Current Topics
2003

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Introduction

As in previous year, the main focus of the paper has been the core exam topics. As a result there may be small overlaps between sections. Apologies to those sitting subjects 303 (general insurance) or 305 (finance and investment) as we have been unable to cover these topics.

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The paper is not definitive and we apologise, taking full responsibility, for any omissions or errors. Any opinions expressed are those of the authors and not necessarily those of our employers, colleagues or local actuarial societies.

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SECTION 1

INVESTMENT

1. 2002 the year in review

General Overview

2002 saw the third consecutive year of negative returns on equities in the UK, Europe, the US and Japan. In 2002, the FTSE 100 Index sank 24.5%, while the FT Eurotop 300 Index fell 32.0%. Germany was the weakest European market, declining 43.9% over the course of 2002, dragged lower by a stagnating economy and its relatively high weighting in the insurance sector.

The winners were those asset classes and sectors perceived to be safe havens -cash, gold, bonds, property and, within equities, the most defensive sectors such as Tobacco and Food Producers. Equity fund outflows hit record levels in 2002. At the stock level, it was the same names that had underperformed in 2001 that fell again in 2002, with technology stocks once again the main culprits. Only early in the fourth quarter did the technology sectors enjoy a brief period of outperformance. The defensive, non-cyclical sectors re-established their domination of the market in December. During the fourth quarter, equity markets experienced an unprecedented level of volatility. This was exacerbated by rumours that insurance companies were close to breaching their solvency levels and were being forced to sell into any short-term strength.

Economic growth and monetary policy

At the start of 2002, financial markets were pricing in a vigorous recovery in the US and a rise in short-term interest rates. After a strong start, with 1st Quarter 2002 annualised US GDP growth reported at 5.0%, the 'recovery' lost steam and attention turned to the chances of the US experiencing a 'double dip'. In the light of weaker economic data, the Fed eventually made another cut in interest rates in early November. This 50 basis-point cut took the Fed Funds rate to 1.75%, the lowest level for 40 years. US economic imbalances apparent at the start of 2002 did not upset the economy as many had feared. The private sector financial deficit narrowed without any severe repercussions. The trade deficit continued to widen, although the dollar remained relatively resilient until late in the year. In the event, the US was one of the strongest economies among the major markets in 2002. The most recent data, from 3rd Quarter 2002, shows annualised US GDP growth of 4.0%. In the UK, Quarter on Quarter GDP growth was 0.9% in 3rd Quarter 2002, while the equivalent figure in the euro area was 0.3%. The ECB left rates on hold at 3.25% until early November, when it cut rates to 2.75%. However, the UK's MPC left monetary policy on hold at 4.0% throughout the year, as the weak manufacturing sector was offset by a buoyant consumer sector. Confidence was supported by low rates of unemployment and a 29% year-on-year rise in house prices, according to the HBOS index released in December. By the year-end, however, there were signs that the UK housing market might be running out of steam. Globally, attention turned to the possibility of deflation.

Corporate Governance

The year was dominated by news of corporate misdeeds, particularly in the US. The collapse of Enron in December 2001 resulted in the downfall of its auditor,

Andersen, in March on charges of an obstruction of justice. This was followed in July 2002 by the US's largest ever corporate bankruptcy, WorldCom, where revenues were found to have been inflated by more than $9bn, and by further accountancy-related frauds at Tyco (where the Chief Executive was indicted on charges of corruption) and Xerox, to name but two. In Europe, Vivendi Universal's Chief Executive came under scrutiny as similar issues dogged the French media company. In an attempt to restore investor faith, the SEC set a deadline of 14 August, by which date all Chief Executives were required to sign off on the validity of their financial reports. Furthermore, the Sarbanes-Oxley corporate reform legislation, passed in July, requires that Chief Executives swear that their financial reports not only conform to the letter of the GAAP accounting law, but also that they present a faithful picture of the company's operations and financial condition. The NYSE now requires that half of a company's directors are truly independent of management. The hope is that these measures will result in companies adopting a less aggressive approach to accounting and a reduction in the number of instances where accounts are manipulated to flatter earnings and, ultimately, directors' share options. Coca-Cola announced in July that it would include stock options in its accounts as an expense, although many companies (technology companies in particular) appear unwilling to follow its lead. In an attempt to reduce further the scope for manipulating earnings numbers, Standard & Poors introduced the concept of "core earnings" numbers, which exclude goodwill impairment charges, gains and losses on asset sales and pension fund gains, but include restructuring and stock option charges. Consequently, there has been a dramatic lowering of earnings compared with "as reported" numbers and 2002 saw a steady stream (and sometimes a torrent) of analysts' downgrades. Some benefit from these moves has been felt in Europe; in the UK, there has been a marked increase in shareholder activism, the removal of Ian Harley at Abbey National and the sudden about-turn over the pay deal of GlaxoSmithKline's Chief Executive are evidence of this.

Global Tensions

These became increasingly evident as the year drew to a close and expectations rose that a US invasion of Iraq was imminent. The most obvious manifestation was the return to favour of defensive stocks and 'safe-haven' asset classes during December. Oil prices soared to over $30/bbl in December, mainly as a result of the oil workers' strike in Venezuela, but the markets were almost certainly factoring in an increased war risk as well. However, throughout the year tensions had played a part in depressing investor confidence. While serious conflict between India and Pakistan was narrowly avoided, the conflict between Israelis and Palestinians deepened as the year progressed. Global terrorism, in the form of bomb attacks in Bali and Kenya, resurfaced in the final quarter.

Corporate activity

Corporate activity remained depressed in 2002. In the UK, the most noteworthy large cap transactions during the year were the successful bid by US cruise operator Carnival for P&O Princess, the formation of National Grid Transco from the merger of National Grid and Lattice, and HSBC's purchase of Household. Meanwhile, Corus and Shire both saw high profile deals fall apart, outcomes that were severely punished by shareholders. In Corus's case, this triggered its eviction from the FTSE 100 index in December. In Continental Europe, the largest deal was that between Credit Agricole and Credit Lyonnais in December. Other deals suffered at the hands of the regulators –including

E.On's proposed acquisition of Ruhrgas - while mere rumours of mergers fuelled the performance of a variety of stocks, such as German banks Commerzbank and HVB in the final quarter. In the US, the biggest deals were the Pharmacia and Pfizer tie-up, agreed in July, and Northrop's acquisition of TRW in February. Other themes that dominated the headlines in 2002 included asbestos-related litigation (which hit ABB and Electrolux, among others), the closure of final salary pension schemes in the UK as a swathe of companies revealed pension fund deficits, and the split capital investment trust debacle, also in the UK.

UK Market

For the third year in a row, equity markets performed badly. As in 2001, overseas equities was the worst performing asset class, falling by 27.4% in 2002. UK equities' more defensive nature still left it falling by 22.7% over the year. Gilts was the top-performing major asset class, returning +9.3%, while cash returned +4.0%. In the UK, all size indices fell by over 20% in absolute terms. The FTSE 100 was the best performer, outperforming by 0.7% relative to the All Share. The Mid Cap underperformed by 3.1% relative. The laggard was the Small Cap Index, which underperformed by 6.3% relative.

In 2002, Resources was once again the best-contributing major sector grouping due to strong performance from both Mining and Oil & Gas. Indeed, both sectors were among the top five sectors in terms of relative contribution in 2002. At a stock level, notable contributions came from BP (+7% relative to the All Share) and Shell (+16% relative), helped by crude oil price rises on concerns over the potential for a conflict in the Middle East. For the third consecutive year, Non-Cyclical Services was the worst-contributing major sector grouping entirely due to the Telecoms sector. In 2002, Telecoms was hit by profits warnings from Nokia, Energis, Cable & Wireless, Ericsson and Sprint as well as the collapse of WorldCom. The worst contributions came from Vodafone (–17% relative), Cable & Wireless (–81% relative) and mmO2 (–34% relative).

Structured Products

The UK market for structured retail investment products continued to expand in 2002 according to figures from structuredretailproducts.com. Gross sales of £6.27bn were up 15% on 2001 with 68 different retail product companies offering a total of 312 individual products during the year.

Several new entrants came to the market in 2002 including Egg and National Savings, which launched three successful tranches of products, the first Government backed structured products in the UK retail market.

With continuing uncertainty in the stockmarkets, the market saw a shift from capital at risk, high income products to capital protected growth type products. Income product sales fell 20% to £1.93bn whereas growth product volumes grew 40% to £4.35bn, predominantly in the form of bank deposits and Life Bonds.

The market continues to be dominated by the major banks and life assurance companies although with the arrival of new entrants the market share of the top players has reduced. The ten largest sellers of growth products saw their market share fall from 71% to 57%.

Issuance of all forms of products, except offshore products, grew over the year. Sales of stocks and share ISAs however fell slightly as the volume of income products overall declined. The use of the Dublin registered company as a vehicle for these products also declined. Jersey and Guernsey vehicles along with medium term note based products now account for almost 25% of structured ISA sales.

The FTSE100 remains the most popular index accounting for 51% of all product issuance and 41% in terms of sales. With the continuing rise in the prices of residential property a total of five products were linked to the Halifax House Price index up from just one product in 2001. Products linked to actively managed funds also increased in issuance with 15 tranches seen in 2002 up from 7 in 2001.

The maturity of all forms of products has been on the increase. Income products in particular have seen a lengthening in maturity with the most common term now five years as against three years in 2001. This is the same maturity as the majority of growth bonds however longer term products are also being offered in this sector. In fact growth products with maturities over five years now account for 16% of all growth product sales

2. 2002 The Year in Graphs

Graphs showing the 2002 values for several major equity indices and also yields on each of the S&P 500, FTSE and a World Index Excluding UK are attached as a PowerPoint attachment.

The graphs are:-

- Comparison of S&P 500, CAC 40, FTSE, XETRA DAX and NIKKEI 225 (rebased to 100 at Dec-01).
- S&P 500 Index
- CAC 40 Index
- FTSE All Share Index
- XETRA DAX Index
- Nikkei 225 Index
- S&P 500 Yields
- FTSE All Share Yields
- World Index Europe Excluding UK Yields

3. 2003 the year ahead

A survey of 40 leading investment managers produced the following predictions for 2003.

Global Overview

For 2003, Hong Kong, South Korea and the UK are predicted to be the best-performing countries and the US is also highly ranked. In 2002, these markets had mixed results with Hong Kong, the UK and the US all in the bottom half of the group of global markets in terms of performance. Japan fared better, but still declined 10.1%, while South Korea achieved +8.6%. The best-performing major countries last year were New Zealand and Austria with returns of +26.1%

and +17.3%, respectively. A handful of the managers predicted that these two countries would continue to be high performers in 2003, but they are not among the most widely favoured countries. Increasingly, managers are choosing to look at the world in terms of global industrial sectors instead of along country lines. The global managers expect the leading sectors in 2003 to be financials and telecommunications. Their outlook is pessimistic for the utilities and consumer staples. The global economy and the threat of terrorism are expected to most likely impact the global capital markets in 2003.

