

# Current Topics 2002

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## **Introduction**

The main focus of the paper is on the core examination topics, as in previous years, with a view to helping students studying for the later exams. An additional section has been included on Private Medical Insurance, to give students a broad understanding of the current issues in this market. Unfortunately, we have been unable to include a section on General Insurance this year.

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

Finally we would like to thank all those who assisted in the writing of this paper.

It is stressed that any opinions expressed are those of the authors and not necessarily those of our employers, colleagues or local actuarial societies.



## **Section 1 – Investment**

### **1. Investment Markets in 2001**

#### **1.1 Economic Backdrop**

Investors started 2001 in a positive frame of mind. Although the previous year had seen global economic growth stumble a little, the general consensus was that this year would be different.

However, rather than getting better, economic conditions darkened considerably in 2001. In response to this, business and investor sentiment started to fall rapidly and the feedback loop, which had produced boom conditions in the late 90's, began to work in reverse. The falling consensus growth expectations fuelled reduced business investment plans as businesses and investors lost confidence. Confidence eventually reached a nadir on September 11, after the terrorist attacks on the US.

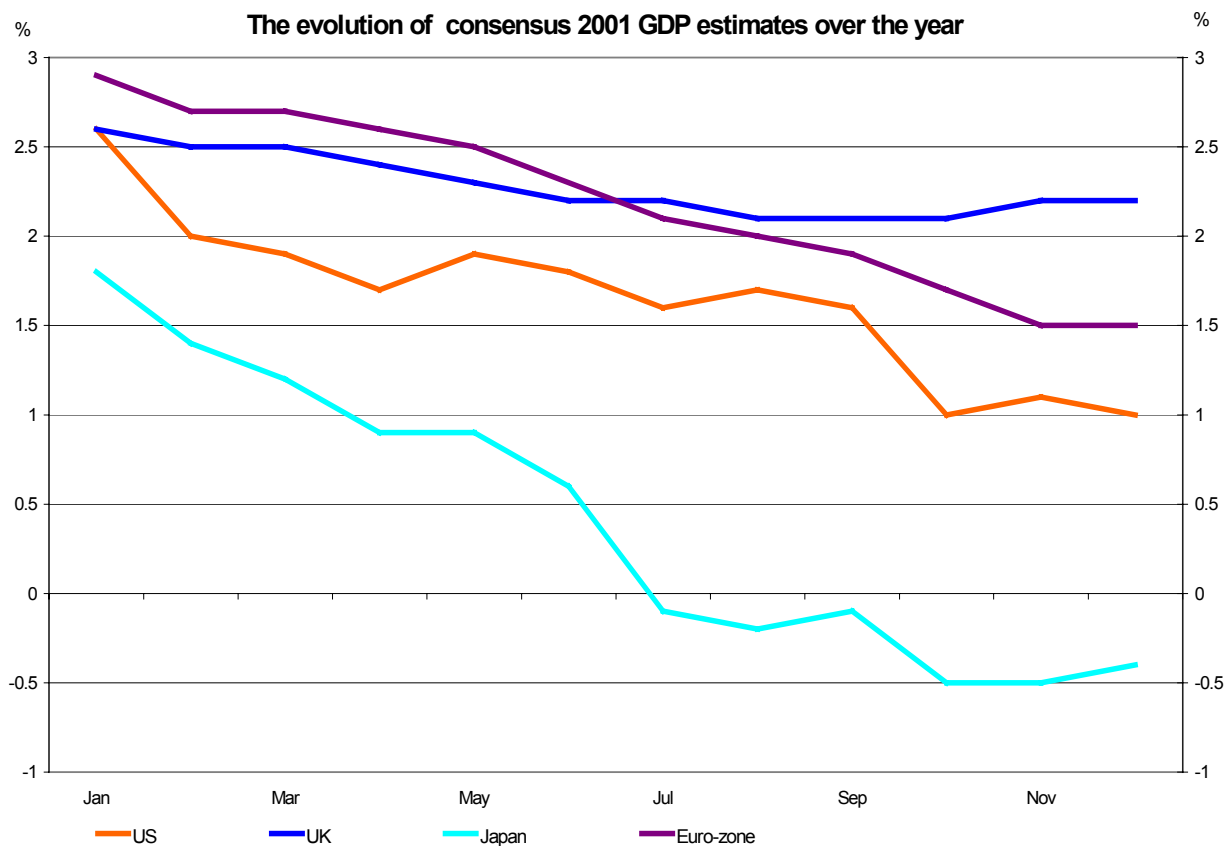
In the US the sustained weakness in economic growth combined with the threat to the financial system posed by the September 11 atrocity, prompted the Federal Reserve to cut interest rates eleven times during the year to 1.75% - the lowest level in 40 years.

The stalling US economy also had big ramifications for Japan. With interest rates already at zero, and therefore precluding any significant monetary action, and a bloated budget deficit preventing material fiscal measures, the Japanese were very dependent on a resumption in economic growth in the US in order to allow them to export their way out of recession.

Europe was also affected by the slowdown in the US, but not nearly to the same extent as Japan. The European Central Bank had the scope to cut rates, and did so by 1.5% over the course of the year. This acted as the much-needed brake on falling confidence that Japan lacked.

While the UK was not immune to the global economic downdraught, it remained the most resilient of the global economies. A strong consumer, who had been sustained by higher average earnings (particularly in the public sector), falling interest rates and rising house prices, supported the economy. The Bank of England's Monetary Policy Committee (MPC) cut interest rates seven times during the period to stand at 4.0% at the end of the year. This was partly a prescient move to avert a slow down in consumption, and partly in response to a concerted plan by central banks to reflate the global economy post September 11.

As the chart below demonstrates, over the year, growth expectations for 2001 fell in the US, Japan, Europe and the UK. As we will see later, it was the unwinding of this economic growth optimism over the course of the year, which made 2001 such a poor year for equity investors, and such a good year for bond markets.



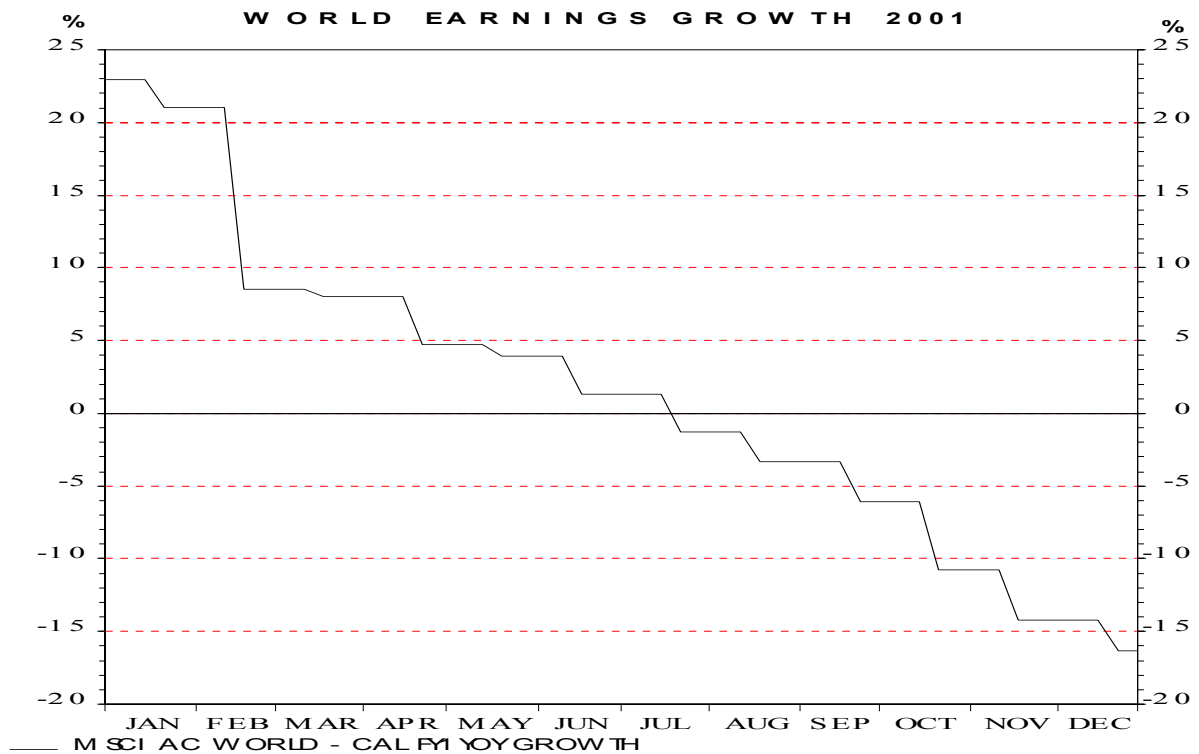
## 1.2 Equity Markets

After a poor 2000, during which equity investors suffered from the bursting of the bubble in hi-tech stocks, as well as an unexpected growth stumble, many equity investors started 2001 feeling that the worst was behind them. They were quickly shaken out of their complacency by the continued deterioration in economic growth.

The rapidly cooling global economic picture precipitated sharp downward revisions to corporate earnings forecasts. Earnings expectations were hit by the double impact of slower growth leading to anticipated slower growth in sales, but also the complete lack of evidence of corporate pricing power which caused many to query their margin expectations.

This simultaneous downward revision to revenue and margin expectations translated into a savage collapse in corporate earnings expectations. The chart below shows how global corporate earnings expectations for 2001 fell from an anticipated 23% increase to a 17% fall over the course of the year.





Source: DATASTREAM

This re-appraisal of earnings expectations of course dampened investor sentiment, which was further hit by the events of 11 September. This event precipitated a final blow out for equity markets. However, it also served as a catharsis. Very quickly the view took hold that after this event the news could surely not get any worse. It, therefore, marked something of a turning point for investors, who were encouraged by the concerted global monetary action and the speed of events in Afghanistan, as well as evidence that US consumer spending was holding up. This prompted equities to recover sharply in the later part of the year as the market looked towards global economic recovery.

Despite the slight note of optimism at the close of the year, the US market was well down over the course of the year. It could hardly do anything else as growth expectations for the year were slashed by 1.5%, and earnings growth expectations by 30%.

Other equity markets tend to take their cue from the US and 2001 was no exception. They were driven by the implications that the slowdown in the US had for their economies, and also by the profits warnings from impacted companies. As always some markets were affected more than others.

The UK was one of the best performing European markets; this was partly due to the UK economy proving to be one of the most resilient. However, the fact that relative to the rest of Europe, a smaller proportion of the UK market consists of telecom and technology stocks was probably more important.

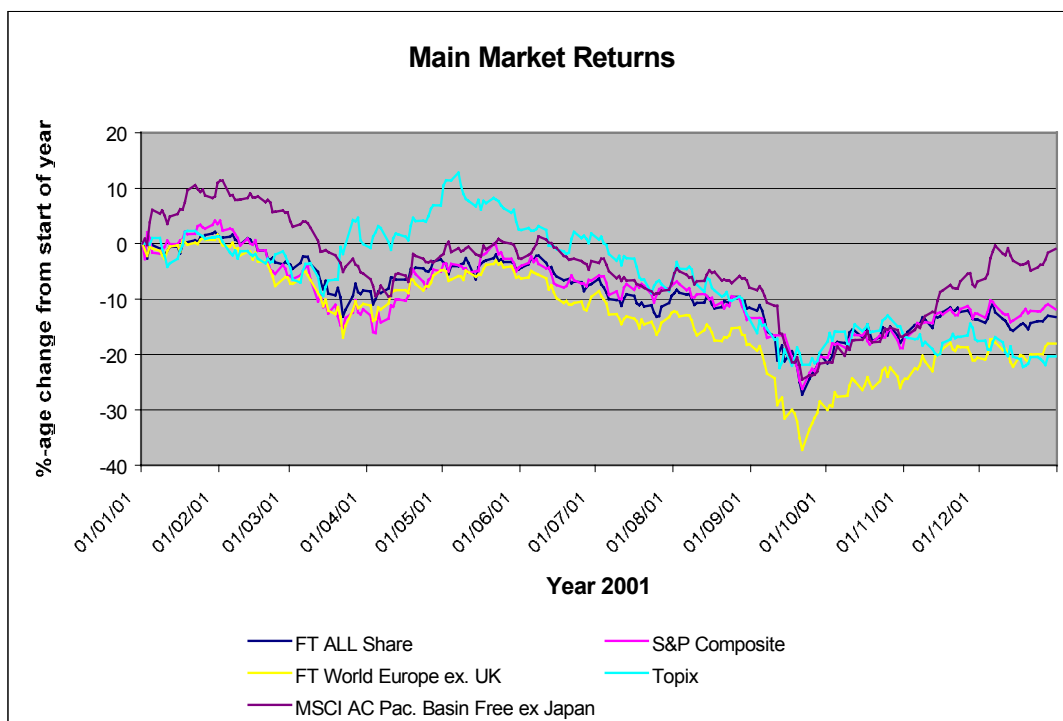
European markets fared worse than the US, which might be surprising given that growth expectations in Europe were not marked down as heavily as the US. However the European Central Bank was not seen as being as accommodative in monetary terms as the Federal Reserve, probably because they were loath to further weaken the Euro. More significant, though, is that fact that many European companies had made acquisitions in the US over the late 90's and 2000, the prudence of this corporate activity came under much more critical scrutiny in 2001. Finally the high percentage of telecom stocks quoted on European bourses counted against them.

