growth of the other markets. The market can be considered to consist of both UK expatriates and mobile foreign expatriates seeking to find a stable home for their capital.

### **7.2.4 Indigenous Populations**

Increased competition, due in part to a rapid rise in the number of offshore insurers, combined with liberalisation of exchange controls has led the offshore industry to seek opportunities far afield. Sales to local populations are seen as a primary source of long term growth.

The industry helps satisfy a demand from high net worth individuals in countries which are politically unstable, suffer high local inflation and weak currencies or have a relatively unsophisticated financial services sector, allowing them to move capital to more secure jurisdictions and currencies.

### **7.2.5 European Pensions**

An EU directive for pan-European pension schemes is intended to be introduced by 2002.

The current low level of funded pension arrangements within Europe and their likely difficulties in meeting increasing liabilities from a contracting workforce have created a potentially huge private-sector pensions market. Offshore financial centres are gearing up to target the market and take advantage of the reduced restrictions on cross-border investing as a result of the introduction of the euro. The demand is not exclusive to Europe and opportunities also exist further afield.

Luxembourg and the Isle of Man both introduced new pensions legislation in 1999 with the intention of establishing themselves as key centres for international pension funds. The Isle of Man initiative is less EU-focused than that in Luxembourg, targeting expatriates and multinational corporations. As gross investment roll-up is already a feature of offshore investment, the legislation is aimed at establishing investment vehicles and providing the necessary security for pension scheme members, such as placing obligations on trustees to provide regular information to members.

One further requirement for the development of a genuine international pensions framework is to obtain recognition and taxation concessions from the countries of residence of investors. This may still be some way off.

## **7.3 Offshore Centres**

The main established offshore centres for life insurers are:

- The Isle of Man
- Dublin International Financial Services Centre (IFSC)
- Luxembourg
- The Channel Islands

A key factor in the choice of offshore location is the insurer's attitude to marketing within the European Union. Luxembourg and Ireland are full EU members and companies based there may sell cross-border within the rest of the EU. The Isle of Man and the Channel Islands are outside the EU for insurance purposes. As a consequence Luxembourg and Dublin have become the base for those insurers primarily seeking penetration of the European markets whereas the Isle of Man and the Channel Islands have attracted those targeting the rest of the world. All of the centres are equally well placed for sales back into the UK.

The issue of tax harmonisation within the EU continues to be debated with pressure being exerted on Luxembourg and Dublin to move towards a common tax structure. The IFSC's special tax treatment is due to expire in 2005 and the Irish Government intends to harmonise Irish corporate taxation at 12.5% by 2003. Although given exemptions under the Treaty of Rome from a requirement to follow EU taxation dictates, the Isle of Man and the Channel Islands are not divorced from the debate and a number of initiatives are underway which question their tax-free status.

## **7.4 Products**

### **7.4.1 Single Premium Bonds**

Single Premium unit-linked bonds are one of the most significant offshore products. They tend to be more back-end loaded than UK counterparts with initial costs recouped by an establishment charge, typically over the first three, four or five years of the bond's duration.

### **7.4.2 Personal Portfolio Bonds**

Personal Portfolio Bonds (PPBs) are another large constituent of the offshore market. They are unit-linked single premium bonds that offer a wide range of assets which the policyholder may select at an individual level. The choice of assets may be restricted to pooled funds (personalised portfolio bonds) or may be more extensive, including individual equity holdings (highly personalised bonds). Administration may therefore become complex and expensive. The tax treatment of PPBs by the UK Inland Revenue is a contentious issue.

### **7.4.3 Guaranteed Bonds and With-Profits Bonds**

The concept of with-profits bonds has been very successfully exported from the UK to the offshore market. Bonus rates have fallen significantly during 1999 and this trend seems likely to continue. Despite this, the market is likely to remain strong.

Guaranteed growth and income bonds have been strong product lines in the UK for some years. This success has not generally been replicated in the offshore market, due in part to aggressive tax structuring of onshore products. Offshore bonds do permit a greater flexibility in their design and this has led to a number of successful recent product launches.

### **7.4.4 Regular Premium Contracts**

Although single premium contracts have been the major growth area in offshore life assurance, expansion of the regular premium market has also been significant over the last ten years.

The market for regular premium products is more international than for single premium business. Sales back into Europe are less significant, with the Far East, Middle East, Latin America and Africa being key markets. Products fulfil a demand for hard currency products in stable jurisdictions, offering flexibility of investment vehicles and benefits that may be unavailable in the policyholders' domestic markets. Available products include a full range of pension plans, school fee funding contracts and protection policies.

In recent years a number of companies have withdrawn from countries in which regular premium sales are strong, particularly in Latin America, to refocus their operations on other markets. This has tempered new business growth.

#### **7.4.5 Funds Business**

The diversification of offshore life insurers into fund management and unit trust business has been a major source of development in the industry. Many companies have established retail fund subsidiaries, using partners for distribution and forging corporate links. Funds can offer some additional flexibility over insurance bonds and are likely to be increasingly dominant in the market place.