The managers expect average returns of +10.3% for the MSCI World Index and +11.0% for the MSCI EAFE Index in 2003. The global managers' outlook for the US is less optimistic, however, with the firms predicting the S&P 500 to return +8.9%. The results would be considerably better than for 2002, when the MSCI World Index declined 19.5% and the MSCI EAFE and S&P 500 declined 15.7% and 22.1%, respectively. Emerging markets remain attractive to the managers, who expect the MSCI Emerging Markets Index to return +13.5 % for 2003. The three-year outlook for global markets is expected to continue in line with the 2003 positive predictions. The majority of managers expect an increase in the level of merger and acquisition activity, with only a handful expecting it to decrease in the near future - another sign of cautious optimism.

United States

A majority of the money managers (56%) believe that the most important issues for 2003 in the US capital markets are the US economy and geopolitical stability. The average prediction was that the US Fed Funds rate will rise by 50 basis points over the year, ending at 1.75%. Inflation is not expected to rise significantly as the economy continues to slowly recover. Despite three years of underperformance, managers continue to expect positive performance across all equity indices. Expectations are lower than last year, possibly the result of larger negative returns in 2002.

The top issues expected to affect the US markets are:-

1. US Economy
2. Geopolitical Stability
3. Global Economy
4. Unemployment
5. US Interest Rates
6. Fiscal Policy
7. Inflation
8. Monetary Policy
9. US Technology Sector
10. Global Currency Rates
11. Global Interest Rates
12. International Trade Deficit

The managers also predicted their top and bottom three US Sectors for 2003 to be:-

Top Three	Bottom Three
Healthcare	Utilities
Technology	Consumer non-durables
Finance	Consumer durables

Managers predict the Top 5 US Stocks for 2003 to be

1. El Paso Corp.
2. Pfizer Inc.
3. Tyco Int'l
4. Bristol-Myers Squibb
5. Liberty Media

Europe

Managers are generally positive about European equities in 2003, expecting returns of about 15% for both UK and Continental stock markets. Government bonds should produce more modest returns than of late, but still positive at around 3%. Looking further out, most managers anticipate similar returns from bonds over the next three years and between 5% and 10% from equities.

When asked to identify the three most important issues for Pan-European markets in 2003, not surprisingly the global economy and corporate earnings feature highly, followed by international terrorism. Interest rates were ranked next highest although they are expected to remain low during 2003. In Europe managers expect another 0.25% cut by mid-year, to be reversed before the year end as economic growth improves. In the UK, expectations are for a 0.25% rise in the second half of the year.

The managers predicted their top and bottom three European Sectors for 2003 to be:-

Top Three	Bottom Three
Telecommunications	Utilities
Financials	Energy
Healthcare	Consumer stables

Japan

The stock market continues to drift at close to 19 year lows on very low volumes, foreign investors appear to have lost interest having sharply reduced their Japanese equity weightings and corporates (particularly banks) are still large structural sellers of equities; sentiment could not be worse. There has been tremendous disappointment regarding the efforts of the Koizumi government to address the problems in the banking system – measures so far announced have been ill-conceived, poorly presented and there is no sign of policy coordination.

Meanwhile the outlook for the economy is steadily deteriorating. Exports, the only area of growth at present, are losing momentum as global economies slow, whilst government spending, despite a supplementary budget, remains contractionary. Deflationary expectations are worsening. The US consumer has so far been the main engine of growth worldwide, but given the levels of individual borrowing the sustainability of this is in doubt, although the recent announcement of $700 billion of tax cuts in the US may well provide some support. A possible war with Iraq will only serve as a distraction to consumer spending, not to mention the potential negatives should the fighting become protracted.

Cross-shareholding unwinding is also likely to weigh heavily on the market, particularly in the first quarter. Most banks are behind their announced schedules for disposal of equities whilst the fund set up by the Bank Of Japan to absorb some of this selling was disappointingly small.

On the more positive side, the appointment of a new Governor to the Bank Of Japan may lead to more proactive monetary policies, such as setting an inflation target. An inflationary environment, where goods are assumed to become pricier next year rather than cheaper, is seen as the best way to draw hoarded yen from a populace fretting about job security and shrinking pensions. Recent comments by some politicians seem to indicate that candidates in favour of such a policy would be preferred. However, the cooperation of other, more conservative, BOJ board members would be necessary to implement such a policy, although it would be well-received by the stock market.

In addition, whilst the outlook is bleak, it should not be forgotten that by far the majority of investors are already pessimistic. Any sustainable good news could quickly lead to higher weightings in Japanese equities.

4. Bibliography/References

- Schroder Salomon Smith Barney – 2002 UK Market Review
- Goldman Sachs – 2002 Equity Indexes / Equity Derivatives Global
- Merrill Lynch – 2002 Quantative Viewpoint
- ABN Ambro – Fund Managers Monthly

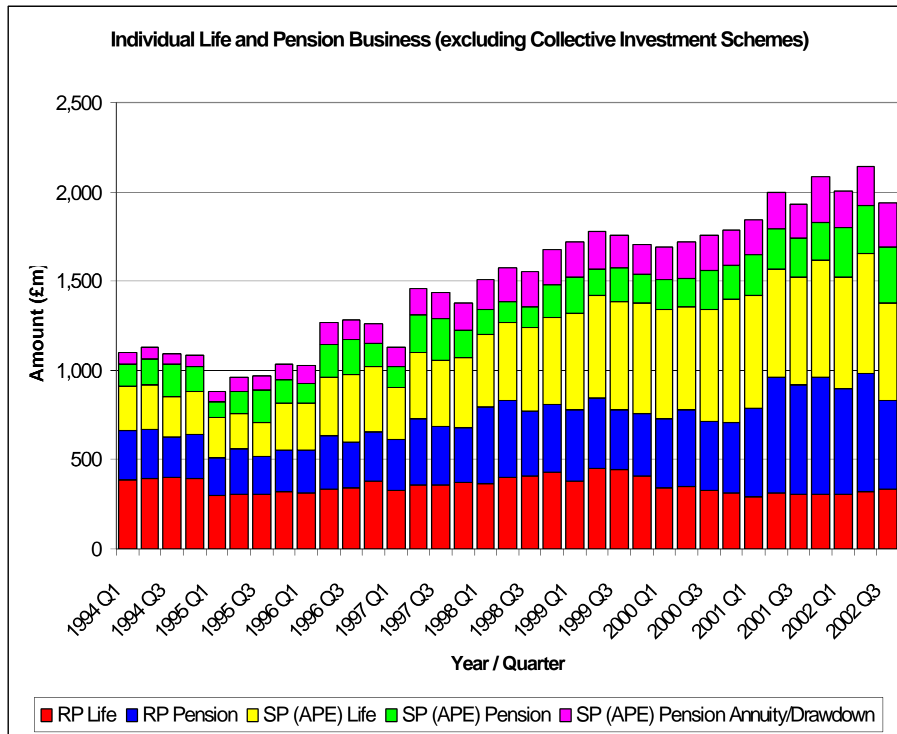
SECTION 2

LIFE INSURANCE

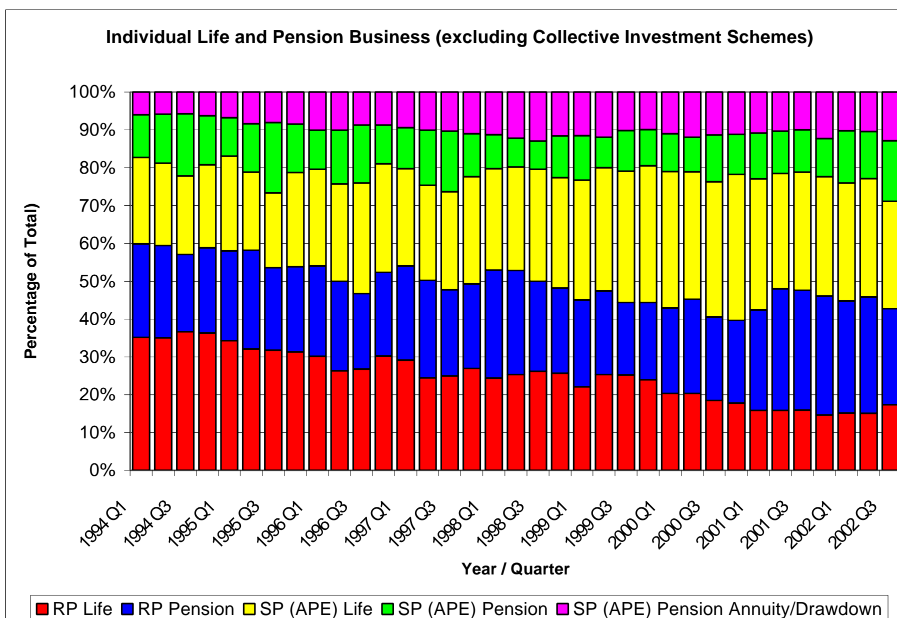
1. NEW BUSINESS

Current Sales Volumes and Past Trends

The following graph shows quarterly new business figures produced by the Association of British Insurers (ABI) from 1994 Q1 to 2002 Q3, excluding Collective Investment Schemes (CIS). Single Premium figures are divided by 10 to give an Annual Premium Equivalent figure.



The following graph shows the proportions of the total figure by category.

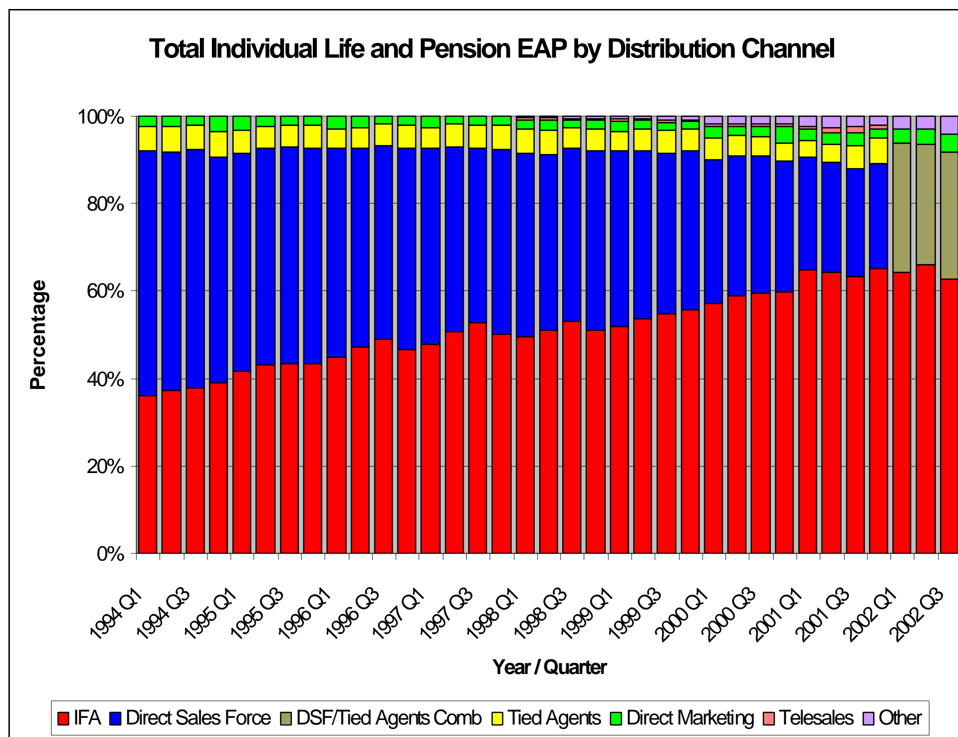


The main points to note from these are:

- Regular premium life business has remained fairly constant over the period, and reduced as a proportion of the total business.
- Regular premium pension business increased slowly over the period, rising more sharply in the first half of 2001 with the launch of stakeholder pensions.
- Single premium life business has more than doubled over the period, as have SP pension/drawdown premiums.
- Single premium pension has shown slow growth over the period.