Japan, however, was the worst casualty. In addition to being troubled by the downward growth revisions in the US, the equity market here had other problems to contend with. The banking sector, which already has a problem with non-performing loans, also owns about Y30 trillion of equity as part of cross share holding agreements with their corporate customers. The customers in turn hold a stake in the banks. These problems are not new, they just compound as the equity market falls.

The election of Prime Minister Koizumi in the spring of 2001 sparked hopes that Japan would embark on a programme of reform. However, much of his programme of reform would have been negative for domestic demand in the short term. Hence, he was relying on some growth in the rest of the world in order for Japan to generate some export growth to counter weakness in domestic demand. Of course this did not happen, and hence little progress has been made.

The Pacific Basin's high correlation with the technology-biased US NASDAQ Index was detrimental for much of the period. Volatile performance and a rising number of profit warnings from US technology companies affected sentiment for the sector. However, while Pacific Basin markets suffered in September, the liquidity driven equity rally of the fourth quarter, boosted the region's performance to such an extent that it was one of the best performing equity classes.

The chart below shows the total returns achieved on the world's major stock markets over the past year.



### 1.3 Fixed Interest Markets

Just as the correlation between global equity markets has increased over the years, so have the linkages between international bond markets. This could be due to the closer synchronisation of economic cycles, due to increased trade. However, it is also linked to the increasingly international view of capital markets taken by corporate borrowers. This means that if a company treasurer feels

that the US bond market is expensive, he may raise capital in Europe. Of course this has the effect of increasing supply in Europe relative to the US and therefore bringing the two debt markets closer in line.

Given the economic picture in 2001, it is not surprising that it was a good year for bonds. Bond markets benefited from the falling growth and inflation forecasts.

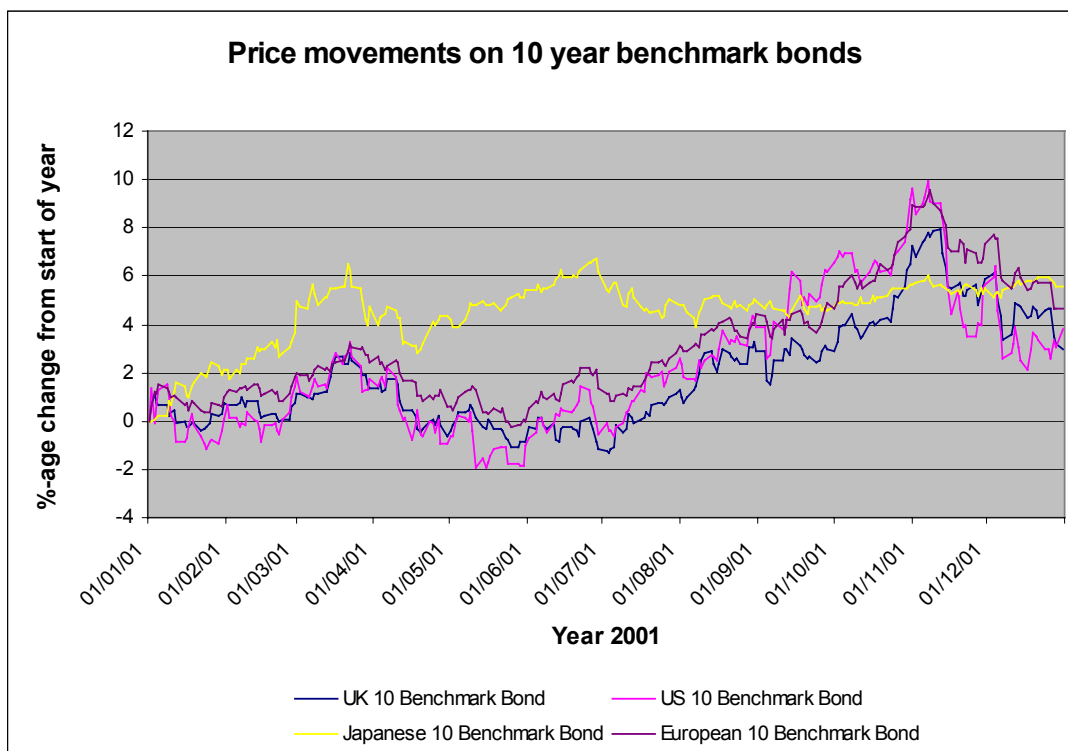
In the first quarter of 2001, the slowdown in the US prompted a series of interest rate cuts and provided a supportive background for bond markets. In these conditions, the yield on short dated bonds typically falls much further than on long dated bonds. In other words, the yield curve steepens, and we saw this happen in all major bond markets over the quarter.

During the second quarter, global monetary easing remained a theme and resulted in the continued steepening of bond yield curves. However, concerns grew that central banks may be overly focused on stimulating economic growth to the neglect of inflationary risks. As a result, market sentiment deteriorated and the third rate cut of the quarter by the US Federal Reserve marked the beginning of a more difficult period for fixed interest investors. Longer dated yields rose while shorter dated yields remained broadly unchanged. In Europe, data releases showed that industrial production slowed significantly. The European Central Bank's (ECB) resolve to fight inflation foundered on the weight of criticism levelled against their inaction. Ironically, inflationary pressures in the Euro-zone intensified following the surprise 0.25% rate cut. The only major bond market immune to inflationary fears appeared to be Japan, where price pressures are downward rather than upward.

However, during the third quarter, positive sentiment for bond markets reappeared as evidence of a prompt re-acceleration of growth failed to materialise. Following 11 September, as the US Federal Reserve led other central banks in a concerted round of monetary stimulus in an attempt to boost consumer and business confidence, bonds benefited

Central banks continued their efforts to revive the global economy in the fourth quarter. Just as equity markets rallied as investors gave a vote of confidence in the adequacy of the monetary measures being taken, longer dated bond yields increased to reflect the increased likelihood of recovery.

The chart below shows the returns achieved on the major bond markets.



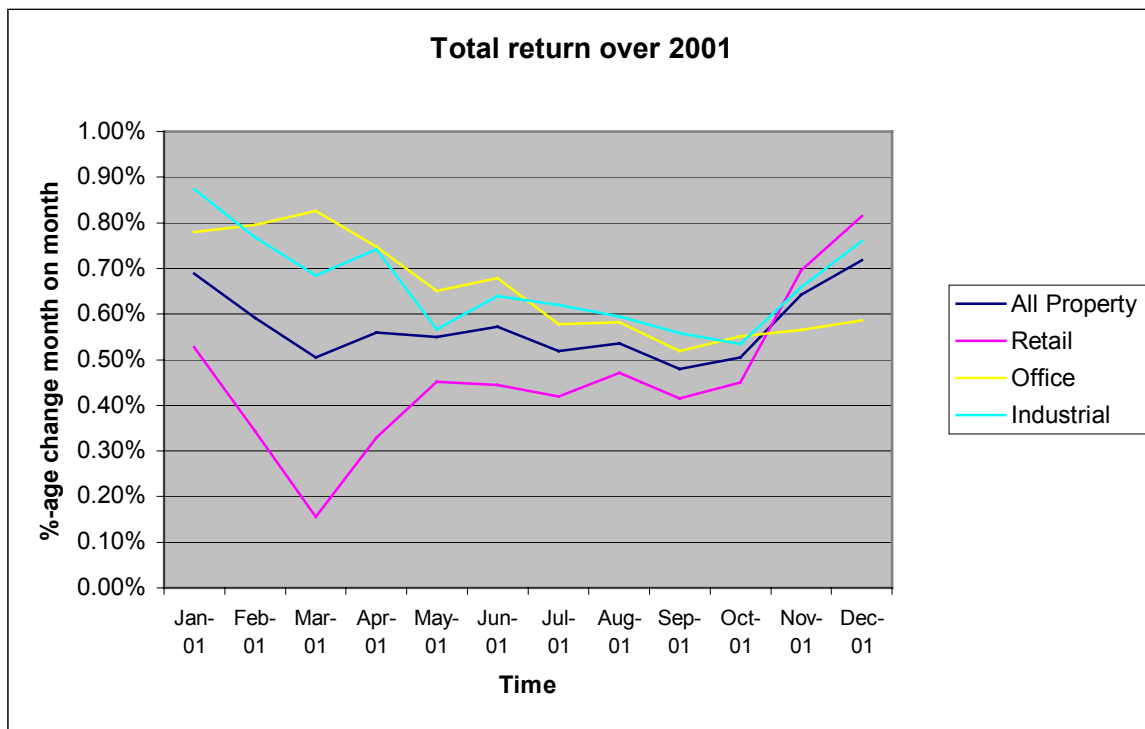
## 1.4 The UK Property Market

Property Returns (as measured by the IPD Monthly Index) have fallen from 10.4% for the year to December 2000 to 7.1% for the year ending December 2001, continuing the gradual downward trend which began in early 2000. This reflects a reduction in returns across all sectors of the market.

However property clearly still significantly outperformed equities over the year, and bonds too, albeit to a lesser extent.

This reduction in returns from 2000 was, in part, due to the slowdown in occupier demand, which should be expected given the economic backdrop. There was also evidence of increased investor pessimism following 11 September. Institutional activity remaining subdued also contributed to the down beat sentiment. The combination of buyers anticipating possible yield increases and vendors unwilling to expose their property to a market with little enthusiasm for anything but demonstrably cheap stock, meant activity was light. Moreover, many companies placed their expansion and relocation decisions on hold until a clearer picture of the economic and political landscape emerged.

The chart below shows the returns achieved in the UK property market.



## 2. Some Fund Management Issues

### 2.1 Active versus Passive

Fund managers came under a lot of criticism during the technology bubble years for under-performing their benchmark indices. As a result cheaper fund managers, who promised to replicate index returns, attracted a lot of business.

This transfer of business compounded the problem for the active managers. The fund managers who were sacked were typically holding value orientated stocks, and were under-weight the high flying technology type new entrants to the indices. Of course when the newly appointed index manager received the mandate he sold the overweight positions in the value stocks and bought into the expensive stocks. This created a vicious circle for the active value managers, and a virtuous one for passive managers.

The collapse of technology bubble has turned this around. According to Russell/Mellon CAPS, even the median UK equity manager has managed to beat the index by 1.4% in 2000 and by 0.3% in 2001, and of course by definition 50% of managers did better than this. The longer-term numbers have improved too, over the past 5 and 10 years the median UK equity manager has delivered returns in excess of the FTSE All-Share.

Will this turn the active to passive tide?

Well, active managers certainly hope that the events of recent years have demonstrated that financial markets are not efficient, and that a good (indeed even an average) investment manager can add value.

### 2.2 FRS17, the seeds of a new bubble?

After two years of falling equity markets it is no surprise that the retail investor is turning to what they perceive to be safer investment options such as with profit, fixed interest and property funds. However, institutional investors, who are purportedly invested in equity markets 'for the long term' are becoming restless. This, however, is driven by more than investors feeling jumpy.

A new accounting standard for occupational pension schemes, FRS17, becomes fully in force for accounting periods ending after 22 June 2003. This standard will demand that assets are accounted for at market value, and that all liabilities be valued by discounting at the yield available on high quality corporate debt. The net asset or liability arising from this calculation will not feed through to the P/L but will appear on the balance sheet.

If Finance Directors want to avoid volatility on their balance sheet from year to year the solution is clear. They need to switch the pension funds investments to corporate bonds from equities. The Boots pension fund attracted a lot of media attention by switching 100% into bonds last year. A major question for fund managers is are Boots unique, or are they a harbinger of more to come?

The defined benefit pensions market is a £1000 billion industry, hence a 10% asset allocation swing towards bonds requires a £100 billion pound switch. This would imply serious selling pressure in UK equities. The other side of the equation is, however, equally concerning. The combined UK gilt and corporate bond market is capitalised at around £450 billion. Supply of sufficient scale to satiate pension fund demand is not likely to be forthcoming. Hence there is the risk that pension funds collectively try and fit a quart into a pint pot. FRS17 does create the risk that the UK fixed interest markets could be the scene of the next asset bubble – watch this space.