#### **7.4.6 Developments**

Product developments offshore have tended to mirror those within the UK. The high volatility witnessed within equity markets has led to increased demand for guaranteed products, particularly with-profits bonds and defined-risk funds. The introduction of the euro has led to the launch of a number of euro-denominated funds. The Long Term Care market has also seen continued expansion.

The levels of charges on offshore products have generally been higher than their UK onshore equivalents. This is due to a number of factors, primarily lack of tax relief on expenses, but higher communication costs, complex products, high premium/low volume products and supply-side pressures within the offshore centres also contribute. The introduction of Stakeholder pensions and CAT marking has led to downward pressure on charges for UK onshore insurance companies accompanied by pressure to reduce expense levels. It will be interesting to see whether reduced expectations of what is a reasonable charging structure by UK based clients leads to a similar trend offshore.

### **7.5 Regulation**

#### **7.5.1 Fiscal Representation**

April 1999 saw Tax Representative regulations introduced under the UK Finance Act 1998 come into force. The provisions arose due to a view by the UK Inland Revenue that UK resident policyholders were not reporting taxable gains from offshore policies.

The requirements required offshore life companies to appoint tax representatives in the UK to be responsible for reporting gains on the life policies of UK residents to the Inland Revenue. In practice most companies will receive exemptions from this by providing the following information from 6 July 1999:

- For policies issued on or after 6 April 2000 the office must supply sufficient information to those policyholders which it knows to be UK residents to allow them to complete their self-assessment tax returns. Copies of this information will be provided to the Inland Revenue where the gain is greater than £14,000 (half the higher rate tax threshold).
- For any business written on or before 5 April 2000 the office must inform the Inland Revenue if a policy has terminated and the amount paid out on termination is greater than £56,000 (twice the higher tax rate threshold).

The original proposals ran into legal difficulties as the reporting would have contravened Luxembourg's secrecy laws, resulting in a decision by the UK Inland Revenue to exempt Luxembourg from the rules. This led to complaints of unfairness from other offshore jurisdictions where companies have had to absorb the costs of additional reporting.

Other European Union member states may follow suit by requesting similar representation.

### **7.5.2 Personalised Portfolio Bonds**

The UK Inland Revenue changed the rules relating to taxation of personalised portfolio bonds (PPBs) in the 1998 Finance Act. The 1998 Budget announced rules to deem an income from PPBs of 15% of the premium to be charged to tax annually, regardless of when the policy was taken out or the actual investment return.

Following a great deal of protest from existing investors, the Inland Revenue relaxed its stance and announced that the majority of existing bondholders would be exempted from the additional taxation. Finalised rules are nearing completion.

### **7.5.3 OLAB Changes**

The Inland Revenue ruled in October 1999 that term assurance and critical illness sold by UK life companies to non-UK residents must be written through Overseas Life Assurance Business funds. This is likely to lead to more expensive products as tax relief will no longer be received on expenses. The change has caused a number of insurers to consider withdrawal from the particular market.

## **7.6 International Scrutiny**

### **7.6.1 Introduction**

Over the last two years offshore jurisdictions have been put under pressure to justify favourable tax structures and have been subject to considerable examination of their regulatory frameworks. This scrutiny took a number of forms.

### **7.6.2 UK Initiatives**

At the end of 1998 a former Treasury official Andrew Edwards, reporting on behalf of the UK Home Office, delivered a report into financial regulation in British crown dependencies (Jersey, Guernsey and the Isle of Man) including the combating of financial crime and co-operation with other jurisdictions.

The commissioning of the report created some consternation on the islands that the UK was meddling in their affairs, but there was little they could do to prevent it.

In the end the report was generally favourable to all of the jurisdictions. Financial regulation arrangements were generally endorsed, although a number of recommendations for changes were put together for each of the islands.

The Edwards Review was followed in March 1999 by a UK Foreign Office White Paper on the future relationship between the UK and its overseas territories, although this did not cover the Isle of Man and the Channel Islands. This is to be followed by an Edwards-style review into the standard of regulation on the islands.

### **7.6.3 OECD Initiatives**

The OECD published a report on Harmful Tax Competition in April 1998. The project is intended to combat regimes tailored to erode the tax base of other countries. A Forum of Harmful Tax Practices was established which will produce a recommendation of which centres should be included on a list of alleged tax havens. Its initial report included a preliminary list of 47 jurisdictions. Member countries will be submitting the results of their self-assessments of their preferential tax regimes by April 2000. The intention of the OECD is to eliminate harmful tax features by April 2003. Some criticism has been levelled at the focus on offshore centres rather than larger economies such as Luxembourg and Switzerland.

The criteria for defining 'harmful' are:

- the tax breaks apply only to non-residents or to deals involving non-residents;
- benefits are ring-fenced from the domestic economy;
- the tax-breaks lack transparency - especially where benefits are given by relaxing statutory rates without prior knowledge.

Wide ranges of special tax schemes within the EU are expected to be targeted.

## **7.7 Bibliography**

- AILO Statistics
- Current Topics Papers 1997 and 1998
- An Introduction to Offshore Life Assurance Business (British Actuarial Journal Vol 1, Part III (1995) (Boal & Tyler)
- Press Cuttings

## NOTES



## NOTES

## NOTES