Distribution Channels

The following graph shows the breakdown of individual life and pensions total annual equivalent premium by distribution channel. It is based on ABI data over the same period. Note that in 2002, direct sales force and tied agents are reported as a combined figure.



This clearly shows the trend of an increasing proportion of business sold by Independent Financial Advisors (IFA) at the expense of direct sales forces, but that this trend appears to be slowing down. Also interesting is that the 'Other' category appears to be growing, which may indicate new forms of distribution such as the internet.

2. FINANCIAL STRENGTH

The financial strength of companies has been under increasing pressure for the last couple of years. The main reasons behind this are the falling stock market, improving mortality on annuity contracts, and the well publicised problems with guaranteed annuity options and mortgage endowments. Companies continued to find their financial strength being increasingly eroded over 2002.

End 2001 Free Asset Ratios (FAR)

The FAR represents the excess of assets held by an insurer over the liabilities, expressed as a percentage of the liabilities. It is used as a measure of financial strength. There are variations in the calculations, methods of reporting and underlying factors that often make individual company comparisons difficult or misleading. However at a general level it is clear that financial strength reduced significantly over 2001 (delays in reporting mean the current topics paper is always a year behind).

The average FAR fell from 11% in 2000 to 7% in 2001 (it was 18% in 1999). The falling stock market is the main reason behind the change, removing billions of pounds of assets from company balance sheets with considerably less impact upon liabilities due to mismatching of assets and liabilities. The FTSE all-share index fell by 15% in 2001.

These FAR figures however may not reflect the true worsening of solvency of many companies who have increasingly looked to 'manipulate' or strengthen the balance sheets to improve their position through:

- Receiving additional capital from parent companies
- Weakening the valuation basis
- The FSA relaxing rules regarding the reporting of liabilities (see the 'regulation and reporting section elsewhere in this paper)
- Making use of implicit items (eg allowing for future profits as a current asset)
- Making use of other forms of alternative capital (eg subordinated debt or financing reassurance arrangements)
- Raising additional capital through share issues
- Reducing exposure to inadmissible assets

The current financial strength position will be clearer when companies publish their 2002 year-end FSA returns, however it is widely accepted that company solvency has reduced over 2002. The FTSE fell 24% over 2002.

Equity Backing Ratios

Another indication of financial strength is the equity-backing ratio (EBR) which is the proportion of with-profit assets held in property and equities. A stronger office is more likely to adopt this riskier asset allocation in order to benefit from traditionally higher returns.

One downside of equity investment is that it reduces the valuation interest rate, forcing companies to hold higher reserves. Over 2002 as capital became a serious issue for companies there was a move away from equities to gilts in order to hold lower reserves and demonstrate solvency. This created further problems and a viscous cycle for insurers as it drove the stockmarket down

further, reducing solvency further. The move out of equities also meant that companies will benefit less from any market recoveries in the future.

There was a lot of discussion with the Financial Services Authority (FSA) regarding solvency over the year. The FSA eventually relaxed the minimum statutory solvency requirements in light of the depressed stock market. The rules were eased provided a company could prove they were financially sound with regard to their 'realistic liabilities'. However as well as relaxing conditions the FSA also took a more active roll in monitoring individual companies and are now asking most companies for half-yearly 'realistic balance sheets'

Ratings

Another measure of financial strength of insurers is the ratings given by rating agencies such as Standard and Poors. These ratings cover other lines of business provided by the companies but give a good indication of financial strength. Over 2002 these ratings fell across the industry as concerns grew over underlying solvency.

A comparison of a few companies illustrates this.

Company	Rating start 2002	Rating start 2003
Standard Life	AAA	AAA
Scottish Mutual	AA-	A-
Swiss Re	AAA	AA+
Munich Re	AAA	AA+
GE Frankona Re	AAA	AA-
Gerling Global Re	AA-	BBB

Note that Standard Life was downgraded to AA shortly after the turn of the year.

Reassurance companies have been included. They are some of the biggest carriers of insurance risk in the UK and although they also deal with general insurance their continued solvency underpins the solvency of many direct writers. At the end of 2002 only one AAA reassurer remained.

Implications

The reduction in financial strength opens up many questions for the industry regarding how they run their business. They must consider, amongst many other things, how best to use capital to finance new business, how to award bonuses on with-profit contracts and how to maintain solvency if the markets do not recover or worsen.

3. CORPORATE ACTIVITY

In terms of acquisitions and mergers, 2001 was a relatively quiet year for corporate activity in the Insurance Sector, 2002 proved to be even quieter. 2003 may see more activity due to the pressure on solvency in the current market and the proposed polarisation rule changes, in particular the abolition of the "better than best" rule leading to product providers buying into product suppliers.

The impact of the takeover activity of recent years is however still being felt, arguably particularly in Scotland, with most of the traditional Scottish offices now owned by non-Scottish companies, and some shedding jobs. Additionally, there have been trends towards actuaries being employed by consultancies rather than life offices and most offices moving away from being ultimately controlled by actuaries, with the regulatory system moving in a similar direction, as discussed below.

Below is a list of some recent announcements that have been made:

Sun Life Financial Services of Canada is to sell its Basingstoke-based group insurance business to US-owned Unum for undisclosed terms. 14-Jan-03

Prudential is to sell its German life insurance business to Canada Life for £82m. 15-Nov-02

Wesleyan is to acquire the financial services business of the British Medical Association, which provides financial advice and insurance to doctors, for undisclosed terms. 17-Sep-02

Aviva is to sell its Spanish general insurance business [Which probably is not called *Aviva Espana*] to Groupama of France for £157m. 09-Jul-02

Prudential is to acquire ING's life insurance business in the Philippines, which includes 17 offices and 100 staff. 19-Jun-02

Royal & Sun Alliance is to sell its Isle of Man-based life assurance operations to Friends Provident for £133m, as part of a strategy to focus on general insurance. 12-Jun-02

Royal & Sun Alliance Insurance Group is to sell its life and general Benelux subsidiaries to Achmea of the Netherlands for £77m. 20-May-02

Endsleigh Insurance Services, the operator of 129 insurance shops, is planning a management buy-out from Dutch-based Goudse for undisclosed terms. 24-Jan-02

Liverpool Victoria is to acquire the administration and investment operations of Hearts of Oak Insurance Group, which has funds under management of £350m. 20-Dec-01

Royal Liver, the mutual insurance firm, has bought the industrial branch business of Irish Life & Permanent for £107m. 07-Dec-01

Prudential is to sell its general insurance business to Winterthur of Switzerland for £353m, and has also announced plans to shed up to 2,100 jobs at sites in London, Reading, Belfast and Stirling. 02-Nov-01

Apart from mergers and acquisitions, following Royal and Sun Alliance's decision to close to new life business in December 2001, other offices have reacted to solvency pressures and the falling from favour of with profits policies as we know them, by injections of new capital, for example from rights issues, or from parent companies, or by closing their with profits funds to new business. Additionally, as discussed below, some reassurers are turning away from the UK Life Assurance market.

4. REASSURANCE AND CRITICAL ILLNESS COVER

Recent months have seen huge changes in the market for Critical Illness cover in the UK. Almost all the insurers in this market have increased premiums, typically by up to about 50%. Many have ceased to offer conventional term assurance cover, where the premiums are guaranteed for the term of the product, but are instead only offering polices where the premiums are subject to review. Additionally, some premium rates for pure Life Assurance term assurances have increased, which had been very rare in recent years.

Why?

In the main, office premiums have been driven by the reassurance markets. Direct offices have relied on reassurance both to limit their risks in the critical illness market, which is relatively new to many of them, and to generate extra profit via forms of reassurance which improve capital efficiency. Reassurers have recently (a) increased their view of the underlying risks (b) refused or become more reluctant to offer reassurance on the basis of guaranteed premiums and (c) stopped offering reassurance which includes capital support for the direct office.

This is partly a reaction to September 11. The losses that reassurers incurred then have made them ask themselves harder questions about the risks they are running and how they use their capital. Also it has led to hardening of rates in the general reinsurance market, and they are therefore keen to deploy more of their capital in that field, as they believe it can make a bigger return.

Turning to reasons more directly related to the product itself, some of the upturn in rates is probably cyclical, competition having driven premiums down to unsustainably low levels.

Some are concerned that there may be a long and large select effect on CI business, and so the ultimate experience is yet to manifest itself, as it has mostly been written in the past five years. There is also a worry that the business has significant Incurred But Not Reported claims, which are leading to claim rates being underestimated.

Some of the main reassurers, such as Munich Re, have always been wary of guaranteed C.I. term business. The aim of Critical Illness products is, as the name suggests, to cover policyholders against life-threatening events and events which have a serious long term effect on earning capacity. However, advances in medical science continually change the landscape of such events by reducing the impact of many of the conditions covered, giving rise to potential windfall gains at the point of the claim.

Furthermore, better diagnostic techniques mean that more events that meet the definitions in current generation Critical Illness products will be identified, many of which will not be "critical" when the diagnosis is made.

Although changes can be and are made to illness definitions, as has happened recently with prostate cancer, these cannot be retrospective, leaving both insurers and reassurers always exposed to claims on the existing book for conditions they would rather not cover.

Some have suggested product innovation for example basing payouts on how severely the life of the assured is changed. This, however, would go against the relative simplicity and straightforwardness of the product, which has enabled it to achieve such strong sales growth in the UK market in recent years.

5. WITH-PROFITS: AN UPDATE

The 2002 Current Topics paper contained a section looking at the future of with-profits (WP) policies, picking up on the criticisms that have been levelled at such business and outlining the early stages of the process to 'fix' the problem.

The FSA With-Profit Review

The Financial Services Authority (FSA) started its with-profit ball rolling towards the end of 2001. Four issues papers were published and brief coverage of these was presented in last year's paper. A fifth paper was issued shortly after last year's current topics was presented. These papers were:

1. Process for dealing with the 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)
5. Governance of with-profits funds and the future role of the Appointed Actuary (March 2002)

Paper Five

The fifth paper looked at how to improve the interests of policyholders through the management of WP funds. It was in two parts, although many of the ideas highlighted were later abandoned:

Part 1 considered the governance of WP funds in the context of the 'excessive' discretion afforded to insurers and lack of transparency. The paper suggested five options for change:

1. Any with-profit fund would need to declare its 'Principles and Practice', and disclose its level of compliance. This picked up on the theme in issues paper 4.

2. A policyholder should sit on the Board and visibly representing the interests of WP policyholders.

3. There should be a committee, either separate from the board or a sub-committee of the Board, with a role in the supervision of WP funds.