## **Section 2 - Life Insurance**

### **1. New Business**

#### **1.1 Current Sales Volumes**

New Business figures produced by the Association of British Insurers (ABI) for the last five and three quarter years (2001 figures only available up to the third quarter at time of writing) indicate the following trends:

<b>Total Individual Life and Pensions Business (Excluding CIS)</b>			
	<b>New Regular Premiums £m</b>	<b>New Single Premiums £m</b>	<b>Equivalent Annual Premiums £m</b>
1996	2,451	23,939	4845
1997	2,707	26,947	5402
1998	3,214	30,973	6311
1999	3,157	38,073	6965
2000	2,927	40,349	6962
2000 Qtr 1	728	9,660	1694
Qtr 2	778	9,435	1722
Qtr 3	713	10,467	1760
Qtr 4	707	10,787	1786
2001 Qtr 1	784	10,622	1846
Qtr 2	952	10,381	1990
Qtr 3	892	10,124	1905

Notes:

- Equivalent Annual Premium (EAP) = AP + SP/10
- The ABI figures cover Collective Investment Schemes (CIS) separately.

Based on total premiums, new business for the first three quarters of 2001 increased by 6.2% over the same period in 2000.

Breaking this result down we note that new pension business premiums have increased by 14.35% reversing the decreasing trend reported in recent years. Much of this can be attributed to the 'stakeholder effect', which has seen charges reduced across the board, and a widening of company pension ownership.

In contrast, total new life assurance business has remained fairly stable with just a 0.9% increase in premiums. Single premiums were up by 1.5% but regular premiums were down by -10%.

## 1.2 Distribution Channels

The following table shows the distribution of individual life and pensions business by sales channel over the past five and three quarter years

<b>Total Individual Life and Pension EAP Split by Distribution Channel %</b>							
	Direct Sales		Tied agents	Direct Marketing	Telesales	OTHER	TOTAL
	IFAs	Force					
	%	%	%	%	%	%	%
1996	47.0	45.8	4.9	2.3	n/c	n/c	100.0
1997	50.5	42.1	5.2	2.2	n/c	n/c	100.0
1998	46.0	44.5	4.6	3.2	1.1	0.6	100.0
1999	47.9	42.1	4.8	3.5	0.9	0.8	100.0
2000	52.9	37.1	4.2	3.0	1.0	1.9	100.0
2000 Qtr 1	50.5	38.8	4.7	3.0	1.1	2.0	100.0
Qtr 2	52.1	38.2	4.2	2.6	1.1	1.8	100.0
Qtr 3	54.0	36.7	4.1	2.5	0.8	1.9	100.0
Qtr 4	55.0	34.5	3.8	3.8	1.0	1.9	100.0
2001 Qtr 1	58.4	31.6	3.5	3.2	0.9	2.4	100.0
Qtr 2	58.9	30.4	3.8	2.9	1.4	2.7	100.0
Qtr 3	60.5	27.6	5.2	2.3	1.4	3.0	100.0

Notes:

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

This split by source of new business shows that the trend, of an increasing proportion of business sold by IFAs at the expense of direct sales forces, continued during 2001. However the distribution for stakeholder plans has proven to be very different to the distribution of traditional pension products. More than three fifths of stakeholder regular premiums in the first 3 months have come through direct sales. For single premium stakeholder business over 11% of sales were through direct marketing. It is still too early to say what the effect of stakeholder will be. However given the extent of the difference between stakeholder distribution and that of the market in general it looks likely that stakeholder will have a significant impact on distribution channels in the future.



## **2 Pensions Review**

### **2.1 Personal Pensions Mis-selling**

The target date for completing the review is 30/06/02 and firms are now planning the decommissioning of their review teams. This includes setting up procedures for dealing with future complaints and auditing/sampling of calculations and procedures.

In October the PIA issued an update informing firms that windfall benefits in whatever form should not be taken into account when assessing loss. Where windfall payments were received as a policy augmentation, firms are not permitted to issue offers to investors pending further guidance from the FSA on how the augmentations should be excluded from policy values. Guidance is not expected until at least May 2002. The FSA have recognised that this issue will mean some firms may not be able to complete all their cases by 30 June 2002.

In the meantime, firms who believe they are able to determine the value of the windfall to be excluded can apply to the FSA for a waiver. If granted this would enable them to recommence issuing offers for affected cases.

In November the PIA issued guidance requiring the recalculation of some offers which have already been accepted. This follows an announcement issued in December 1999 relating to assumptions in respect of SERPS. The recalculation is for Phase 2 transfer cases which were offered before December 1999. The PIA are offering to do the recalculations but many firms will be doing this rework themselves. The rework is to be completed by 31/12/02.

### **2.2 FSAVC Review**

In June the FSA issued a revised list of matched and subsidised schemes that fall into the review. The original list was 67 schemes and the new list comprises of 151 schemes, excluding the original number. However, the new schemes are much smaller in number of members than the original schemes. The total number of cases now expected to be reviewed under the FSAVC review is around 120,000, which is equivalent to about 10% of all consumers with FSAVC policies. As a result of this increase to the number of cases the deadline for completing the review has been extended from 30/06/02 to 31/12/02, but firms must have made an offer in 90% of cases by 30/06/02. The list of schemes will not be amended in the future, although other subsidised or matched schemes will be posted on the FSA website as they are discovered.

The FSA have been issuing further guidance in the form of bulletins throughout 2001 and the guidance is now largely complete.

The problem of windfall payments is also an issue for the FSAVC review but to a lesser extent, and mainly affects cases with a defined benefits calculation. The affected cases will need to be stockpiled until further guidance is issued.

Firms are generally finding that the FSAVC review is more time consuming than first anticipated. Data collection is a particular problem.

### **3. The Sandler Review**

#### **3.1 Background**

The government have concerns regarding the effectiveness of the competitive processes in the long-term savings industry. The main concerns fall into the following 2 broad categories:

- (1) Is the consumer being well served with products that are low cost and offer attractive returns in relation to the risks involved?
- (2) Do the incentives for investment performance that operate in the industry lead to effective allocation of capital?

Because the answers to these questions are far from straightforward the Chancellor has asked Ron Sandler to conduct a review of medium and long-term retail savings.

In July 2001 Sandler and his team issued a consultation paper setting out the key issues that Sandler believes need to be addressed.

Here we will look at the scope of the review and the key sections of the consultation paper. We will also look at the response to this paper from the Association of British Insurers (ABI) and the Actuarial Profession.

#### **3.2 The Consultation Paper**

##### **3.2.1 Terms of Reference**

The terms of reference for the markets for long-term savings are:

“to identify the competitive forces and incentives that drive the industries concerned, in particular in relation to their approaches to investment and, where necessary, to suggest policy responses to ensure that consumers are well served.”

##### **3.2.2 Scope of the Review**

The review covers:

- Life insurance savings products;
- Pensions sold either direct to retail investors or to retail customers via their employers; and
- Collective investment vehicles.

The review considers whether the UK market, as currently structured, leads to efficient investment decision-making and to optimal outcomes for consumer interest more broadly. It looks at products, government and regulatory infrastructure but does not consider the adequacy or effectiveness of current regulations.

### 3.3 Key Sections

The key sections of the consultation paper are:

- Extent of consumer influence
- Choice of distribution channel
- Product providers
- Product design

We shall look at each of these in turn. Questions in italics are some of the questions that the Sandler team have asked in the consultation paper.

#### 3.3.1 The Extent of Consumer Influence

The population as a whole have a relatively poor understanding of investment and savings issues. Consumers do not generally research widely prior to making a purchase decision, nor do they monitor effectively the results of a decision after it has been made.

This means that consumer influence is weak. This weakness of consumer influence plays a fundamental part in shaping the way in which the market functions and how firms compete. This lack of influence leads to:

- Greater weight being placed on the need for advice and the role of financial advisors
- A tendency to front-loaded cost structures due to the time and expense involved selling to consumers who do not understand long-term investment issues
- This in turn leads to issues with transparency and can create barriers which discourage product switching

*What can be done to improve consumer influence?*

*Are there any actions that could be taken to compensate for weak consumer influence?*

#### 3.3.2 Choice of Distribution Channel

Due to the relative lack of consumer understanding distribution issues are central in defining how the retail savings market functions. Most sales involve a face to face meeting with a salesperson or advisor. Direct sales are difficult and make up only a small percentage of total sales.

*Why are there not more direct sales?*

*Is an increase in direct sales desirable?*

Some of the other questions asked in relation to distribution are:

*Why are consumers reluctant to pay for advice?*

*Why is advice bundled with selling?*

*Could a market for advice be developed and how?*

*Are there alternative methods of remuneration for IFAs and direct sales forces?*

*What factors drive commission levels?*

*Is there a case for regulatory interaction in the setting of fees and commission levels?*

### 3.3.3 Product Providers

Recent years have seen a clear trend towards consolidation within the financial services industry. It is not clear whether this consolidation will lead to a different approach to creating and distributing retail savings products or if it simply leads to cost savings for the firms involved.

Several questions are asked in relation to investment decisions by product providers:

*How are investment objectives set for individual markets or a fund managers within a particular product provider?*

*What benchmarks are used, and over what timescales?*

Particularly for Managed and With Profit funds:

*How are asset allocation decisions taken?*

*Against what targets?*

The Myners review has put forward a set of investment principles. The Sandler Review asks whether these principles would be applicable to life insurance companies and collective investment schemes.

It is noted that the governance requirements of providers of long-term retail savings products are unusual in a number of respects. There is concern that the legal duties of the board of shareholders operate inappropriately against the interests of policyholders. Concern has also been expressed about the role of the Appointed Actuary.

### 3.3.4 Product Design

In the last 5 years there have been a number of trends in product design:

- Single premium savings business has grown very rapidly, particularly With Profit Bonds
- At the same time, pensions business as a whole has grown more rapidly than savings business

*What is driving these changes in product mix?*

*What is their impact on industry costs and profitability?*

It is recognised that the actions of the government clearly have an extremely important influence on product design. The government can influence product design via product regulation (as seen with unit trust and stakeholder pensions) and initiatives such as CAT marks. They can also influence indirectly through other forms of regulation and the taxation system.

*To what extent has the product regulation regime prompted or restricted innovation?*

*To what extent has it been necessary to protect consumers from unsuitable products?*

*What other impacts, particularly of an unintended nature, has regulation and tax treatment had on product design and the cost of products?*

With Profit policies are raised as a specific issue. They have been widely criticised for their lack of transparency, poor surrender values and the high level of discretion available to product providers. Despite this, particularly for bonds, the demand remains high.

*What factors drive the demand for with profit products?*

*Why has there been a substantial increase in the sales of with profit bonds?*

*Is the with profit vehicle a superior way of reducing volatility for consumers, or could more conventional investment product provide this equally effectively?*

## 3.4 The Responses

Having looked at the scope and the key sections of the review we will now look at the responses to the review by the ABI and the Actuarial Profession.

### **3.4.1 The ABI's Response**

The ABI represents over 97% of the UK insurance market. The ABI has over 400 members and their response takes into account the views of these members.

The key points from the response of the ABI are:

#### **Savings Gap Widening**

The ABI believe that one of the objectives of the review should be to reduce the savings gap by increasing the overall levels of saving in the UK.

It is estimated that the shortfall in the working populations annual savings required to generate an acceptable retirement income amounts to around £27 billion. As you would expect the gap is proportionately greater for lower income groups. Closing this gap would require a 54% increase in total annual savings and investment flows, which currently amount to around £50 billion per year.

The ABI believe that any proposals for further regulation would have to be very carefully considered or the unintended result could be a further widening of the savings gap. They make the following quote:

“Although clever saving may be better than just any saving, some saving is certainly better than none.”

#### **More and Better Advice to Consumers**

Independent economic analysis undertaken for the ABI shows clearly that the most effective way of closing the savings gap will be through more and better advice to consumers. Without this, the less well off will not save and the better off may save, but not as effectively as they should. The regulatory regime should meet the different advice needs of different groups of people with better tailored and more flexible rules.

#### **More Transparency**

The ABI believe that the best way forward lies with better disclosure and more transparency. The Raising Standards initiative and the move to increasing the transparency of with profits are steps towards this.

They believe that the way in which commission is disclosed could be improved to increase the transparency to consumers. This would give the consumer more choice as to whether to pay a fee or whether to pay for advice as part of the plan.

#### **Regulation**

The ABI recommend that care should be taken with regards to further regulation. The current environment is already highly regulated. The benefits to the consumer of further price or product regulation are likely to be very limited. Further regulation of the CAT mark type could reduce the supply of products causing a consequent decline in consumer choice. Any changes to regulation should promote rather than inhibit savings.

A more tailored approach should be considered as an alternative. Focus should be on reducing the savings gap for those consumers (household income between £9,500 and £17,500) for whom the gap is largest. Increased access to advice for this sector is believed to be the key to success.

### **3.4.2 The Professions Response**

The following are some of the comments that the Actuarial Profession have made in response to the consultation paper:

#### **Disinvesting as well as Saving**

Disinvesting should be considered as well as saving. Consumers face serious issues when disinvesting money. There are a variety of options from annuities through to equity release.

#### **The Time to Save**

The profession comment that it is over simplistic to suggest that everyone should save more and sooner. It should be taken into account that for the majority their biggest investment will be their house and that this will dominate their savings. Research by the profession shows that an average family would need to engage in different strategies at different stages in it's life cycle in order to meet the needs it faces.

#### **Education**

The profession believe that increased consumer education is important but that it should be recognised that consumers have limited interest or grasp of financial issues. There is a limit to how much consumers are capable and willing to absorb.

It should be recognised that however well educated people are, they buy emotionally as well as rationally.

#### **Distribution**

The profession point out that there is limited competition for advice. In general the advisor seeks out the customer rather than the reverse. This is because the products are usually sold rather than bought.

The profession do not believe that there will be an effective market for advice until advice is clearly seen to be paid for. Consumers also need to appreciate the real value of advice before they would be prepared to pay for it.

#### **Role of the Appointed Actuary**

The Appointed Actuary role has come to be regarded by the supervisory authorities as one of the central features of the prudential supervision of life companies. The role has been described as a form of regulator within the company. Evolution of the role will come about and is likely to result in increased responsibility to policyholders. The profession is actively pursuing a process by which the Appointed Actuaries role is made more effective and is monitored through a peer review process.

#### **Product Design**

The profession would support a move towards simpler more transparent products, combined with lighter, less dominant retail regulation. However, the opportunity to manufacture more complex advanced products, designed to meet specific needs, should not be precluded.

The trend in product sales and design are substantially driven by taxation issues. However we can expect to see demographic change driving a growing volume of dis-investment products (e.g. annuities).

Level charging is now becoming the norm. However this requires more capital to fund the initial cost as the structure does not match up well with the incurred costs. The incurred costs remain very front-

end loaded largely due to commission. Until customers can be persuaded to pay separately for advice or IFAs accept level commission this will remain a problem.

The IFA industry could be persuaded to do more to manage the inevitable transition away from high initial commission towards much lower initial and higher ongoing commission. It is possible that some form of regulatory limit on commission levels may be needed to start the process of market readjustment.

### **3.5 The Outcome**

It is not clear what the outcome of the review will be. However it is likely that the outcome will have a significant impact on the life insurance market.

## **4 FSA Review of Polarisation**

### **4.1 Background**

The current polarisation regime covers the selling of life insurance contracts (other than those purely for protection purposes), personal pensions, collective investment schemes such as OEICs and unit trusts, and investment trust savings schemes. The rules at present mean that advisers selling these products fall into two distinct categories – independent or tied.

Independent advisers act on behalf of the customer, whereas a tied adviser is a representative of a single company, who can only advise on the products of that company. An adviser is required to disclose their status as part of their initial discussions with a customer.

This regime was intended to help the consumer understand the role of the person they were dealing with as their adviser, and clarify who was responsible for the advice they were given.

The Director General of Fair Trading reviewed the polarisation rules in 1987, prior to their implementation, and felt that they would have an anti-competitive effect on the market. However, the government minister at that time felt that this disadvantage was outweighed by the protection offered to consumers under the new regime.

In 1999, the DGFT published a further report, stating once again that the rules were anti-competitive, but that they were more than likely justifiable for life assurance products, on the grounds of consumer protection. The report then became a matter for the Government to consider. This then led to the FSA review of polarisation which has been carried out in two stages.

The first stage was implemented in March 2001, and made the following changes

- product providers could ‘adopt’ the stakeholder pension product of other providers, and sell them through their distribution channel
- direct offer advertising was removed from the scope of the polarisation rules

The proposals resulting from the second stage of the review are detailed in Consultation Paper 121 from the FSA.

In carrying out their review of polarisation, the FSA have statutory objectives which they must bear in mind, as well as the principles of good regulation, which are outlined in the Financial Services and Markets Act 2000.

Statutory Objectives<sup>1</sup>:

- market confidence
- public awareness
- the protection of consumers
- the reduction of financial crime

The principles of good regulation state that in carrying out its functions, the FSA must keep in mind:

- the need to minimise the adverse effects on competition
- the desirability of facilitating competition between firms regulated by the FSA
- the desirability of facilitating innovation
- the principle that a burden or restriction should be proportionate to the benefits

The FSA has conducted various pieces of research in coming up with their proposal, to investigate how the current regime is working in practice, and the impact it has on both the industry and the consumer.

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<sup>1</sup> Taken from CP121 published by the FSA



## 4.2 The Consultation Paper

In the consultation paper, the FSA offer three options for potential changes to the polarisation rules, although they have a stated preference for option 1.

### Option 1 – abolition of polarisation.

The current polarisation rules would be removed completely, and there would be no new rules introduced to regulate the market. The resulting market would allow various distribution models to exist:

- independent advisers, which, under a new definition of independence, would require them not to operate on a commission basis, but be paid according to an upfront defined payment arrangement with their customer, which could be, for example, an hourly rate, a fixed total charge, or a percentage of funds under management for portfolio management services.
- Authorised financial advisers, where the adviser has access to the whole market in making his recommendation, but is remunerated by commission, at least in some cases if not all, and hence cannot use the term independent
- Multi-tied, where the adviser can recommend products from providers to which he or she is tied (see option 3 below for further details)
- Product adoption, where providers choose to adopt products manufactured by another provider, essentially extending the current rules for Stakeholder pensions to other products.

Another rule which is currently in place means that if a product provider has a holding of more than 10% in an IFA firm, in order for the IFA to recommend products from that firm, they must be demonstrably better than other products available from other providers. This is known as the 'better than best' rule, and in practice means that providers with a significant holding in an IFA firm receive very little business from that firm.

The FSA propose to abolish this rule, in order to assist the transition from commission to defined payments for those firms who wish to retain their independent status under the new definition. The consumer will be protected through increased disclosure by the IFA, prior to advice being offered.

### Option 2 – adoption of packaged products

As mentioned above, this would allow a provider to adopt the products of another provider, and therefore sell these adopted products through their tied sales force. The adoption could be to fill gaps in a product range, or to replace or even compete with existing product lines.

### Option 3 – Multi tied distributor firms

This option would allow adviser to tie to a number of providers. There would be no restriction on the number of ties which would be allowed. Advisers would be required to offer best advice, based on the products available from their tied providers. Firms could either tie to providers for all products, or only for certain products. For example, a firm could simply tie to 4 providers, or could choose to tie to providers A & B for pensions products, company C for investment products and D for protection products.

These firms would be directly regulated by the FSA, unlike current tied advisers who are regulated through the provider they are tied to.

This is a model which has operated successfully in other countries.

### Other Initiatives

The consultation paper also includes other initiatives which the FSA would like to progress in order to increase access to advice, and encourage more people to save.

These include:

- a new multi tiered adviser structure, with lower level advisers only allowed to recommend certain products (likely to be CAT marked products), or possibly only give general advice on product type, and not provider
- new disclosure requirements, separating the cost of a product from the cost of advice on that product
- the introduction of portable fact finds which could move with a customer to different advisers
- the possible use of Citizens Advice Bureaux to offer advice to the less well off, who are less likely to use a financial adviser.

Although these are mentioned in the paper, no detail is given, and hence we will have to wait for further consultation papers over the coming months.

### **4.3 Timetable**

The FSA are seeking responses to their proposals by 19 April 2002. Following this, in summer 2002, a further paper will be published detailing draft rules, and a policy statement on the final decisions reached. Opinions will then be sought on these draft rules by the autumn, with changes potentially being implemented by the end of the year, although the final date will be dependent on the extent of the changes finally decided upon.

### **4.4 Implications**

Many firms, both providers and advisers, are still considering the implications of the proposals, prior to making their response to the consultation paper.

Assuming that option 1 goes ahead, then there are some potential benefits offered by the new regime, particularly for the 80% of customers currently using tied advisers who have restricted choice through the tie to a single company (potentially with access to a fairly restricted product range), but who tend not to shop around for advice.

- if providers choose to adopt products from other providers to fill gaps in their product range, customers will have an increased choice, and are more likely to purchase suitable products
- they could also receive better value for money if providers choose to replace their own offering with a better product from another provider
- they could be offered more choice if providers adopt competing products to their own
- consumers will have more choice as to the type of adviser, with the introduction of multi-tied advisers, which may lead to increased competition and therefore better terms for consumers

There are however, potential areas for concern, a few of which are highlighted below:

- there is scope for increased consumer confusion through the introduction of more types of adviser, and potential consumer detriment as a result. Changes to the disclosure required by advisers to demonstrate their status have been suggested to counteract this.
- there is scope for confusion over who is responsible for advice, and the difference between responsibility for the product and the advice given. Again, disclosure would be needed to counteract this.
- the current IFA sector is likely to shrink as some advisers will become multi-tied (FSA research has suggested that consumers have a preference in principle for independent advice, although in practice, 80% use tied advisers)
- commission levels could increase, as multi-tied firms may put increased pressure on providers (although it is suggested that comparisons of commission offered by all tied firms may be provided to allow the consumer to judge whether the adviser is motivated by commission)
- removing the 'better than best' rule could lead to providers buying distribution (the FSA have asked how likely this is to happen and also for suggestions to prevent it, in the consultation paper)
- there is a risk of consolidation in the market place through alliances of major providers, but this should be counteracted by a continuing IFA sector

## 5 Financial Strength

In the ten years to 31/12/1999 the total return on the FTSE all share index averaged nearly 15% a year. It is surprising then that at the end of a decade of such good returns financial strength had not improved. Indeed published financial strength had generally declined.

Where free assets had been diluted by business requiring less capital support actual strength need not have suffered. Free assets have, however, been depleted by a range of factors. These include: high regular bonuses on with profit business; sales of with profit bonds with significant guarantees; increased reserves for guaranteed annuity options due to falling interest rates and improving mortality; increasing maturity volumes leading to payouts of unreserved terminal bonus; new business financing; and the cost of pensions mis-selling compensation.

UK equities have now delivered two years of negative returns with the inevitable consequences for the financial strength of with profit offices. This has come at a time of increasing press interest in the financial condition of insurers following the closure of Equitable Life to new business in December 2000.

	31/12/99	31/12/00	Change over year	31/12/01	Change over year
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FTSE All-Share capital index	3242.06	2983.81	-8.0%	2523.88	-15.4%
All-Share dividend yield	2.12	2.23	5.2%	2.63	17.9%
FTSE 15yr gilt yield	5.09	4.68		4.98	

## **5.1 Published Financial Strength**

### **5.1.1 End 2000 Free Asset Ratios**

The average published free asset ratio<sup>1</sup> of with profit offices fell by 5.2% from 15.0% at the end of 1999 to 9.8% at the 2000 year end. Poor equity returns were the main cause of falling ratios. For free asset ratios to remain unchanged returns must be high enough to cover the valuation interest rate and provide sufficient surplus to meet the cost of bonus, finance new business and the cost of any strengthening in reserving bases.

New regulations on the valuation of unitised with profit contracts led to significant increases in reserves for some companies. The rules, introduced during 2000, require allowance for policyholders' reasonable expectations on surrender. This limits the ability to discount the face value of units both pre and post resilience unless a surrender value below face value can be justified on PRE grounds. Media reports speculated that the new rules would take £15bn off published free assets across the industry.

Offices with significant guaranteed annuity option exposure are likely to have been hit by lower fixed interest yields at the end of 2000. Faster than expected improvements in mortality also led to strengthening of annuitant mortality assumptions.

The use of subordinated debt, contingent loans, alternative reinsurance and implicit items continued to increase in 2000. At the end of 2000 nearly £10bn of alternative capital was being used to improve solvency, up by £1.3bn on 1999<sup>2</sup>. Six offices were relying on alternative capital in order to report excess assets over their required solvency margin.

### **5.1.2 Outlook for 2001 Statutory Solvency**

Poor investment returns during 2001 are likely to have further weakened the published position of with profit offices at the 2001 year end. This will have been offset to some extent by new regulations on the valuation yield on equities. The new rules allow some recognition of earnings not distributed as dividends and may add about 1% to the equity valuation yield at the year end. Higher long term interest rates may provide some relief to insures with GAO liabilities.

A further fall in average free asset ratios of a similar order to last year does not seem implausible. Offices with the heaviest equity exposure and the shortest liabilities are likely to have suffered most.

## **5.2 Investment Freedom**

There was little sign during 2000 of life offices moving into fixed interest to protect solvency. Indeed the average equity exposure of with profit funds quoted in the Money Management financial strength survey increased over the year. The Prudential, however, ended 2000 with 7% lower equity exposure citing investment considerations.

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<sup>1</sup> Source: Money Management. Free asset ratio defined as excess available assets and implicit items after meeting the minimum margin divided by admissible assets and other than long term assets allocated toward long term business required minimum margin.

<sup>2</sup> Source: Ernst & Young UK Life Insurance Companies 2000 Capital & Solvency Review

Anecdotal evidence suggests that offices did start to move more heavily into fixed interest during 2001. On 10 September the Financial Services Authority wrote to appointed actuaries temporarily suspending the third element of the resilience test. This test required a 25% fall in equities together with a 3% increase in long term interest rates. Two weeks later the FSA again wrote to appointed actuaries. This time the 10% minimum fall under the second test was relaxed and left to the judgement of the appointed actuary. At the same time the FSA said they would look favourable on requests to anticipate new rules allowing a higher yield on equities.