4. Change the duties of Directors to require they have regard for the interest of the policyholder.

5. Make the WP policyholders the owners of the WP assets.

Part 2 considered the Appointed Actuary role and its development. It was not limited solely to with-profits business. Again, five main points were considered:

1. Discontinue the Appointed Actuary system with more responsibility falling to the board.

2. Continue the Appointed Actuary role but look to reduce possible conflicts of interest.

3. Monitor the role of Appointed Actuaries who are external to the company for whom they carry out those duties.

4. The use and distribution of the Financial Condition Report.

5. Independent review, by an external Actuary, of the work of the Appointed Actuary.

Follow-up to the Issues Papers

Having taken on board responses to the issues papers (from several parties including the ABI and Actuarial Profession) the FSA produced feedback statements in May 2002. The first statement covered the points raised in the first three issues papers. It identified the need to provide improved access to clearer and more transparent information for consumers, informed users (eg financial advisers) and those policyholders involved in a re-attribution of inherited estate exercise. The timetable to do this was set out - and slipped later in the year - and currently involves issuing the following consultation papers (CP):

1. Regulatory Reporting: clearer presentation of solvency of with-profit funds (this led to CP144: 'A new regulatory approach to insurance firms' being published in the July 2002. The contents are discussed elsewhere in this current topics paper).

2. Regulatory Reporting: disclosure of realistic liabilities (Spring 2003).

3. Disclosure to consumers on with-profits: pre point of sale (This led to CP170: 'Informing consumers: product disclosure at the point of sale' being issued in February 2003. This consultation paper primarily proposes changes to the current key features document - to be called key facts in the future. The changes will standardise information across companies, streamline projections, reduce company branding and increase the profile of the FSA).

4. Disclosure to consumers on with-profits: post point of sale (Winter 2003).

5. Process for attribution of inherited estates (Summer 2003).

The second feedback statement covering the governance of with-profit funds and the wider role of actuaries in the governance of life companies was followed in January 2003 by CP167. This consultation paper made the following proposals:

1. Firms carrying out with-profits business must:
    - Define and make publicly available the 'Principles and Practices of Financial Management' (PPFM)
    - Ensure the governance arrangements of the insurer allow the PPFM to be adhered to
    - Produce annual reports to WP policyholders outlining how they have met the obligations of the PPFM (including how conflicts of interest have been addressed)

2. Changes to the role of actuaries in the governance of life insurers:
    - Discontinuing the Appointed Actuary regime (despite responses from the ABI and Actuarial profession supporting the continued role of the Appointed Actuary)
    - Introducing two new functions: actuarial function and with-profits Actuary
    - Introducing new requirements where the with-profits Actuary is on the Board in order to deal with conflicts of interest

3. Regulatory Reporting:
    - More responsibility for directors and senior management in assessing the size of reserves and other decisions taken on the back of actuarial advice
    - New audit requirements for liabilities
    - Consequent changes to certification in returns

Responses to CP167 are due by the end of April 2003.

The Actuarial Profession With-Profit Review

The 2002 current topics paper covered the work by the profession's 'Transparency of With-Profits' working party. This was published in early 2001. In February 2002 the 'Actuarial Governance Working Party' submitted a paper in order to promote debate on the topic. It was published before the outcome of FSA review and highlights some differences of opinions.

The paper accepted that the introduction of external review of Appointed Actuaries is key to ensure:

1. the Appointed Actuary complies with professional standards and policyholder expectations,
2. the Appointed Actuary benefits from the experience and views of an independent party
3. comfort for the policyholder that conflicts of interest do not impact upon decisions

It also outlined the need for clearer identification of the duties of the board of directors towards the interests of policyholders.

Four Possible Models for the role of the Appointed Actuary were highlighted:

1. Internal Appointed Actuary, integral to senior management (often as director) with review necessary to ensure that conflicts of opinion do not bias any advice

Advantages – maintains influence of Appointed Actuary in running of company, increases responsibility of Board to policyholders
Disadvantages – cost of strict review, undermining/weakening the role of actuary by reviewer (shadow Appointed Actuary)

2. Internal Appointed Actuary, not a director, whose responsibilities are primarily confined to the actuarial function, with limited review required

   Advantages - retains responsibility of Appointed Actuary, lower cost of review
   Disadvantages – reduces influence of Appointed Actuary and increases confrontation with Board

3. Internal Appointed Actuary (Chief Actuary), may be senior management and/or director sharing responsibilities with external Appointed Actuary with formal statutory and whistle-blowing responsibilities

   Advantages – maintains influence of Appointed Actuary
   Disadvantages – cost and difficulty in making arrangements work in practice

4. External Appointed Actuary with light review as conflicts of interest do not exist

   Advantages – Perceived independence
   Disadvantages – No knowledge/practice share, Difficulty in maintaining independence

The overall belief was that options 1 or 3 provide best solutions; however different solutions better suit different set-ups eg mutual v proprietary, small company v big company.

Company Responses

Companies transacting With-Profit Business have had a tough year.

With-profit contracts are sold on the basis of smoothing the volatile investment returns in the market for the protection of policyholders. The falls in the stock market and reductions in financial strength have led many companies to take measures including:

- significantly reducing terminal bonus
- declaring a zero reversionary bonus
- declaring more regular adjustments to bonuses mid-year (traditionally there has been a single announcement at the start of the year)
- applying (or increasing) market value adjusters that reduce payouts on surrender (ensuring fairness for all policyholders at a time when payouts have been smoothed in an upward direction).

These changes have been well publicised, but not always understood by the press or consumers. This further increases the pressure on with-profit contracts The press generally criticising companies for the reduction in payouts from one year to the next

eg Legal and General recently reduced payouts with a typical endowment maturing on 1/3/03 paying £59,047 compared to £66,061 on 1/11/02 and £73,566 on 1/3/02.

It is clear that the industry needs to be able to respond to such criticism and explain apparent 'anomalies' in order to increase confidence for new business and prevent lapse of existing business. It is predicted that payouts will continue to decrease in the future even if investment returns are positive. Press coverage is likely to become more negative unless the industry can explain such issues effectively. The explanation needs to be in the context of how with-profit funds are managed, policyholder reasonable expectations and the changing markets (not just in the last couple of years but also in longer term reflecting the 80s and 90s).

The uncertainty surrounding the product given the various review processes has led companies to consider how to alter their product proposition and/or asset split. A few companies have launched 'new style' with-profits while many more are considering their own offering with a view to launches in the coming year. Conflict clearly exists between the risks of anticipating the result of the review process and the benefits of being pro-active in the market.

Scottish Widows made probably the highest profile change to their product in July 2002. Widows closed the existing With-Profit fund for bonds (including to increments), while keeping the existing fund open for all other With-Profit products.

For bond new business, two new funds were created; the with-profit growth fund (invested primarily in equities) and the with-profit income fund (invested 25% in property and 75% in fixed interest securities). While clarifying the 'type of return' through the new funds they also tried to increase transparency by stating that only investment risk/return impact policyholder returns (any business risk is carried by the shareholders) and creating formulaic 'rules' for the application of market value adjusters (MVAs) to remove the discretion of the Actuary.

How successful the changes made by Widows and other companies will prove to be is unclear at this time. The press and analysts have given both praise and criticism. What is clear is that 2003 will be a year of continuing change for With-Profit providers.

6. THE PROPOSED ABOLITION OF POLARISATION

The Financial Services Authority (FSA) is proposing to abolish and replace the current regime for advising on and selling life assurance and other savings and investment products.

This chapter summarises the current position, and is therefore based on the latest FSA consultation paper (CP) on the subject, CP166, which was published on 20 January 2003 and is available on the FSA website, www.fsa.gov.uk.

What is polarisation?

Polarisation rules came into effect in 1988. These rules were made by the then regulatory authority, the Securities and Investment Board (SIB), and control the way some savings and investments can be sold. Advisers on life assurance, personal pension policies, collective investment schemes (unit trusts and OEICS) and investment trust savings schemes have to be either:-

independent (an IFA) and advise across all products and companies on the market
or
tied and represent just one company and sell only its products.

This is obviously very different from the way products are sold in other areas of life; to my knowledge, no one has ever suggested that all supermarkets should be forced to offer either all own label goods or a selection of the best available goods from other brands.

The justification for making different rules when it comes to financial products, is the importance, the long-term nature, and the complexity of the issues, products and decisions involved and the consequent need for advice during the sales process. The theory was that polarisation would encourage competition by simplifying the regime so that potential customers could understand where they stood, and what they were being offered in terms of advice, and act accordingly.

In March 2001, two changes were made to the polarisation rules increasing the range of products advisers could sell. Under those changes firms can now adopt stakeholder pensions from other providers and sell these through advisers. Also, all authorised firms may now use direct offer advertising methods to distribute the packaged products of one or more providers.

Why has the FSA been reviewing it?

In August 1999 the Director General of Fair Trading (DGFT) made a report to the Treasury, which concluded that, in practice, the polarisation rules restrict or distort competition to a significant extent by preventing some innovation in retail markets. The decision on the DGFT's report rested with Treasury Ministers. The FSA Board decided in 1999 that the FSA should commission an independent study of polarisation to help inform the Treasury. The study was published by the FSA on 5 July 2000 and broadly concluded, despite lobbying from IFAs and others to retain the status quo, that the polarisation rules appear to have some anti-competitive effects in the tied channel. In March 2001 the FSA undertook to conduct more wide-ranging consultation and research. This included the consultation paper CP121.

In CP121, the FSA suggested that to be an IFA an adviser would have to adopt a defined payment system, whereby the customer pays the IFA a fee for advice directly. There was a great deal of lobbying against this by IFAs, who insisted that many potential customers preferred or would be better off, if IFAs were remunerated by commission.

The FSA therefore announced in October 2002 that it would instead be developing the so-called ‘Menu’ approach, under which the IFA can offer the policyholder upfront the choice of whether to go down the fee-paying or the commission route. However the FSA Board did confirm its decision to abolish polarisation on 21 November 2002.

The FSA say they believe polarisation has failed to deliver the benefits that were hoped for when it was introduced and that the new regime will increase choice for the vast majority of consumers for whom the polarisation regime denied such choice.

They argue that, the average consumer, whose financial needs do not lead him to consult independent financial advisers, will get better access to advice on

suitable products and greater choice, whilst nothing will be taken away from those who already have access to independent advice.

CP166 proposes that:

- firms currently restricted to selling just one company's products to customers will in future be able to offer their customers more choice;
- firms which wish to continue to hold themselves out as 'independent' can do so provided they both advise from across the market and offer their customers the option to pay by fee;
- abolition of the polarisation regime means that firms must clearly explain to consumers what the scope of advice or service they are offering is. This will be achieved through a new specific initial disclosure document; rules about disclosure in advertising and on stationery, all firmly backed up by a consumer education campaign.

As part of its campaign the FSA intends to include consumer alerts on the Consumer Help part of their website; use leaflets, press activity and joint campaigns with organisations such as the Citizens Advice Bureau (CAB) and through the Post Office. Firms may be encouraged to send approved literature to consumers explaining the charges that have been made. All of this can also be used to support the introduction of the specific initial disclosure document which, along with certain other FSA required documents, will be recognisable by the 'Key Facts' logo.