The FSA clearly saw the need to take action to avert the forced selling of equities by insurers struggling to remain solvent.

### **5.3 Smoothing**

In response to sharp falls in equity values during 2001 many offices introduced market value adjustments significantly reducing the smoothing available on surrender. A few companies also cut terminal bonuses mid-year.

It is very likely that offices will be smoothing up payouts during 2002. The large range of cuts in payouts announced to date are likely to reflect the financial strength of the insurers concerned as well as differences in policy on smoothing.

### **5.4 Future Solvency**

The extreme timing mismatch between expenses and charge income on “1% world” products means that this business is likely to be a drain on free assets for very many years. Clearly the problem is exacerbated by payment of upfront commission. It will be interesting to see how companies respond to the challenge of financing this business. It is possible that the Stakeholder charge cap will lead to an excess of demand from consumers over the supply of capital.

The Financial Services Authority has indicated that it will be looking closely at the use of implicit items and alternative reinsurance to support solvency. Some arrangements act to enhance published strength without improving security for policyholders. It is possible that implicit items will be phased out and that financial reinsurance will only be recognised if it involves a material transfer of risk.

## **6 Future of With-Profits**

With-profits has had a long and successful history from its origins as a means of enabling investors to obtain long term life assurance in the eighteenth century. More recently with-profits has allowed investors to share in rapid stock market growth over the last 25 years.

In the last few years, however, with-profits has increasingly become the subject of criticism from the press and consumer organisations. Some of the principle complaints include:

- lack of transparency;
- lack of consumer understanding of the risks involved in with-profits investments;
- concern over the extent of discretion companies have over the management of funds;
- the perception that companies are deliberately underpaying policyholders in order to build up their estates;
- the fear that with-profits policyholders are footing the bill for management mistakes including pension mis-selling, endowment shortfalls and the costs of guaranteed annuity options;
- poor surrender values; and
- hidden charges.

## **6.1 Transparent With-Profits**

The Faculty and Institute's Transparency of With-Profits working party was formed in late 1999 to respond to the critical perception of with-profits and to support the inclusion of with-profits as an option under Stakeholder pensions.

The working party's report *Transparent With-Profits – Freedom with Publicity* was published in early 2001. The report identified the need to improve the transparency of operation of with-profits business whilst retaining sufficient discretion to allow effective management for example over smoothing and bonus policy.

The authors observed that many of the criticisms of with-profits stemmed from a lack of understanding by consumers resulting from poor communication. To tackle this the working party recommended extending Raising Standards requirements for with-profits. As well as improved disclosure at the point of sale Raising Standards proposed yearly statements to policyholders including the current value of policies and projected maturity proceeds. The additional working party proposals include the disclosure of the investment return on the assets backing the with-profits fund, the asset mix of the fund and the effect of miscellaneous profits on policyholder returns.

The report also proposes a reporting model for with-profits. This includes the identification of separate asset share, smoothing and guarantee accounts for each class of with-profits business.

## 6.2 Financial Services Authority With-Profits Review

The events surrounding the closure of Equitable Life to new business pushed the future regulation of with-profits high up the FSA's agenda. Early in 2001 the FSA announced a review of with-profits. Acknowledging the benefits with-profits had provided in the past, the FSA identified what it described as serious disadvantages of with-profits. The review is looking at the prospects for change in:

- the extent of discretion available to management over the operation of with-profits funds and how that discretion is exercised;
- improvements in the transparency of information sent to policyholders and regulatory returns;
- better information for policyholders about the progress of their investments; and
- the clarification of the interests of consumers and the fair treatment of consumers in the context of with-profits.

To date four issue papers have been produced:

1. Process for dealing with attribution of inherited estates – October 2001
2. Regulatory reporting – November 2001
3. Disclosure to Consumers – February 2002
4. Discretion and fairness in with-profit policies – February 2002

A fifth issue paper covering Governance of with-profits is expected in the near future.

The second issues paper considers a reporting model based on asset shares for with-profits business with summary information disclosed for each with-profits fund. The actuarial profession's response points out that some companies are likely to experience extreme practical difficulties in calculating asset shares for all policies and that existing calculations would be unlikely to be of audit standard.

The fourth paper looks at the extent of discretion available to management of with profit funds and how discretion can be exercised without treating policyholder unfairly. One indication that policyholders have been treated unfairly is when they feel "unpleasantly surprised" by an event or decision. The paper identifies the exercise of unqualified discretion as potentially delivering unpleasant surprises. Such unqualified discretion may also fall foul of the Unfair Terms in Consumer Contracts Regulations 1999 on the grounds of causing a significant imbalance in the rights of parties to the contract.



The paper proposes publication of ‘principles’ and ‘practices’ qualifying the use of discretion stressing that it is not intended that greater transparency should constrain the operation of with-profits to the detriment of consumers. Principles are intended to be high level and not subject to change for example ‘investment strategy will look to provide the highest returns commensurate with an appropriate level of risk’. Practices reflect the insurer’s current approach given current circumstances and could be expected to change for example ‘the target proportion of the fund held in equities is x-y%’.

It is clear that there are going to be significant changes in the regulation of with-profits including very much greater disclosure. The final report is due in spring 2002.

## **7 Regulation and Reporting**

### **7.1 The Financial Services Authority**

The Financial Services and Markets Act 2000 finally came into full force at midnight on 30 November 2001. With this the Financial Services Authority assumed its full powers and responsibilities as the single regulator responsible both for conduct of business and prudential regulation of the financial services industry.

The FSA has four statutory objectives under the Act:

- maintaining confidence in the UK financial system;
- promoting public understanding of the financial system;
- securing appropriate protection of consumers; and
- reducing financial crime.

The rules and guidance for all regulated firms are contained together in one place in the FSA Handbook. The handbook contains over 4,500 pages.

There are likely to be significant changes in the approach to regulation under the new regime. The FSA will be taking a risk based approach with attention focussed on companies where the risk is judged to be greatest based on an impact and probability assessment.

The FSA have indicated that they will be more assertive and challenging than in the past, be more focussed on industry wide issues and engage in themed visits to companies.

One change is that greater emphasis will now be placed on the responsibilities of key individuals in the management of organisations. There are now several controlled functions that can only be carried out by approved persons. Approved persons are responsible for ensuring that there are appropriate and adequate risk management systems and controls in their area of responsibility. These individuals can be fined for failing to carry out their obligations.

Far more radical changes are likely to occur over the next few years. In December 2001 the FSA announced a far-reaching overhaul of insurance regulation led by John Tiner, FSA managing director of consumer, investment and insurance matters. A report on the progress of the Tiner Project will be issued in September 2002.

## **7.2 Regulatory Returns**

Most of the previous regulations and guidance have been carried into the FSA Handbook in the Interim Prudential Sourcebook for Insurers. This brings together the previous rules under the Insurance Companies Act 1982, the Insurance Companies Regulations 1994, the Insurance Companies (Accounts and Statements) Regulations 1996, the Insurance Company Prudential Guidance Notes and Dear Appointed Actuary letters.

In many respects the rules have been carried forward unaltered from the previous regime. There have, however, been a few changes to the valuation regulations discussed below. Additionally:

- Annual returns will need to be submitted earlier. The 6 month deadline has been reduced to 4 months for reporting years ending on or after 31/12/2001 reducing further to 3 months for years ending 31/12/2002. Tighter deadlines apply if the returns are not submitted electronically.
- The European Union Groups Directive has been implemented. One requirement is that the solvency position of groups is to be calculated at the level of the holding company above the insurer. This prevents double counting of capital.

### **7.2.1 Modifications to the Valuation Regulations**

The Interim Prudential Sourcebook also contains some amendments to the valuation regulations.

The regulatory returns now require greater disclosure on with-profits business. Information is required for each fund in which policyholders are entitled to participate in profits including:

- how the with-profits fund is defined, which assets, liabilities, income and expense are allocated to it.
- whether any non profits insurance business, or profit from such business, is allocated to the fund;
- details of how the assets are invested;
- the level of surplus or free reserves to be maintained in the with-profits fund;
- the relationship between the performance of the with-profits fund and discretionary benefits allocated to policyholders; and
- the principles followed by the insurer in setting actual proportions of profits distributed to policyholders and shareholders.

There have also been changes to the rules on the valuation yield assumed on equities. Previously, under Regulation 69 of the Insurance Companies Regulations 1994, the dividend yield was required. In response to the view that companies are now distributing their earnings in other ways, share buy backs for example, the rules have been changed to take some credit for earnings not distributed as dividends. The new rules allow the dividend yield plus half the excess, if any, of the earnings yield over the dividend yield. This amount is subject to a maximum of twice the dividend yield.

### **7.3 Integrated Prudential Sourcebook**

Far greater changes to the prudential regulation of insurers are only a few years away. The Integrated Prudential Sourcebook is intended to form a uniform, risk based approach to regulation that is not sector specific. The aim is, as far as it is possible, to bring the regulation of banks, life insurers, friendly societies, general insurers, investment firms etc. under one consistent set of rules. Current plans are for the Integrated Prudential Sourcebook to take effect from the beginning of 2004.

The FSA issued a consultation paper, CP97, on the Integrated Prudential Sourcebook in June 2001 setting out draft rules and guidance.

### **7.4 Role of the Appointed Actuary**

In December 2001 the Faculty and Institute set up an inquiry into the events surrounding the closure of Equitable Life to new business and its implications for the profession. The Corley inquiry reported back in September 2001. A principle recommendation of the Corley Report was that the work of Appointed Actuaries should be subject to external peer review. The Baird review into the role of the FSA in the supervision of Equitable Life also recommended independent external review of Appointed Actuaries equivalent to an external audit.

In response to the Corley Report the Faculty and Institute's Life Board issued a set of seven principles in relation to compliance review. These include a duty on the reviewer to report to the directors and "whistle-blow" where necessary. The compliance review proposed is to cover the FSA rules and mandatory guidance. The Life Board intends to issue more detailed proposals for compliance review and the implications for professional guidance.

The Actuarial Governance Working Party of the Life Board has recently (February 2002) issued a discussion paper on Actuarial Governance. The paper covers the work of actuaries in the life office, the regulatory framework, and compliance review. Four models for the future shape of actuarial governance are considered. These give particular consideration to managing the potential conflict of interest that may arise when the Appointed Actuary is a senior manager or director of a life office.

The role of the Appointed Actuary will also be considered as part of the FSA's Tiner Project and falls within the scope of the With-Profits Review where it will be considered under the Governance Issues paper.



## **Section 3 – Pensions**

### **1 Reform of the MFR**

#### **1.1 Security for Occupational Pensions**

In September 2000 the Government issued *Security for Occupational Pensions: A consultation document*. This paper sought views on various options including compulsory insurance, prudential supervision, a central discontinuance fund, and a common funding standard such as an amended MFR or on-going funding statement. This was included in last year's Current Topics paper.

The consultation period ended on 31 January 2001 and subsequently the Government issued *Security for Occupational Pensions – The Government's proposals* on 7 March 2001. It stated the responses indicated little support for the MFR. There was also little support for a central discontinuance fund, compulsory insurance or prudential supervision by a regulator.

There was, however, some support for a common funding standard that would apply to all pension schemes irrespective of size. Those who supported this approach felt it should be designed with the aim of ensuring an adequate level of long term funding without distorting investment management plans. However there was no general agreement on the exact basis of this standard, and the Government decided to reject the proposal as it felt it was little different to the current MFR environment.

The other option, which received substantial support during the consultation process, was for a long-term, scheme specific funding standard with a regime of transparency and disclosure. The Government has therefore decided to replace the MFR with this option. It builds on the framework recommended by the Myners Report, and also includes the following extra measures:

- A statutory duty of care towards scheme members on the scheme actuary
- Stricter conditions about voluntary wind-up
- An extension of the fraud compensation scheme

#### **1.2 Key Elements of the Proposals**

##### **1) Funding Statement**

Each scheme will have to have a funding statement setting out:

- The funding objectives of the scheme
- The scheme's investment policy and projected returns on its assets
- Assumptions for projecting its liabilities
- A contribution schedule agreed by the trustees and the employer

The statement will be scheme specific, and on a long-term basis assuming the employer will continue in business. It will also take account of the employer's financial strength. As the employer pays contributions into the scheme, and has to ultimately meet the balance of any costs, it is important the employer is fully involved in discussions about funding and in agreeing the contribution rate. The statement will be distributed to members and made publicly available.

## **2) Recovery Plan**

Each scheme will have to compare itself regularly against the Funding Statement. If the scheme is not adequately funded it will have to produce a recovery plan for returning the fund to adequate funding within a relatively short period of time. This is suggested to be three years. The scheme will have to file this recovery plan with OPRA (as well as making it available to members) and to report annually to OPRA on progress against it. The trustees, actuaries, and auditors will have whistleblowing duties to report to OPRA if contributions are not paid in accordance with the recovery plan. OPRA will have some discretion to allow extensions to the deadline for making good funding shortfalls, and will keep its existing powers to dismiss and replace trustees.