- the so-called "better-than-best" rule will be abolished. This rule effectively prevents an independent intermediary firm from recommending a product from any provider which owns 10% or more of the firm. Abolition of the rule will mean that independent firms will be free to attract investment to increase their financial strength. There will be safeguards in place to ensure that such investment does not undermine the independence of a firm; and
- the FSA believes it important that there be greater transparency for consumers over the cost of advice and it will be consulting separately on measure to achieve this in the Spring. The FSA does not propose to implement the removal of the polarisation restrictions until it has also concluded its separate consultation on the cost of advice. This means that removal of the polarisation restrictions is not likely to take effect until late 2003 or early 2004.

To conclude, although the matter is still out for consultation, the shape of the post-polarisation regime is beginning to emerge from the regulatory mists. It remains to be seen how many IFAs will change to "multi-tied" status (i.e offering products from only a limited number of providers) and how many direct and tied sales operations also move towards offering products from a range of providers. Beyond this, it will take a while longer to determine whether the new regime improves the cost and provision of financial advice and financial products for the general public.

7. SANDLER REVIEW

The 2002 current topics paper considered in depth the consultation paper issued by Ron Sandler (reviewing the long-term savings industry on behalf of the government) considering the issues that needed to be addressed. In July 2002 Sandler made his recommendations.

Many of the conclusions overlap with other investigations being conducted at the same time, however Sandler's key conclusions are:

1. A suite of simplified regulated products with diversified underlying investments, capped charges (1% of fund suggested) and the ability to exit on reasonable terms is required to reduce the savings gap. These products could be sold without regulated advice and the government would have control on product specification. The FSA have issued a discussion paper (January 2003) considering how such a range of products could be regulated.

2. A streamlining of the sales process for these simplified products is necessary to make long-term savings more accessible to lower-income customers. Sandler suggested 3 levels of advice:

   - 'Self Help': removal of requirements placed upon advisors to "know your customer" before offering advice.
   - 'Guided Self Help': the use of filtering questions to screen out consumers clearly not suitable for the product.
   - 'Focussed Advice': maintain "know your customer" requirements but reductions in the depth of knowledge necessary and the qualifications required for advisors. These reductions are possible due to the protection inherent in a simple contract.

3. A new model for independent advice. Only advisers not paid by providers would be permitted to call themselves "independent advisers". Payment for advice could still be contingent on sale but would be negotiated between adviser and client rather than adviser and provider as currently. This is a development from the FSA recommendations in CP121 and has been welcomed by the industry.

4. Support for a new breed of simple and transparent with-profits products. Including ring-fencing of funds and an end to the link between shareholder returns and bonus declared (the 90/10 approach).

5. Tax simplification measures, including abolition of the "qualifying policy" regime for life savings policies and an overhaul of pension taxation. Sandler discourages the government from attempting to stimulate savings through tax incentives.

6. Measures to boost consumer education in financial matters including more financial resources, a ring fenced budget for this purpose and a higher profile within the FSA.

7. More stringent investment qualifications for financial advisers.

Many life offices argue that the low take up and low profits of Stakeholder pensions point to a 1% cap as providing too little margin, and some may be unwilling to meet this requirement. Further discussion/consultation is to follow in 2003.

8. REGULATION & REPORTING

The Financial Services Authority

When the Financial Services and Markets Act 2000 (FSMA) came into force on 1 December 2001, the Financial Services Authority (FSA) became responsible for prudential regulation of all insurance firms and the conduct of business regulation of life insurance firms.

The previous prudential regulations for insurance firms were under the Insurance Companies Act 1982 and friendly societies under the Friendly Societies Act 1992. Life insurance firms' conduct of business was regulated under the Financial Services Act 1986. Most of these previous regulations have been carried into the FSA Handbook in the Interim Prudential Sourcebook for Insurers, albeit with a few changes (see last year's paper for a summary).

As a new regulator, they plan to be more proactive, focussing resources on companies perceived to be of greatest risk to the achievement of their statutory objectives.

The Tiner Project

As a follow-up to the Baird Report, the independent review into the Equitable Life, Ruth Kelly MP, Economic Secretary to the Treasury, wrote to the FSA asking for a full report covering the action they had taken, and intended to take, to implement the recommendations on the regulatory approach.

The 'Tiner Review' report was issued on 20 November 2001, with an announcement that the FSA Board had asked John Tiner, managing director of Consumer, Investment and Insurance at the FSA, in September 2001 to lead a major project (known as the 'Tiner Project') to take forward the FSA's work to strengthen insurance regulation. It will integrate work to date (such as depolarisation, with-profit review and prudential sourcebook) with new work, such as investigating effects of financial engineering on disclosed positions.

Integrated Prudential Sourcebook

On 7 June 2001, the FSA *published 'Consultation Paper (CP) 97 – Integrated Prudential Sourcebook (PSB)*', which sets out proposals for a risk-based approach to regulation that will apply consistently across different types of firm e.g. banks, building societies, insurance companies, friendly societies and investment firms.
This included draft text and responses were invited by 31 December 2001.

At the time CP97 was published, the FSA anticipated implementing the PSB on 1 January 2004. This was assuming that negotiations on a new Basel Accord (an International Capital Adequacy framework) and related EU legislation would be completed in time to be included in the PSB. However, shortly after publication both of these announced delays to their intended implementation. Therefore, the FSA published *'CP115 – Integrated Prudential Sourcebook – Timetable for Implementation'* in November 2001. In this they proposed implementing the PSB in several parts (and at different times for different categories of firms), the first in 2004 for material that is likely to remain consistent with the eventual PSB. The rest would be implemented at a later date once other relevant legislation was further progressed.

The Actuarial Profession's response to CP97 was issued in December 2001. They raised four major concerns with the proposals

- Timing – as there was a strong possibility that fair-value accounting would be required from 2005, they raised the question as to whether it would be better to wait and implement both changes at the same time.

- Resilience Reserves – there should be consistency with life and general insurance solvency margin requirements (for general insurance business, the level of solvency margin is not currently not linked to reserves).

- Reserving for Terminal Bonus – they were disappointed that the with-profits review on regulatory reserving and report on future regulation of insurance appeared to indicate that the FSA had already made its mind up about this issue, rather than it being out for consultation. A terminal bonus reserve on a net premium valuation with restricted future rate of interest was likely to provide an excessive amount. They suggest aggregate asset shares as being a measure of policyholders reasonable expectations (PRE), and as long as the reserves are not significantly less than this figure, it could be reasonably assumed that the office had the ability to meet PRE.

- Separation of with-profits business – they suggest the costs may outweigh the advantages and having separate 'pots' could make offices less able to withstand adverse condition than if all in one.

They also raised concern on the proposals for assessing capital requirement for credit risk. They felt the requirement of assuming 100% failure of a long-term insurer or re-insurer seemed excessive, especially given the practice of certain firms of using reinsurance for a large percentage of certain blocks of business. Also it may be difficult to restrict exposure to particular external counterparties due to the small number of reinsurers of sufficient size to accept substantial blocks of business.

In March 2002 *'CP 128 – liquidity risk systems and controls*' was issued as consultation on the liquidity risk module of the PSB (which was not included in the original CP97).

In May 2002 *'Discussion Paper (DP) 12 – The new regulatory reporting environment'* was issued by the FSA. The aim of this was to stimulate debate on how regulatory reporting and information needs could be developed further. The main problems with the current returns were identified as:

- The balance between prudential and business conduct information does not reflect the relative degree of risk. The focus is primarily on solvency requirements, with business conduct information sought separately, for example through persistency returns.

- Too much focus on historical financial information compared to qualitative information. They have a lot of detail on past experience and assumptions underlying the point estimates at the balance sheet date, but no way to investigate the impact of changing these assumptions. There is also a lack of forward-looking information such as business plans and forward projections.

- The returns are too large and unwieldy and often out of date. Even expert users may find them complex and so not very useful to consumers. They

are only formally required once a year and submitted well after the balance sheet date.

- All the information formally required as regulatory reporting is also on the public record. There is no distinction between what is needed for the public record to provide market discipline and what is needed for supervision.

After some discussion on various possibilities for reform, the FSA proposed four different options for change, their preferred option being to replace the current requirements with a new risk-based approach in line with the implementation of the PSB. This proposes streamlining the current reporting, reducing the volume of data but increasing the quality of information. For some firms this could involve increasing private reporting to the FSA which would be more forward thinking, such as strategic plans, which would be commercially sensitive but help in identifying key risks. They also suggested publishing returns on the company websites. The FSA were keen to reduce the impact by utilising information that would already be produced for internal purposes. They also wanted more prospective reporting with scenario testing and stress analysis. A consultation paper by early 2003 will make detailed proposals for insurance firms' regulatory reporting.

The actuarial profession responded to DP12 on 16 August 2002, highlighting the need for adequate time to alter systems and the question of adequate resources given all the other changes in the industry. They felt that making information publicly available was no substitution for regulatory analysis, and that the public generally feel it is safe to do business with a regulated provider.

On 9 May 2002, *'CP136 Individual Capital Adequacy Standards'* was published by the FSA, proposing an outline framework through which they could extend the setting of risk-based individual capital standards to a wider range of firms. The proposed framework includes two key elements: a self-assessment undertaken by firms within a framework of rules and guidance set out within the FSA Handbook; and a supervisory assessment by which a firm may be required by the FSA to hold additional capital in response to specific systems and controls related concerns.

The Actuarial Profession responded in September 2002. They were largely in support of the proposal, but had some concerns, especially over the supervisory supplementary capital assessment (SCA).

On 30 July 2002, the FSA published several papers:

- *Policy Statement on Integrated Prudential Sourcebook: Feedback on CP115 (Integrated Prudential Sourcebook - timetable for implementation) and CP97 (Integrated Prudential Sourcebook).*

  The feedback indicated the latest timetable for implementation, which had been affected by several developments since CP115 was published:

  - ♦ The Treasury announced that the FSA would be responsible for regulating mortgage advice and the sale of general insurance products from Q2 2004.
  - ♦ Revised Basel Accord and EU capital adequacy provisions revised implementation date of end-2006
  - ♦ International Accounting Standards

- *Consultation Paper 142: Operational risk systems and controls.*

This gives revised guidance to firms on the establishment and maintenance of appropriate systems and controls to manage operational risk.

- *Consultation Paper 143: Integrated Prudential Sourcebook: Feedback on insurance chapters of CP97 and supplementary consultation.*

  This covers the responses to the insurance aspects of CP97 and also re-consults on two insurance related issues, both of which were raised in the actuarial profession's response to CP97:

  - Credit risk of re-insurers

    The original proposals were that no single reinsurance exposure should be greater than the insurance firms' free assets. This would mean that if a re-insurer failed, the company would not become insolvent. Any portion of reinsurance exposure above 100% of the free assets would become inadmissible.

    They felt the 100% limit provides an incentive to firms to diversify their reinsurance, but recognised that providing no exception to the limit may be impractical. For instance, it may force a firm to spread its reinsurance cover but doing this may damage the overall quality of its exposures if there are few high-quality re-insurers in a particular market. Also small firms may find it difficult to spread their reinsurance for a small book of business and still maintain quality cover.

    Therefore, they proposed to 'soften' the regime, with a proxy limit of the premium paid to a reinsurer relative to the firm's total earned premiums in the financial year not to exceed 20%. They would make exception for small firms, and have set a floor of £4m on the reinsurance premium limit.