The three year timescale is relatively short, especially considering the five year period to achieve 100% MFR funding, and there may be pressure from the pensions industry to lengthen this timescale.

## **3) Statutory duty of care on the actuary**

This proposal will mean a duty of care on the scheme actuary directly to the scheme members and will be set out in legislation. It will include an explicit duty to consider the implications of funding plans for the scheme members and beneficiaries.

The actuary will have a duty to report to OPRA if:

- Contributions are not being paid according to the funding statement
- There are any delays in drawing up a recovery plan in an underfunded scheme
- Contributions in an underfunded scheme are not being paid in line with the recovery plan
- Either the funding statement, or the recovery plan in an underfunded scheme, are not being adhered to.

An important change is the scheme actuary will now be expected to take into account the employer's financial strength when making recommendations about the funding plan. This could be a difficult area for actuaries to become involved with, and may require access to the type of information produced by credit rating organisations.

## **4) Voluntary wind-up**

The Government will legislate to make it clear companies will not be able to walk away from a scheme leaving it insufficiently funded to meet liabilities. The company will have the choice of meeting these liabilities immediately, or putting in place an arrangement to meet them as they fall due.

## **5) Pensions Compensation scheme**

The level of compensation will be increased to cover not simply 90% of the MFR liabilities as at present, but the cost of securing member's accrued benefits (or the amount of the loss, whichever is the lesser).

## **6) Wind-up on the insolvency of an employer**

The Government will consider whether any increase to the priority of the debt relating to the pension scheme can be made.

## **7) Priorities on wind-up**

As the MFR is to be replaced the priorities on wind-up will also need to be examined.

## **8) Cash-equivalent transfer values**

Similarly, cash equivalent transfer values will need to be further considered as the MFR currently provides a legislative minimum.

## **9) Interim changes suggested by the Faculty and Institute of Actuaries**

As the Government has decided to replace the MFR it did not feel it sensible to introduce some proposed changes recommended by the profession. These involved changes to mortality and pension increase assumptions, and altering the equity MVA reference yield from 3.25% to 3%.

# **1.3 Minimum Funding Requirement: The Next Stage of Reform**

Following the publishing of the Government's proposals on 7 March 2001 it received various comments from interested parties about what should happen in the meantime. In light of this the Government issued *The Minimum Funding Requirement: The Next Stage of Reform* on 18 September 2001 which proposed some short term interim changes and draft regulations which it hopes to bring in before 5 April 2002. It also announced the setting up of a Consultative Panel with representatives from pension industry bodies, consumer organisations, employers, trade unions etc. to take forward the MFR reform. The Faculty and Institute of Actuaries are also included.

The interim changes proposed were:

### **1) Extension of the period for making up MFR deficits**

The current MFR requires an MFR deficit to be corrected within five years or by 5 April 2007 if later. If a scheme is less than 90% MFR funded then it must achieve the 90% level within one year or by 5 April 2003 if later.

The Government proposes the five year period be extended to ten years, and the one year extended to three years. These extensions will only apply for MFR valuations signed after the new regulations are in place.

This has been generally welcomed by the industry as it means any short-term volatility in investment returns will not drive a scheme's funding and investment policy. It also means the proposed three year correction period with the new funding standard looks increasingly short thus adding pressure for it to be lengthened.

### **2) Removal of the current requirement for automatic annual recertification**

The current requirement is for a schedule of contributions to be recertified on each anniversary of its start date. It is proposed to remove this requirement for schemes which at the last MFR valuation showed the scheme fully funded on the MFR basis. The Government is also considering combining this with bringing into force Regulation 11 of the current MFR regulations. This would be the requirement for an MFR valuation to be carried out if the Trustees suspect an event (or series of events) has meant there is a serious risk the MFR will not be met throughout the remaining period of the schedule of contributions.

The Government is working with the actuarial profession on the detailed wording of Regulation 11. The profession, however, is concerned about potential increases on the duties for scheme actuaries and further regulatory burden arising from this Regulation.

### **3) Stricter conditions on voluntary wind-up**

There was a fear the interpretation of the Government's original proposal meant the debt on the employer would be based on the full amount needed to buy-out members' benefits. The Government has now decided this would be too high a cost for schemes to bear. It suggested young members may be better off in a money purchase type arrangement instead of a guaranteed deferred annuity, and also the size of the insurance company buy-out market would be insufficient to cope with the potential huge increase in volumes.

The proposal is the current method of calculating the debt on the employer should be strengthened in the long term to include:

- the actual costs of winding-up the scheme;
- the actual costs of annuities for pensioner members; and
- cash-equivalent transfer values for non-pensioner members calculated on the new long-term funding basis.

As the new long-term funding basis has yet to be formalised the interim proposal is for cash-equivalents on the MFR basis to continue for non-pensioner members.

This move away from the possibility of full buy-out costs will limit the number of employers choosing to wind up schemes quickly under the current rules in order to minimise any debt. A problem with the new proposal, however, is it still requires a buy-out cost for pensioners which can only really be obtained from the annuity market. It is unclear how the limited bulk annuity market would cope with this.

## **1.4 The Future**

The Government is hoping to implement the proposed interim changes by 5 April 2002. The longer term changes will be developed in conjunction with the new Consultative Panel, however, it seems certain the MFR environment will remain with us for another two to three years. It will be interesting to see the development of the new long-term funding standard, and any changes required on scheme actuaries to cover their revised statutory duty of care.

## **2. Myners Review**

Paul Myners was asked to carry out a review of institutional investment by the Chancellor in the 2000 budget. The review was to consider if there were any factors that encouraged institutional investors to follow industry standard investment patterns which focus overwhelmingly on quoted equities & gilts, and avoid investing in other smaller companies.

The review makes recommendation in a number of areas:

- Investment code
- Actuaries & investment consultants
- Fund managers
- MFR



- Life Insurance
- Pooled Investment Vehicles
- Private Equity

In this paper we have chosen to concentrate on the code of investment principles that was published as part of the report.

## **2.1 Investment Code**

Paul Myners published his review of institutional investment on 6 March 2001. The review contained a number of proposals and principles which the Government consulted on between 15 March and 15 May 2001. Over 115 responses were received from institutions, pension funds, fund managers and other interested parties. The Government subsequently issued its response to the review on 2 October 2001.

Some of the principles were amended to reflect concerns raised during the consultation process.

The Government expects pension schemes to voluntarily adopt the principles and set out annually what they are doing to comply with each of the principles. If trustees choose not to meet a particular principle they should explain their decision publicly and to their members.

There were a number of criticisms that the principles were difficult to implement for small schemes. The Government does not accept this and the code also applies to small schemes. Again, if the trustees choose not to comply with a principle they should explain why. The principles do not apply to insured schemes.

The Government will review progress in March 2003 to see if the voluntary code has been effective in changing behaviour. If further action is needed the government is willing to legislate to ensure compliance.

## **2.2 Defined Benefit Schemes**

The proposed investment principles for defined benefit schemes are:

### **1) Effective decision-making**

Decisions should only be taken by people with sufficient knowledge and skills, and trustees taking investment advice should have the expertise to evaluate it.

Trustees should be paid for their duties and have sufficient in-house staff to support them in their investment responsibilities.

### **2) Clear Objectives**

Trustees should set out an overall investment objective for the fund, including taking account of the fund's liabilities and their attitude to risk.

### **3) Focus on asset allocation**

Strategic asset allocation should be fully considered and looked across all asset classes, including private equity. The assets should reflect the fund's own characteristics and not those of other funds.

### **4) Expert advice**

Contracts for actuarial and investment services should be opened to separate competition.

## **5) Explicit mandates**

The mandate between the Trustees and investment managers should cover the investment objective and benchmarks to be measured against. It will also include details of the manager's approach in achieving the objective, and clear timescales for measurement and evaluation.

## **6) Activism**

There should be an increase in Fund managers' shareholder activism.

## **7) Appropriate benchmarks**

Trustees have to consider in consultation with their investment managers the ongoing suitability of any benchmarks, and for each asset class whether active or passive management would be more appropriate.

## **8) Performance measurement**

Trustees should arrange for measurement of the performance of the fund, and assess their own and their advisers' procedures and decision making.

## **9) Transparency**

A strengthened Statement of Investment Principles is required.

## **10) Regular reporting**

The Statement of Investment Principles and the results of any monitoring of advisers or investment managers should be annually sent to members.

Myners also made other recommendations including:

- the replacement of the MFR;
- the Law Commission to look at clarification of the legal ownership of pension surpluses;
- reduction of the rate of tax on withdrawal of any surplus;
- a legal change which would raise the duty of care for trustees, requiring them to be familiar with investment matters where they take investment decisions.

In reply:

- the Government's response on the MFR has been discussed in the previous section;
- the Government is discussing with the Law Commission whether more clarity could be obtained over the ownership of surplus;
- in the 2001 Budget the Government reduced the taxation rate on repayments of pension surpluses from 40% to 35%;
- the raising of care for Trustees is to ensure they take decisions with the skill and care of someone familiar with the issues concerned. The Government is aiming to issue a consultation document on the possible legislation required.

## **2.3 Defined contributions**

Much of the reviews analysis focused on occupational defined benefits pension schemes. However, the review also recognised that defined contribution schemes will become increasingly important in new pension provision.

Many of the issues raised for defined benefit schemes apply equally to defined contribution schemes. The review recommended that investment decisions taken on behalf of defined contribution members should also follow the principles of the investment code. In particular:

- where a fund is offering a default option trustees should ensure that an objective is set for the option including expected risks & returns
- when selecting investment options trustees should
  - take into account members preferences
  - ensure that they offer a sufficient range of funds to satisfy the risk and return combinations reasonable for most members
- defined contribution schemes should, as a matter of best practice, consider a full range of investment opportunities, including less liquid and more volatile assets. In particular, investment trusts should be considered as a means of investing in private equity
- the Government should keep under close review the levels of employer and employee contributions to defined contribution pensions and the implications for retirement incomes
- the NAPF investigate ways of collecting more comprehensive data on the investment decisions of defined contribution scheme.

### **3. Stakeholder Pensions**

Previous current topics papers have discussed the reasons why the government introduced stakeholder pensions (2000) and the key features of stakeholder pensions (2001). This year's paper will look at the impact stakeholder pensions have had on the pensions market.

Stakeholder pensions are low cost, value for money, flexible pensions that were launched on 6<sup>th</sup> April 2001. They are a key part of the Government's attempt to help those on moderate earnings (between £9,600 and £20,000 pa) to save for retirement.

#### **3.1 Employer Designations**

Employers were given until 8<sup>th</sup> October to designate a stakeholder scheme for their employees. The Department of Work and Pensions estimate that between 300,000 and 350,000 employers fall into this category.

The employer does not have to contribute to the stakeholder scheme but must they must provide access for relevant employees to join the scheme. Employers that failed to meet the October deadline may be liable to a fine of up to £50,000.

### 3.2 Sales of Stakeholder

	<b>Number of Policies</b> (at end of month)	<b>Number of Employer Designations</b> (at end of month)
June	224,598	88,073
July	293,685	123,158
August	356,899	146,950
September	415,805	212,242
October	491,694	284,821
November	567,728	304,750
December	637,966	312,096

The sales of stakeholder pensions have increased steadily from April to December. As the end of the tax year approaches we can expect to see an increase in the number of people buying stakeholder pensions.

The pace of employer designation rose sharply in September as the 8<sup>th</sup> October deadline approached. The latest figures for November and December 2001 show that the number of companies designating schemes has started to slow as expected now that the deadline has passed. A large percentage of the relevant employers have now designated schemes.

### 3.3 The Stakeholder Effect

The introduction of stakeholder pensions has led to a wider “stakeholder effect” in the pensions market.

		<b>New Individual Regular Premiums</b>	<b>New Individual Single Premiums</b>
		£ m	£ m
1994		1016	5926
1995		904	5249
1996		1081	6145
1997		1292	7219
1998		1611	5557
1999		1474	6999
2000		1593	7329
2000	Qtr 1	385	1698
	Qtr 2	429	1569
	Qtr 3	388	2173
	Qtr 4	391	1889
2001	Qtr 1	488	2283
	Qtr 2	634	2292
Comparisons			
Quarterly		48%	46%
Year to Date		38%	40%

Source : ABI Press Release August 2001  
Individual Pensions figures include Personal Pensions, DSS Pensions, FSAVC and Group Personal Pensions.  
Quarterly Comparison – Percentage change between the current quarter and the same quarter of the previous year.

ABI results for Q2 2001 show that new personal pension premiums rose by 50%.

- 304,000 regular premium pensions were sold - an increase of 55% over the same period last year. The value of new premiums was £634 million, up 48% on last year's £429 million. The figures include 59,000 stakeholder pensions with new premiums of £64 million. (This does not include employer-sponsored stakeholder pensions.)
- 231,000 new single premium pensions were sold, an increase of 192%. New premiums, at £2.3 billion, were up 46%. This includes 144,000 single premium stakeholder schemes, worth £54 million.

A number of factors have contributed to this :

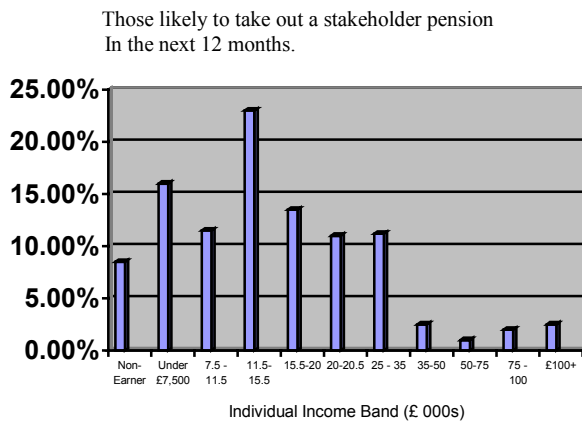
- increased public awareness due to the government stakeholder campaign, stakeholder providers advertising campaigns and press articles
- increased competitiveness in the pensions market with many companies reducing charges on group personal pension within the 1% charge cap
- employers have widened the eligibility criteria for group personal pensions and occupational pensions as a direct result of the introduction of stakeholder
- the movement of some business from Equitable Life.

### 3.4 Public Response

A majority of the public now say that they are aware of stakeholder pensions thanks to media coverage and Government advertising, according to research undertaken by NOP for the Association of British Insurers (ABI). The research showed :

- 14% of adults saying they are likely to take one out in the first 12 months
- people in all income groups, not just those with moderate incomes, will purchase stakeholder pensions
- awareness of stakeholder pensions is lower amongst lower income groups
- one in ten respondents told the survey that they could not afford a stakeholder pension
- Individuals are 54% more likely to take out a stakeholder pension if their employer contributes.

The government intended that stakeholder pensions would be mainly aimed at working people on moderate incomes. ABI research shows that over a third of those likely to buy a stakeholder pension have moderate incomes between £11,500 and £20,000 pa.



Source : The Prospects for Stakeholder Pensions, ABI

Additional work is needed in order to encourage further new and inexperienced savers into the savings market. The research also suggests take-up could be increased significantly if employers also made contributions.

### 3.5 FRS17

The Accounting Standards Board introduced a new financial reporting standard 'FRS17 – Retirement Benefits' as a replacement to SSAP24. The phasing in of the new standard starts for accounting years ending on or after 22 June 2001, with full implementation required for accounting years ending on or after 22 June 2003.

Some of the technical aspects of the new standard were discussed in last year's Current Topics, but there has been much press coverage in the past year of the effects it is currently having, and likely to have in the future.

The main changes from the existing accounting standard SSAP24 are:

Liabilities to be discounted at a rate related to the return on AA rated corporate bonds

Assets to be valued at their market value

Reported pension costs to be split between the Profit and Loss (P&L) account and the Statement of Recognised Gains and Losses (STRGL)

FRS17 will result in greater volatility in company balance sheets and STRGLs, and to a much lesser extent in P&L accounts. This is because the liability discount rate is related to AA bonds, but most schemes have a significant proportion of their assets in equity type investments.

To decrease this volatility some companies may want their schemes to move from equity type investment into gilts and bonds. Boots pension scheme (£2.3bn) recently moved most of its portfolio from equities to bonds citing FRS17 as one of the reasons, and for many other schemes there is evidence of a continuing general shift. Although this will produce greater stability it may mean losing out on the potentially higher returns available from equities, thus increasing the required contribution rate. FRS17 is also likely to lead to a greater focus on asset and liability matching for UK final salary pension schemes.

One consequence of the new standard is the effect the funding position of a company's pension scheme can have on the company dividend. In October 2001 an engineering company, Eliza Tinsley, issued a statement saying it was cutting its dividend after examining the position of the pension scheme. A year previously the scheme had a healthy surplus, but the fall in world share prices at the time had moved the scheme into deficit. To pay for the extra cash required the company decided to cut its future dividend payments by two-thirds.

FRS17 also requires any past service benefit improvements to be shown fully in the P&L account in the year the improvement is granted. This could make companies less happy to agree to such improvements.

Although early adoption of the new standard is encouraged it is likely most companies will prefer to avoid any extra volatility for as long as possible. However it is important companies try to find out the likely effect on their accounts sooner rather than later, especially if the size of the pension scheme is comparative to or larger than the company.



## **4. State Pension Provision**

The aims of the government are :

- to get extra help quickly to pensioners in poverty
- to provide more support to those on modest incomes
- to ensure those on higher incomes are treated fairly by the tax system

### **4.1 Minimum Income Guarantee**

In April 1999 the government introduced a new Minimum Income Guarantee (MIG) for pensioners. The MIG is a guarantee of minimum income for pensioners which tries to take account of their personal circumstances. From April 2001 the MIG has been set as £92.15 per week for single pensioners and £140.55 per week for couples.

From April 2001 the government increased the capital sum allowed before MIG entitlement is affected. A pensioner can have savings of £6000 before their benefit entitlement is reduced. They can have savings of up to £12000 before their entitlement is removed. Initially the MIG also differed according to age but that has now been removed.

The MIG penalises those individuals who have made the effort to save. For those over the £6000 threshold then the MIG is reduced by £1 for every £1 personal income. It also involves a weekly means test which can make pensioners reluctant to apply.

### **4.2 State Second Pension**

The new State Second Pension will replace SERPs on 6<sup>th</sup> April 2002. It is being implemented in two stages. The principle aim of the government is that no one should be worse off under the State Second Pension whilst lower earners will receive considerably enhanced benefits.

From April 2002 the State Second Pension will be an earnings related scheme similar to SERPs but with three different accrual rates depending on the level of earnings. At some date in the future it will become a flat rate scheme. The date and details of this change have still to be confirmed. When the flat rate accrual is introduced it is expected to be based on 40% accrual and for calculation purposes eligible individuals will all have earnings at the lower earnings threshold. Carers and disabled people will also qualify for accrual provided they have paid National Insurance contributions for one tenths of their working life.

### **4.3 Pensions Credit**

A new pensions credit will be introduced in 2003. A consultation paper was published in November 2000 and the State Pensions Credit Bill was introduced to the House of Lords on 28<sup>th</sup> November 2001. It aims to remove unfairness in the current system by

- getting extra help to the poorest pensioners
- rewarding pensioners with low or modest incomes who currently gain little from any savings, private pension income or other earnings because of the way the MIG operates.

The main features of the proposed pension credit are :

- A guarantee credit which is designed to ensure a minimum level of income for people over the age 60. This will replace the MIG. This is expected to be £100 per week in 2003.
- A savings credit for people over the age 65 which will provide an additional income for pensioners who have low or modest incomes in addition to the full rate of basic state pension. This is expected to be 60% of any additional income above the full basic rate pension.

The total amount payable as a result of these two components will be referred to as pensions credit.

**Example** – single pensioner with income below £100 per week

Pre-credit income (including basic state pension)	£87.00
Guarantee credit (to bring up to £100 minimum ie £100 - £87)	£13.00
Savings Credit (60% of £87 – 77)	£6.00
Total post-credit income	£106.00

The pension credit calculation will ignore the amount of capital held if it is below £6000. If more than £6000 capital is held then the excess over £6000 will be treated as qualifying income in the pension credit calculation at a notional interest rate of 10%.

The government has indicated the rates at which it intends to introduce the Pension Credit in 2003. These would :

- guarantee an income of £100 per week for a single claimant and £154 for a couple
- pay a maximum savings credit of £13.80 per week for a single claimant and £18.60 for a couple
- mean that entitlement to pensions credit would run out at an income around £135 per week for a single claimant and £201 per week for a couple.

The government intends to introduce a new claims process and administrative procedures for Pension Credit which are designed to make it easier to claim and increase take-up. A new Pensions Service will replace the part of the Benefits Agency that currently deals with pensioners. The Pensions Service will be responsible for calculation and payment of the basic state pension and pension credit. Once claimants reach age 65 the credit would be assessed every 5 years unless there is a major change in circumstances.

#### **4.4 Issues arising from the Pensions Credit consultation**

The government received fifty seven responses from groups representing pensioners, trade unions and the financial services industry. The government published formal responses together with the Pensions Credit Bill in November 2001. Draft regulations were due to be published in January 2002.

Issues that have been raised are :

- the complication of the calculation could lead to a reduction in take-up rates
- the pension credit will need to be carefully designed to allow interaction with other state benefits e.g. housing benefit
- the effect of pensions credit on the saving behaviour of people currently of working age
- the long term viability of the different strands of government pension policy
- increased complexity may increase the need for personal investment advice which may put people off saving altogether

## 5. Annuity Reform

Over the past year subject of annuities have been widely debated.

In June 2001 the Retirement Choices working party published a paper on “Extended Retirement Options”. The paper looks at four different retirement options:

- traditional annuities
- extended annuity options including some recent annuity product developments
- the proposals in the Choices report issued in 2000 in which a minimum annuity was purchased at retirement with freedom to invest and draw income from the balance of the retirement fund
- The Personal Distribution Plan - a proposal developed in the paper in which there would be no compulsion to buy an annuity at retirement. The retirement fund could be invested and drawn from without restrictions but an annuity would have to be purchased on or before the fund reached a level at which it could secure the minimum income an individual requires (including State benefits) to maintain a satisfactory standard of living.

These options were then evaluated using the following criteria :

- |                      |  |
|----------------------|--|
| - Choice             | can the solution be tailored to needs of individuals?                        |
| - Security           | how much risk attached to option?  |
| - Inheritability     | can remaining fund be passed to dependants?                                  |
| - Flexibility        | can the option be change at a later date to meet changing circumstances?     |
| - Self Reliance      | can individuals be confident they will not need support from state benefits? |
| - Investment         |  |
| Efficiency           | what sort of investment choice & return will be available with option?       |
| - Cost effectiveness | what are the direct & indirect cost of settling up the option?               |

It is the Working Party's view that different people will attach different priorities to each of these criteria. Consequently, there should be a range of retirement products which provide the choices required by savers. Some priorities are not adequately catered for in the existing products which can be provided within current legislation. The Working Party believes that this highlights the need to examine ways in which the legislation should be changed to widen the choice available and better meet these needs.

### 5.1 ABI Report

In January 2002 the ABI published a paper on the topic of annuities “Reforming Annuities – Big Bang or softly, softly?”. It suggested that a package of minor reforms to annuities and the pension system as a whole might be a better way to address current complaints about annuities.

The suggestions are:

- Raising retirement age to 70

- Paying annuities gross once long-term care is required
- Allowing occupational pensions to be drawn while a person is still employed to allow people to opt for partial retirement
- Borrowing from pensions savings to meet emergency payments
- Allow people to transfer between providers after they have purchased their annuity
- Further tax incentives to encourage people to save
- 25% of pension pot to be taken as a tax free lump sum, a further 25% could be transferred into an account to accumulate tax free (to be withdrawn as required) and the remainder could be used to purchase an annuity.

## **5.2 The Pensions Annuities Bill**

In January 2002 MP David Curry pushed through a private members Bill on annuity reform. The bill was based on proposals published in March 2000 by the Retirement Income Working Party, a group made up of academics and industry representatives.

The bill proposes savers buy a modest annuity income big enough to keep them off state benefits. The balance of the pension fund could be used to provide income in anyway the saver chooses e.g. the surplus could be passed to children.

The bill now goes forward to committee stage but the government has indicated it will oppose it. It is unlikely to become law.

## **5.3 Government Consultation Paper**

In February 2002 the government issued a consultation paper “Modernising Annuities”. The document proposes ways to make the annuities market work more effectively, enabling everyone buying pension annuities to purchase products that will meet their needs and achieve good value. The government has requested responses by 5<sup>th</sup> April 2002.

The government believes that reform is necessary to make the annuities market work better, so that customers are better informed and providers have greater flexibility to provide a wider range of annuity products. It also states that annuities continue to provide a financially efficient and secure means of turning pension capital saved through defined contribution pensions into income that lasts for all pensioners’ retirement.

In developing policy on annuities the Government is determined that any action

- should, where possible, increase the level of retirement income that people can expect to gain through an annuity
- should ensure that funds saved with the benefit of tax relief are used to provide a secure income in retirement.
- should contribute to the Government's aim of encouraging people to save more for their own retirement. The Government is keen that people should understand annuitisation and the options on offer so that they make the right choices and receive good value.

Some of the ideas the Government has outlined in the document are :

- Flexibility for pensioners to switch providers after they retire
- Options to return to work after retirement
- Creating a CAT standard annuity to identify well priced, transparent products
- How to publicise open market option
- Can new annuities be designed that offer flexibility for customers without conflicting with Government principles

## **6. GMP Equalisation – Update On The Williamson Case**

It was hoped that this year the question of equalising GMPs would become clearer following the appeal to the High Court in the Williamson case.