  - Reserving for with-profits business

    There was concern that adding realistic reserves for discretionary bonuses to already prudent statutory reserves was potentially double counting. They also thought it would be over-prudent to include provision for final bonus within the mathematical reserves and then to impose a resilience reserve and solvency margin on top of this.

    The new approach would be a 'twin test' approach, with additional capital required if realistic reserves including final bonus were greater than the valuation prudent mathematical reserves. Thus realistic reserves could be calculated in one of three specified alternatives:

    - A prospective method, requiring explicit valuation of future cashflows

    - A retrospective method based on asset shares, taking into account known or expected smoothing of bonuses where these are expected to be in excess of asset shares.

    - The profit accrual method, based on the amount set aside in the statutory accounts in respect of technical provision and fund for future appropriations. This last method is only permitted until 2006, to give insurers time to develop their

systems to enable them to move to one of the alternative methods.

The Actuarial profession responded to CP143 in October 2002 with concern over the timescales for implementation, especially given that for the end of 2004, end 2003 comparative figures would also be required.

The 100% failure of a counter-party they felt was too high, with perhaps a 15% default for a life reinsurer and a 50% default more reasonable. They generally agreed with the 'twin test' approach for the treatment of final bonuses (as it was similar to their suggestion in response to CP97).

- *Consultation paper 144: A new regulatory approach to insurance firms' use of financial engineering.*

  In the Tiner Report, the FSA announced it would look at financial engineering, as improper use had contributed to difficulties seen in several insurance companies in the UK and overseas. Financial engineering is a method of improving or smoothing reported profits or improving the reported balance sheet position, and includes financial reinsurance, implicit items and contingent loans.

  These can be valid methods of strengthening solvency position, but they can also be used to obscure the true underlying position of a firm, which could mislead consumers or the regulator.

  Therefore, they proposed two new forms in the regulatory returns, taking effect from the financial year ending 31 December 2002:

  - Form 9A - an analysis of the effects of financial engineering on the financial condition of the firm. This aims to provide clearer, and more directly comparable, information on an insurer's ability to meet its liabilities, give a better indication of the relative strength of life insurers than that in Form 9, and require insurers to explain the effect of these adjustments.

  - Form 9B - equivalent disclosure at an individual with-profit fund level.

  They also propose amending the Abstract of valuation report to ensure that all financial engineering is covered, and explicitly require that the nature and extent of cover under reinsurance treaties be described accurately.

  The Actuarial profession responded in October 2002 agreeing in general, but calling for further guidance on what would be acceptable and unacceptable.

On 1 October 2002, the FSA issued *'The future regulation of insurance – A progress report'* which detailed the steps they had taken since the Tiner Report was published to improve and strengthen the way they regulate insurance firms, and how they will complete the programme of work.

Changes to Current Regulation

The main changes in regulation requirements for year-end 2002 are:

Deadlines:

These are being reduced by a month, so electronic submissions have 3 months, paper submissions 2 months and 15 days. It is likely that more insurers will opt for electronic submission, which is the FSA's preferred method.

Form 9A:

As mentioned above in CP144, a new form 9A will be required for this end 2002 reporting to demonstrate the effect of financial engineering on its overall solvency position. The proposed form 9B will be required at a later time.

Implicit Item Waivers and Resilience Reserves:

Consultation Paper *'CP123 The Interim Prudential Sourcebooks for insurers and friendly societies – Guidance on implicit items waivers and resilience reserves'* was issued in January 2002

Implicit Items, such as future profits and Zillmer adjustments, arise because the current solvency and accounting rules require life assurance provisions to be valued prudently. In the longer term, when accounting rules value liabilities at fair value, these will cease to exist. The European Solvency I Directive has a transitional period that would see implicit items disappear by 2009. Normally these are not allowed to count for solvency, although companies can apply to the FSA for a waiver to this rule. The consultation set out to:

- Clarify the process for application including relevant information to be submitted
- Detail the general rules and requirements and how requests will be assessed

They require a retrospective test to set the upper limit for the implicit item, and a prospective test to ensure that sufficient surplus is likely to emerge.

Resilience Reserves are additional reserves held to protect against adverse market movements. The last guidance was issued in May 2000 and incorporated in the Interim Prudential Sourcebook as additional material. This guidance consists of three suggested scenarios to test.

Temporary guidance was issued on 10 September 2001; this updated the benchmark assumptions and relaxed the third part of the test that assumed a 25% fall in equity markets combined with a 3% rise interest rates. These tests were further relaxed on 24 September 2001 as a result of the market turbulence following the terrorist attacks on the USA. The basic suggested tests were not removed, but it was up to the Appointed Actuary and management of individual firms to decide on appropriate assumptions for the tests.

On 4 December 2001 further guidance withdrew the previous guidance, reverting to the assumptions originally in the 10 September letter. The measures in this last guidance would lapse on May 2002, so this consultation considered options for permanent guidance to be included in the Interim Prudential Sourcebook.

Their preferred option was to incorporate the temporary guidance of 4 December in the short-term, developing changes to the resilience test in line with the CP97 implementation.

A policy statement was issued in May 2002 that set out the revised guidance in line with CP123. A revised guidance note (4) issued on 28 June 2002 revised the resilience test to give temporary relief when the markets fall and subsequently recover. It states that firms should consider the scenario of a fall in the market value of equities of at least 10% or, if greater, the lower of;

- 25%, or such lower amount which would not produce a P/E ratio on the FTSE Actuaries All Share Index lower than 75% of the inverse of the long term gilt yield;
- 25% less any percentage reduction between the current FTSE Actuaries All Share Index and its average over the last 90 days. The 90 day test effectively gave companies 90 days to do something if they had a problem (i.e. sell equities) since if market stayed level for 90 days this test would no longer have any impact

This will remain in force until 31 May 2003, unless subsequently altered.

A letter was sent from the FSA to Chief Executive Officers of life companies on 31 January 2003 regarding the required minimum margin for solvency requirements. They wanted to maintain confidence in the life insurance market by explaining the terminology to the public and avoid misinterpretation of what 'solvency' actually means.

Life offices that had breached or were close to breaching their required minimum margin of solvency were told to discuss with the FSA what actions they proposed in order to maintain or restore their position. These actions may include capital injection by shareholders, closing to new business, sale or transfer of the business and asset re-allocation. The FSA said that few firms had indicated to them that they might have problems with this.

The FSA are keen to avoid added pressure to sell equities into a falling market, which can trigger a downward spiral in equity prices, as this may not be in the long-term interests of the policyholders.

Overall it is clear that the FSA are becoming far more demanding of life offices in terms of the quality, timeliness and range of information they require. The flow of consultation papers from the FSA is at unprecedented levels and shows no signs of abating, placing more pressure on life offices at an already difficult time.

9. INTERNATIONAL ACCOUNTING STANDARDS & FAIR VALUE

Background

The International Accounting Standards Committee (IASC) was formed in 1973 as a result of an agreement between the major accountancy bodies around the world. Their intention was that the new international accounting standards it released (IASs) must 'be capable of rapid acceptance and implementation world-wide.' The IASC survived for 27 years, until 2001, when the organisation was renamed the International Accounting Standards Board (IASB).

In 1997 the IASC proposed that 'fair value' should be used in general purpose financial statements for all financial instruments. At the same time the IASC set up a Steering Committee to address the lack of an International Accounting Standard for insurance contracts and in December 1999 they published an Issues Paper, which, by 31 May 2000 had attracted 138 (mixed) responses. These were then analysed at meetings in late 2000 and work started on producing a Draft Statement of Principles (DSOP).

The DSOP has been published on the IASB website (www.iasb.org.uk) but is still incomplete at the time of writing this paper. In May 2002, the IASB split the insurance project into two phases, Phase I being an interim step which will lead to an Exposure Draft expected in Q1 of this year. This is to assist insurers who are adopting the IAS by 2005, a requirement now imposed by the EU on all listed EU companies.

Phase I and Amendments to IAS 39 (Financial Instruments: Recognition and Measurement)

The following topics are included in Phase I:

Already discussed within the IASB
- The definition of an insurance contract
- Recognition and measurement of insurance contracts for Phase I
- Application of IAS 39
- Unbundling
- Embedded derivatives
- Measurement of financial assets backing investment contracts and insurance contracts

Still to be discussed
- Cancellation and renewal options
- Performance-linked contracts
- Insurance contracts acquired in business combinations or in the acquisition of a block of business
- Derecognition
- Disclosure

The first bullet point is the most important as it determines whether an insurance contract can still be accounted for in the meantime under local GAAP. An insurance contract is defined as:

"a contract under which one party (the insurer) accepts significant insurance risk by agreeing with another party (the policyholder) to compensate the policyholder or other beneficiary if a specified uncertain future event (the insured event) adversely affects the policyholder or other beneficiary".

Those contracts that do not meet the above definition will fall under IAS 39. An Exposure Draft on amendments to IAS 39 was published in June 2002 with a final International Financial Reporting Standard (IFRS) expected in the first half of this year. This proposes, amongst other things, that financial liabilities and assets be valued at fair value. However, an amortised historic cost will also be acceptable for some liabilities, most notably long-term savings contracts.

The Faculty and Institute of Actuaries responded to the Exposure Draft on 11 October 2002 noting that a very large proportion of UK long-term insurance contracts (especially pensions and unit-linked) would not meet the above definition and would thus fall under the scope of IAS 39. They also expressed concern about the option to value savings contracts on an amortised cost basis arguing that this would fail to communicate to investors the reality of the business. They recommend the IASB restrict the valuation of these contracts to either 'entity-specific value' or 'fair value'.

(The DSOP on insurance defines entity-specific value as reflecting the cash flows that will arise as the insurer settles the liability over its life and fair value as the price of a hypothetical transfer of the liability at the reporting date to another entity. These are similar concepts, differing only in some of the assumptions used.)

It's worth mentioning briefly the last 3 bullet points that were discussed by the IASB – unbundling, embedded derivatives and measurement of financial assets.

- Where insurance contracts contain both insurance (as defined above) and investment components then the latter should be unbundled, and accounted for under IAS 39, if the cash flows from the insurance component do not affect the cash flows from the investment component.

- Embedded derivatives should be separated from the host contract and accounted for under IAS 39 if the economic risks and characteristics of the derivative are not closely related to the host.

- Regardless of whether the related liability is classed as an insurance contract or not, the assets backing this liability have to be valued in accordance with IAS 39.

The IASB expect to issue an Exposure Draft for Phase I in the first half of 2003 and a final IFRS in the first half of 2004.

Phase II

Phase II will address the accounting for insurance contracts as proposed in the DSOP and the IASB has given a commitment to completing this phase without delay. However, given the major issues in the DSOP that have yet to be discussed it's unlikely that a conclusion and a final standard will be in place before 2007, possibly even later.