In summary, the Williamson case involved an actuary, Mr Williamson, who was a deferred member of the Sedgwick Group Pension Plan. He had made a complaint to the Ombudsman on the grounds the scheme treated GMPs differently for men and women and not equalised them. The Ombudsman delivered his determination on 7 January 2000 directing that "GMPs are equalised in accordance with the equal treatment rule of section 62 of the 1995 Pensions Act". He did not say how exactly this should be done, but left it up to employers and trustees to decide on a suitable approach.

The employer and trustees appealed this decision to the High Court on the grounds that (a) the Ombudsman did not have jurisdiction to make a ruling on the case, and (b) the decision was incorrect.

The Judge delivered his determination on 23 February 2001. He upheld the appeal on the basis the Ombudsman was not empowered to make such a determination. This was because the Ombudsman only has jurisdiction to make determinations on those who are directly party to the dispute. As the ruling was a general one for the scheme, and would have affected other members who had not had the opportunity to be represented, the decision was set aside. As the appeal was upheld on the grounds of the first reason it meant the Judge did not have to give a definitive ruling on the second.

It was disappointing for the industry the appeal was rejected on what could be considered technical reasons. The Judge did make some comments on equalisation but the issue remains open. It is still something that needs on-going consideration, especially for schemes winding-up, and it will only become clearer when another case provides a more general legal judgement.

## **7. Boots Pension Scheme**

Boots announced in November 2001 its £2.3bn pension fund had completed switching all its equity holdings into gilts and corporate bonds. The switch was kept secret over a 15 month period.

The scheme Trustees cite the fall in equity markets since the spring of 2000 as one of the triggers for the move away from equities, and also a desire for a greater match of assets and liabilities to reduce risk. Like many large corporate pension schemes Boots is relatively mature with about half of its members being either current pensioners or deferred members.

Another reason could have been the implications of the new accounting standard FRS17 (discussed previously) which will produce greater volatility in company accounts because of a pension scheme's funding position. Investing in bonds will decrease this volatility.

The company also disclosed the move meant a reduction in fund management fees from about £10m a year down to £250,000.

Questions are now being asked whether more schemes will follow this approach. Most commentators think this unlikely as Boots managed to get the timing right and sold at a time when bond prices were high. The actuarial consultancy advising the Trustees and employer also stated that while the strategy was right for Boots it might not be appropriate for all companies.

There is also the problem if more and more schemes followed this approach that there would be an insufficient supply of bonds in the market. The increased requirement for bonds would also push annuity rates down even further. It is clear some schemes are gradually switching part of their equity holdings into bonds, but it is unlikely any will go quite as far as Boots.

## **8. Unilever V Merrill Lynch**

The Unilever Superannuation Fund sued Merrill Lynch Investment Managers (MLIM) for £130m for not meeting its fund performance benchmarks. Unilever claimed MLIM underperformed by 10.5% over a 15 month period to March 1998, and the fund manager breached contract conditions which agreed performance should not be more than 3% below that of the FTSE All Share in any four successive quarters.

After 28 days in court the two parties reached an out of court settlement. It was announced all issues had been resolved, and MLIM agreed to pay a sum to Unilever without admitting liability. Although both sides had signed a confidentiality agreement it is rumoured the settlement was around £70m. The Judge, however, condemned both sides for spending hundreds of thousands of pounds in taking the case to court in the first place.

In light of the outcome it is likely more pension funds will review their arrangements with investment managers in the future. This may mean the possibility of further pension schemes seeking redress for underperformance.

## **9. Pension Simplification Review**

The Government has set up a review led by former National Association of Pension Funds chairman Alan Pickering. The purpose is to decrease the amount of red tape surrounding pensions, and is due to report back in July 2002. The remit covers all private pensions legislation under the Department for Work and Pensions (DWP), and there will be close liaison with other bodies such as the Treasury and the FSA. There will also be discussions with those working on the Sandler Review.

The five areas initially identified for study are:

- Contracting-out and the general relationship between private and state provision
- Preservation rules, deferred pensions and transfer values

- Disclosure of information
- Administration, which is described as covering any area of pensions law not covered by the other four areas
- How Government social policy has interfered with pension scheme design.

The review will be supported by seconded DWP officials and outside experts.

## **10. Money Purchase Illustrations**

A consultation document on Statutory Illustrations of Money Purchase Benefits was published by the Government in September 2000. The detail of the proposed changes was outlined in last years current topics paper.

The regulations place new legal requirements on those responsible for issuing annual benefit statements. Trustees or managers of defined benefit and defined contribution schemes, personal pensions and stakeholder schemes will in the future have to include an illustration of money purchase entitlements on most annual benefit statements, including those where no contributions are currently being paid.

The Government has now issued draft regulations which will require those Money Purchase schemes covered by the Disclosure Regulations to provide illustrations of future pensions entitlement. The Faculty and Institute of Actuaries revised the basis and calculation method for the statutory illustrations after considering the responses from the consultation. Comments on the Draft Technical Memorandum were requested for 5<sup>th</sup> November 2001. The final regulations and Technical Memorandum should be issued early in 2002.

The Financial Services Authority (FSA) is aware of the proposals and will shortly be consulting on changes to its rules with the aim of achieving consistency between the basis proposed in the Technical Memorandum and its own basis for illustrations.

When the consultation paper was issued the DWP proposed that the illustrations would be mandatory from April 2002. However, this was on the understanding that the regulations and Technical Memorandum would be available from April 2001. The proposed starting date has now been changed to April 2003. It is the intention that providers can provide illustrations on a voluntary basis from April 2002.

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Press Cuttings

The Actuary



## **Section 4 -UK Private Medical Insurance**

### **1 Size of Market**

Market statistics produced by the Association of British Insurers (ABI) indicate the following trends (2001 totals were not available at the time of writing):

	Number of subscribers 000	Persons Covered 000	Gross Premium Earned £m
1995	3,102	5,984	1,601
1996	3,174	6,099	1,752
1997	3,217	6,123	1,877
1998	3,251	6,141	1,970
1999	3,400	6,179	2,066
2000	3,470	6,580	2,239

The above figures exclude Third Party Administration (TPA) and Administration Services Only (ASO) business. On this basis, 11% of the UK population was covered by PMI at the end of 2000.

The number of subscribers increased by 2% in 2000, with a corresponding increase in the number of lives covered of 6% and earned premium of 8%. A breakdown of these figures between the Personal and Corporate business sectors helps to explain the changes.

Corporate Sector	Number of subscribers 000	Persons Covered 000	Gross Premium Earned £m
1995	1,836	3,735	756
1996	1,872	3,800	822
1997	1,954	3,979	881
1998	2,043	4,157	966
1999	2,207	4,287	1,027
2000	2,324	4,631	1,092

Personal Sector	Number of subscribers 000	Persons Covered 000	Gross Premium Earned £m
1995	1,265	2,249	845
1996	1,301	2,299	930
1997	1,263	2,144	996
1998	1,209	1,984	1,004
1999	1,193	1,892	1,039
2000	1,145	1,949	1,146

There has been a decrease in the number of personal subscribers in recent years, countered by a greater increase in the number of company-paid subscribers. At the end of 2000, company-paid subscribers represented 67% of total PMI subscribers, having increased steadily from 59% in 1996.

The growth in demand for company-paid PMI is believed to be due to several factors including favourable economic conditions, increased marketing of the product and price discounting. In contrast, significant price increases in the personal market have contributed to the downturn in demand in this sector.

Earned premiums increased in both sectors though for different reasons. The increase for corporate business reflects the growth in the number of subscribers. The increase in earned premiums for the personal sector is due to providers applying premium increases to a declining subscriber base. At the end of 2000, just under half of the total PMI premium came from companies buying PMI on behalf of their employees.

## **2 Product innovation**

Increasing claims costs and low market growth have been significant factors in prompting product developments in recent years. Insurers have been trying to sustain and increase sales by offering lower cost products, with the aim of reducing lapses and making PMI more affordable to a wider proportion of the population. Low-cost options have also been used by new entrants as an attempt to gain market share.

One such innovation has been the introduction of high-excess plans which offer significant savings compared to regular PMI policies. Excess options on such plans typically range from £1,000 to £5,000. Other developments include restricting the benefits of the policy, for example by excluding illnesses associated with expensive treatments such as cancer, or restricting access to certain hospital networks.

One provider has attempted to address policyholders' concerns about future price increases by fixing premium rates for either 5 or 10 years. The monthly premiums are initially higher than the market average, so building up a fund to meet the cost of claims later in the policy life, when premiums are expected to be lower than the cost of claims.

Another new plan encourages policyholders to choose between private and public treatment by offering a cash sum per night spent in hospital at an NHS facility.

As a consequence of these developments, the PMI market now offers customers a greater choice in terms of both cover and price.

## **3 Actuarial issues**

Historically, the rating of individual and small company products has been relatively unsophisticated, with very few rating factors being used. Premium rates varied by the broad age band into which one of the insured lives fell (typically the oldest life, or the employee), and families attracted the same rate irrespective of the number of children included.

In recent years some insurers have started to move towards using more rating factors such as occupation, geographical location and exact ages of each of the lives covered. As always, the more sophisticated rating will result in winners and losers among the insured population. The recent developments in geographical rating should also help penetration into some parts of the country. From the insurers' point of view the aim is obviously to attract business at the correct rates and thereby better manage risk.

In many ways pricing of PMI involves standard actuarial methodology: analyse data on past experience; make adjustments to reflect known differences in the future (such as different benefit definitions); allow for inflation. The wide range and generally high level of estimates of medical inflation that get quoted only prove the point that choosing the inflation assumption is a key part of

the process, yet there is no equivalent of the RPI to act as a guide. The idea of compiling indices of medical inflation has been looked at recently by actuaries and others. However, inflation varies significantly by product type and other factors, so the amount of data in each homogenous, well-understood sector make it unlikely that such indices would significantly help pricing actuaries.

If the movement towards providing premium guarantees gains any momentum then understanding medical inflation will become even more of a priority.

For larger company schemes a range of options is available whereby the insurer and the employer bear different proportions of the risk. Increasing use of flexible benefit packages by employers in several industries is starting to present some interesting challenges to private medical insurers. Employers will expect premium rates that are not too much higher than for a standard PMI scheme, but astute advisers will guide them away from sharing in the insurance risks due to anti selection issues. Opportunities will no doubt exist for actuaries on both sides to play key roles in developing products and pricing strategies which meet everyone's needs.

## **4 Regulation of PMI**

The selling of PMI is currently not supervised by a regulator as non-life business is not covered by the Financial Services Act 1986. The self-regulation of general insurance is the responsibility of the General Insurance Standards Council (GISC). The GISC is an independent, non-statutory organisation regulating the sales, advice and service standards of members with the overall aim of ensuring general insurance policyholders are adequately protected and fairly treated.

However, in December 2001 the Treasury announced that the Financial Services Authority (FSA) will take over the regulation of general insurance in 2004, bringing the regulation of all health insurance products under one banner. This move followed the November 2001 European Insurance Intermediaries Directive which requires member states to introduce the regulation of persons conducting general insurance within two years.

The FSA and Treasury will be consulting widely on the precise scope of the regulatory regime before finalising details. In the interim, the industry will maintain current levels of consumer protection through the GISC.

The business performance of PMI providers is already monitored by the FSA. All insurance companies carrying out business in the UK must submit annual returns to the FSA as required under the Insurance Companies Regulations. All private medical insurers fall into the accounting class accident and health.

## **5 Current political influences**

Provision of health care is a topic high on the current political agenda. One of the key points being debated is where to obtain the vast sums of money required to provide a health service that will meet the increasing demands of the population. The general political sensitivities around the use of private finance in public services have perhaps restrained the pace of change in the health sector, but it seems clear that private money will feature prominently in future health provision.

When the first group of NHS patients travelled to France recently for hospital treatment there was intense media interest – on both sides of the channel. Whether the numbers of NHS patients who will travel abroad for treatment will make any impact on NHS waiting lists will be doubted by many. But the fact that patients are being sent abroad conveys the message that current NHS capacity will not constrain the amount of treatment received by patients on the NHS. Recent moves by the government towards using more UK private hospital facilities to treat NHS patients reinforce this message.

At the same time the government is clearly trying to get more out of the NHS's own facilities. These efforts include addressing the management side of the NHS to ensure that any inefficiencies are driven out.

As far as the PMI industry is concerned the important issue is the public's perception of the services they will receive through the NHS. Any efforts made by the government to improve NHS provision should, in theory, make PMI less attractive to the public. Whether the government's efforts to improve the NHS will have a significant impact remains to be seen, but it is certainly something the government is taking seriously – not least in electoral terms.

If the government is to achieve its target of bringing UK health provision into line with European standards it seems almost certain that private money will be needed. The extent to which private money is required at the point of treatment is not so certain, but this is the area of most interest to the PMI industry. Over the next few years the industry will be watching political movements closely, and no doubt adapting and innovating to make sure that it will continue to have a role in whatever new set-up emerges.