Some of the major issues to be tackled in this phase include:

- Allowance for future premiums/renewals
- Discount rate
- Adjustment for risk and uncertainty

- Own credit risk
- Tax

Conclusions

Despite the introduction of an insurance standard being some way off, a large number of UK contracts will fail the insurance definition and fall under the scope of IAS 39. With an IFRS expected in 2004 it's likely that 2005 balance sheets will be prepared under the new standard and for most insurers, this will require extensive system and data changes. Companies must also consider, if they have not already done so, implications for systems now especially as some contracts and options/guarantees will have to be valued using stochastic, market-consistent valuation techniques. The pressure is already on in light of the FSA's new requirement for the completion of realistic balance sheets of with-profits funds using these techniques.

10. CHANGES TO GUIDANCE NOTES/MAP

Recent changes have been as follows:

30.12.02 GN2: Financial condition reports

The amendments largely relate to the need to update the references to statute and rules, in the light of the Financial Services and Markets Act 2000 and rules or guidance issued by the FSA.

30.12.02 GN8: Additional guidance on valuation of long-term insurance business

This was originally to be extended to apply to Lloyd's life syndicate actuaries, with a new section, Part III. More significantly, the Board took the opportunity to introduce a new paragraph into Parts I and II of GN8, in order to draw attention to the possibility that the use of a single deterministic rate of interest to value an option might understate the liability, and to require alternative approaches to be considered. For example a stochastic approach is to be used for GAOs to ensure they do have a value even if they are currently out of the money.

14.10.02 Due Process for approving Guidance Notes

A new Version has been added to MAP

01.06.02 Professional Conduct Standards (PCS), Version 2.0

This is drawn up to reflect the following principles:-

-The PCS accurately reflects the standards to which the profession is committed and is capable of being adhered to at all times by all members of the profession. The PCS cannot therefore impose as a universal standard anything which cannot be applied in all circumstances.

-The profession is committed, as part of Vision and Values, to expansion beyond the spheres of activity in which it has any traditional role. It is therefore essential that the PCS imposes no unnecessary or unreasonable constraints on its members.

-The profession is committed to acting collectively in the public interest. With this commitment in mind, paragraph 3.5 provides guidance regarding the attention to be paid to the interests of third parties by actuaries when advising their employer or client. This emphasises the commitment of the profession to identifiable third parties.

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SECTION 3

PENSIONS

1. Stakeholder Costs

This year has seen many companies effectively withdrawing from the Stakeholder market. Some companies have actually stated that they will no longer sell the product. Others have said they will no longer pay commission. Either way, the industry no longer seems to be keen on Stakeholder pensions.

It is generally believed that companies can only make money from Stakeholder pensions by selling very large volumes of business. This appears to be the only way to control costs to such an extent that profits can be made.

The take-up rate has been very poor. It seems that the types of people that Stakeholder was aimed at are not bothering to take out the contract. They are more likely to be taken out by people who are trying to maximise their tax efficiency.

The minimum income guarantee, pension credit and income support have put people off taking on a Stakeholder pension. "What is the point of saving your hard-earned cash if the government will pay you the same amount of pension anyway? You might as well just spend it now and rely on the government to look after you." – appears to be the attitude of many.

There is still the possibility that contribution to a Stakeholder pension becomes compulsory. Employers have spoken out against this as they see it as yet another cost. It is likely that employees would also be against this if it meant that they had to contribute. It would, however, be good for the pensions industry. There would be much higher volumes of business and there may be more of a chance of companies lowering their per policy expenses enough to make a profit, or less of a loss, from this.

The other possibility is that the government increases the 1% management charge cap. This has been suggested by the ABI. It would certainly help, as some companies have found this impossible to meet. It also does not seem to have been the great marketing tool that was expected. It was expected that the public would see that if companies were forced to restrict their charges to 1% that then the policyholders would be getting a great deal. However, that has not been enough to persuade droves of people to take out the policies.

Although the take up rate has been poor the Consumers' Association feels Stakeholder pensions have been a success as they have forced providers to become more efficient.

2. Pensions Credit

The DWP proposed that an additional benefit be paid to pensioners that have saved towards their retirement. This is in addition to the Minimum Income Guarantee (MIG).

It is due to come into force in October 2003.

3. State Second Pension

The reform of the State Earnings Related Pension Scheme (SERPS) led to the State Second Pension (S2P). This was designed to give higher accrual to people on lower levels of pay. It came into force on 6th April 2002.

However, rebates are low and not many people think it is good advice to contract out anymore.

4. Modernising Annuities

Background

It seems that nobody has anything good to say about annuities. The low levels of gilt yields, and the continuing improvements in mortality have made annuity purchase so expensive that it seems impossible to get a good deal from an annuity. Currently people can put off buying an annuity until age 75 by taking out contracts like phased retirement or income withdrawal. These delay the inevitable annuity purchase and allow an income to be taken in the meantime. Unfortunately, an annuity must be bought at some time. There is no guarantee that an annuity will provide better value by the time the policyholder is 75 because the level of gilt yields may not have improved and the effect of mortality drag may make the annuity more expensive.

For this reason, some people (like the Liberal Democrats) think that people should not be forced to buy an annuity.

The opposing camp thinks that people need to be protected from themselves. Forcing people to buy annuities ensures they have some level of income for life. Otherwise they may squander their pension fund on holidays, houses, etc.

There needs to be some way of ensuring that policyholders do not run out of money before they die. At the moment buying an annuity does this. However, people need to be saving far more money than they currently are to enable them to buy a decent level of annuity under the current market conditions.

Due to the bad publicity surrounding annuities, people are looking for something new. Annuities are seen as very inflexible. So flexible annuities may be the way forward.

The Government Paper

The Inland Revenue and the DWP published a consultation paper "Modernising Annuities" on 5th February 2002.

The aim of the Government is for pensioners to have sufficient, secure and reliable income in retirement. They are trying to minimise the chance that the Government will have to bail people out.

They have already suggested methods to encourage people to save for example the minimum income guarantee and pension credit. These methods are designed to help those in greatest need, but they can also be seen as disincentives.

The key recommendations are:

- Annuities are the best way to provide for retirement.

- The fact that annuities provide income throughout life is key. Otherwise there may come a point in time when they need (and expect) help from the Government.

- The fact that they pool risk makes them financially efficient.

- People should be informed. This will enable them to make the best choice of how to use an annuity to provide income in retirement.

- People should get the best value for their money.

- People should shop around for the best rates.

- They should also be encouraged to use their open market options.

- The FSA on-line comparative tables of financial products should be extended to cover annuities. This will help people to make an informed choice, and hopefully get better value for money.

- People should get advice on annuities in the workplace.

- People should be able to see the cost of sale for a product. Then they would know how much they were paying for the advice they received.

- Different products should be labelled according to what sort of people they would suit. Decision trees could be produced to help people decide what sort of annuity to buy.

- Increased choice should be available. Annuities would be more attractive if they allowed flexible payment and inheritability. In order to speed up the acceptance of new forms of annuity there should be an agreed set of criteria that have to be met.

- The Government believes the annuity market needs to diversify and become more competitive.

- Tax privileges are still the best way to encourage people to save for retirement. However people should not be able to abuse these privileges. So it should still be compulsory to purchase an annuity by the age of 75. This avoids people using their pension fund for other things.

- People should be able to transfer their annuity from one provider to another.

Types of Annuity

There are many forms of annuity:

- The most common is level annuities. These have the disadvantage that their value is eroded by inflation.

- Another common form is increasing annuities. These can increase by a flat amount, a percentage or in line with an index. They have the disadvantage that they offer less income initially than a flat annuity.

- A newer form of annuity is an investment-linked annuity. These allow for the fact that the payment term of an annuity can cover more than one economic cycle. These can be unit linked or with profit. These have the disadvantage of uncertainty of income, but the advantage of the chance of higher income.

- Another form of annuity is the impaired life annuity. This gives better rates to people with lower life expectancy. These are good for people going into long term care and for people with life-threatening diseases like cancer and AIDS.

- Income drawdown is not an annuity, but it does provide income. It allows the delay of annuity purchase, which can be good if economic conditions are poor. It also allows for varying income levels. This method of providing pension income is only suitable for people with large funds, and possibly some other form of income, due to the higher charges and possible volatility of income.

- People can choose to annuitise each part of their pension fund separately. This is called staggered vesting or phased retirement.

The Government paper suggests that there is not enough choice in the annuities market. A new form of annuity suggested in the paper is limited period annuities. These are more flexible than traditional annuities. People can choose the period of the annuity and the level of the income. People could then plan for a shorter period when they were more certain of their annuity needs. They could use part of their fund to buy an annuity for a limited term. At the end of that term they could think again about what income they need. Buying a series of limited period annuities would let people stagger their retirement. This type of annuity would lead to increased demand for shorter-term bonds. This would ease the demand on longer-term bonds. This would make them cheaper and may allow more affordable lifetime annuity rates for people.

The Green Paper also suggests capital protected or risk-free annuities. They have an inheritability option, whereby a death benefit is paid of the difference between the fund and the annuity payments to date. This would make annuities more expensive.

If people were able to transfer their annuities it could lead to selection against the life office. Currently by pooling risks people who die early help to fund the annuity payments for those who die later. If people could freely transfer their annuities, the people who would transfer would be those who were in poor health and wanted to take advantage of another provider's impaired life annuity. This effect would lead to more expensive annuity rates for everyone. The solution may be to allow transfer only at certain points. This would mean

that policyholders would not be stuck with the choice that they had made. The effect would be similar to offering limited period annuities.

There are a number of things a consumer has to consider before deciding which type of annuity to buy, for example, age, health, occupation, fund size, other income, payment options, guarantee period, attitude to risk, inflation and dependants.

5. The Pickering Report

The Pickering Review “A Simpler Way to Better Pensions” was published on 11th July 2002. It sought to simplify pension legislation and reduce compliance costs.

The primary aims of this paper were:

- To find ways to make it easier for employers to provide good quality pensions for their employees
- To make it easier for providers to sell appropriate pensions products to people who need them
- To make it easier for people to build up pension benefits.

The secondary aims were to make the pensions system more efficient, to ensure that pension scheme members are protected and to build confidence in the system.

The key themes that emerged during the review were:

- A proportionate regulatory environment
- A pension is a pension is a pension
- More pension less prescription.

This summary will deal with each theme in turn.

A proportionate regulatory environment

The new Pensions Act should have the following principles:

- Each statutory requirement should include a statement of that legislation’s underlying policy aim.
- Statutory requirements should focus on the objective to be achieved rather than the process needed to achieve it.
- Statutory requirements should be proportionate to the stated policy aim and should avoid unnecessary complexity.
- Each new piece of pension legislation should not be considered in isolation, but should have regard to the existing law applicable to pension arrangements.

The legislation underlying these principles should be mainly non-prescriptive. Where there is only one sensible course of action it should be specified. More reliance should be placed on professional judgement.

There should be a regulator that also acts as an adviser and is more proactive than OPRA.

The regulator, professional bodies and the Government should produce guidance Notes.

Currently, too much emphasis is placed on disclosure to members, of information that they do not understand. It would be better for only the key pieces of information to be given to members, and for more detailed information to be available on request.

Trust based schemes should have one-third of their trustees nominated by pension scheme members.

A pension is a pension is a pension

Pension scheme members should have the same level of protection whether their pension is in the workplace or via a commercial provider. Individual and occupational pensions should be governed by the same rules.

The regulatory treatment of schemes and employers should be the same regardless of their size.

Inland Revenue and Department for Work and Pension legislation should be streamlined.

More pension less prescription

Employers should be allowed to make membership of their pension scheme a condition of employment.

All types of pension arrangement should have immediate vesting.

Pension transfer rules should become much easier.

Contracting out should have minimum standards of benefits. However, existing requirements are too prescriptive.

Occupational pensions and protected rights personal pensions should no longer have to increase pensions in payment in line with prices.

Schemes should no longer be forced to provide survivors' benefits.

Contracting out should be simplified with a new reference scheme test.

In occupational defined benefit schemes Guaranteed Minimum Pensions (GMPs) should be replaced by a retrospective reference scheme equivalence test.

Conclusions

Many of these recommendations have been taken forward in the Green Paper.

Industry reactions

Reactions to the report have been mixed.

Some say it is too late as the damage has already been done. Others say the remit of the report was too narrow to start with. Some people have said that the reports' recommendations are not radical enough. The Government will

have to go much further to get rid of the gap in pensions savings. It is said that the report does not tie in with Sandler's recommendations for greater transparency in savings. It is thought that removing survivors' benefits could lead to some women being forced into poverty.

However, employers' organisations have welcomed the report. The CBI says the proposals will curtail rising pensions costs. Some people have been saying it is more in line with the system of 15 years ago, when there was less regulation.

6. The Sandler Review

On 9th July 2002 the "Medium and Long-Term Retail Savings in the UK" – by Ron Sandler was published. It was an investigation into the competitiveness of medium and long-term savings.

The main recommendations are:

- There should be a whole set of Stakeholder type products. They should be easy to understand, be good value, be tightly regulated and not require advice. The products should be a mutual fund or unit linked fund, a pension and a with profits product.
- Financial advisers should be required to have more stringent investment qualifications.
- With profit policies should become more transparent and easier to understand. They should have the following features:
  - An explicit smoothing account that will be neutral in the long run. There should be disclosure of both smoothed and unsmoothed asset values.
  - A "100/0" management arrangement with an explicit management charge and no shareholder participation in profits.
  - Standard rules for calculating charges.
  - The annual statement should disclose the value on redemption, the value on death, the value on maturity and the unsmoothed asset share. There should also be an annual report on the condition of the fund, asset allocation, investment performance and costs charged.
  - Language should be simple and payout rights should be clearly defined at the start.
  - With profits should not be used to finance other parts of the business.
- Stakeholder products should have no initial charge and annual charges should be regulated. Surrender charges should be strictly regulated or non-existent.
- Investment risk should be limited through regulation.
- Warnings should be given in plain English.
- If an adviser is called independent the provider should not pay him. Advisers should only be called such if they are independent.
- The FSA should have a ring-fenced budget for consumer education.
- The key features document should be shortened.
- The FSA should say clearly what constitutes mis-selling.
- Tax should be simplified for retail savings products.

Industry reactions

The report has largely been well received.

However, there have been some criticisms. People were disappointed that the report concentrated on removing disincentives rather than introducing incentives. Some people think that with profit funds should be eliminated all together. Other people are concerned that products will be promoted without the advice the policyholders need – this could lead to mis-selling scandals.

The way forward

The FSA are generally happy with the paper, and aim to present a consultation paper on this in Spring 2003.

In January 2003 the FSA published "Discussion Paper 19 – Options for regulating the sale of simplified investment products". This outlined three broad options for introducing a simplified suite of Investment products. The products will be specified by the Treasury to ensure simplicity and control investment risks. The options are:

- Consumers would receive clear warnings about the basis of the sales process and relevant risks.
- A series of filter questions, set by the FSA, would be used by the salesperson to screen out consumers for whom the product would not be suitable.
- An adviser would make a limited assessment of individual suitability, to a scope set in FSA guidance.

Some of these recommendations have been taken forward in the Green Paper.

7. Simplicity, Security and Choice : Working and Saving for Retirement : Government Green Paper

The pensions Green Paper "Simplicity, security and choice: Working and saving for retirement was published on 17th December 2002 by the Department for Work and Pensions (DWP). It was accompanied by a paper from the DWP expanding on a number of points in the Green Paper, and a paper from the Inland Revenue – "Simplifying the taxation of pensions: increasing choice and flexibility for all".

These papers, together with the Pickering and Sandler reviews seek to clarify the future of pensions. They are hoping to simplify the rules by targeting tax and benefits. If pensions are easier to understand then it is more likely that people will invest in them. This will help to ensure that people have sufficient income in retirement and do not have to rely on the Government to provide for them. The Green Paper makes numerous proposals and asks a number of questions as to their appropriateness.

The main aims of the Green Paper are:

- To help people make informed choices about their retirement.
- To reaffirm the role and responsibilities of employers.
- To encourage simple and flexible savings products.
- To introduce measures to extend working lives.

The main concerns are:

- Longer life spans mean that people will have longer retirements.
- There is a decline in pension provision offered by employers.
- The cost of advice and complexity of products on offer puts people off.

- Many people are leaving employment too early.
- Government is sceptical about compulsion because individuals are best placed to judge their own needs.
- Three million people are not saving enough at the moment.

A simpler pensions framework
- The pensions tax regime must be simplified so that all pension schemes are covered by a single set of simple rules.
- There will be a single lifetime fund limit.

Helping individuals to understand financial choices
- More people should receive forecasts of their pension income. State pension forecasts should be issued to people who do not have private pensions. People who have private pensions should be shown their combined State and private pension.
- People should receive information at key points in their lives. An integrated telephone and web-site will be developed.
- Tax relief on individuals' contributions to personal and stakeholder pensions will be re-branded so that they appreciate its' worth.
- The Government are looking for views on whether to offer the self-employed the right to opt in to the State Second Pension.

Making pension provision easier for employers
- The tax treatment of pensions will be simplified. This will help reduce administration costs.
- More flexible rules will be introduced for scheme funding.
- Schemes will be given much greater flexibility in how they comply with the regulations.
- The MFR will be replaced by a scheme-specific funding requirement.
- The structure of contracted out benefits will be simplified.
- Existing pension legislation will be consolidated.

Better protection for members
- New pensions regulator to be created, focusing on schemes with a high risk of fraud, bad governance or maladministration. Members will be better protected when a scheme winds up. They will be fully compensated for amounts lost due to dishonesty. They will have the right to be consulted on changes to the scheme.

Using a good pension to help recruit and retain staff
- An employer task force will be set up.
- Employers should inform employees of the pension benefits offered by providing total benefit statements, information on pay slips and recruitment information. The Financial Services Authority (FSA) will provide packs to help the employer with communication.
- Employers may be able to insist that employees join their pension schemes.
- Schemes may have immediate vesting.

Informed choice in pensions: building trust and understanding in financial services
- Sandler recommendations will be implemented. This will make it easier to save through simple products and sales processes.
- Value protected and limited period annuities will be introduced.
- The regulation of equity release and home reversion plans will be reviewed to see if it offers enough protection for consumers.

- Steps should be taken to ensure that pension fund trustees have appropriate investment experience.

Extending opportunities for older workers
- The Government will provide help for those over 50 or on incapacity benefit to return to work.
- They will treat people between 60 and 64 as active in the labour market.
- Compulsory retirement ages will be made unlawful.
- People will be allowed to work after receiving their occupational pension.
- Public service retirement age to be set at 65 for new members.

State pension age
- State pension age will not be increased.
- People who defer their state pension will get more generous increases to their pension.

Pensions and women
- The Government will look at the information they provide women.

Ensuring progress
- An independent pension commission will be established. It will report regularly to the Secretary of State for Work and Pensions.

8. Simplicity, Security, and Choice : Technical Paper

This technical paper was published with the Green Paper on 17th December 2002.

It sets out the Government's proposals involving technical changes in regulatory reform in more detail.

Changes to contracting out
- There may no longer be a requirement to provide survivor's benefits.
- There may no longer be a requirement to provide Limited Price Indexation.
- The reference scheme test will be reformed. The minimum accrual will change from 1/80th to 1/100th. Contracted out schemes will be allowed to choose whether to calculate pensionable salary on a career average or final salary basis.
- GMPs will be simplified.
- Anti-franking provision will be simplified.
- The age at which contracted out benefits are paid may be changed.
- The trivial commutation level may be increased.
- Contracted-Out Mixed Benefits Schemes (COMBs) may be abolished.
- Safeguarded rights arising from pensions on divorce may be abolished.

Greater flexibility for schemes
- The restrictions under which schemes can modify accrued rights may be reviewed.
- One third of trustees need to be member nominated. The process of selecting and appointing these trustees will be less prescriptive.
- The time limit for internal dispute resolution may be changed.

Preservation and Transfers
- The regulations regarding transfers will become less complex. Schemes will be allowed to set their own transfer value basis.

Communication with scheme members

- The items of communication that are supplied automatically may be reviewed. Some may become available on request and some may have time limits attached to them.

Pensions on divorce

- Pensions on divorce legislation may be simplified.

Protection in the case of wind-up

- It is suggested that solvent employers who wind up a scheme should have to buy out the full benefits of pensioners and those near retirement, and provide transfer values for others.
- Should pension schemes be given a higher priority than other unsecured creditors?
- A central discontinuance fund could be set up or a fund could be set up to negotiate the purchase of deferred annuities.
- It is proposed to remove restrictions on the amount of compensation that can be paid in cases of dishonesty.

Transfer of undertakings (Protection of Employment)

- Options are proposed for extending protection of scheme benefits.

Transfers without consent

- Trustees of occupational pension schemes should be able to transfer de minimis amounts to a stakeholder pension where members left the scheme 6 months previously. The de minimis amount suggested is £7,000.

9. Simplifying the Taxation of Pensions : Increasing Choice and Flexibility for all : Inland Revenue Review

This Inland Revenue review was published with the Green Paper on 17th December 2002.

This has widely been thought to propose more important changes than the Green Paper.

Currently the complexity of the tax rules puts people off saving for retirement. It also increases the costs faced by individuals, employers and pension providers.

The review proposes radical simplification of pensions taxation. The aim is for a system that is transparent, consistent and flexible. People should be encouraged and enabled to save for their pensions. There should be increased choice and flexibility for individuals, employers and pension providers.

The main proposals

- All pension savings after implementation will follow a single set of rules.
- There will be a single set of rules about how pension savings are turned into benefits.
- There will be a single lifetime fund limit on the amount of pension saving that can benefit from tax relief. This limit will be £1.4m. It will apply to all types of pension savings and will increase in line with prices.

- There will be a light touch compliance regime. The limit on value inflows to each person's pension fund will be £200,000 per year. This will increase in line with prices.
- There will be a single set of rules about delivery of pension benefits.

Pensions in payment

- The tax-free lump sum would be set at 25% of the value of matured pension savings.

Flexible retirement

- People will be allowed to draw benefits from their pension while continuing to work, if scheme rules allow it.
- The earliest age from which a pension can be taken will be raised from 50 to age 55 by 2010. The concept of normal retirement age will vanish from tax legislation.
- New kinds of annuity will be possible. For example limited period annuities and value protected annuities.

Industry Reactions

Industry reactions to the Green Paper and the Inland Revenue Review have been mixed.

Most people have said that the most important changes are contained in the Inland Revenue Review, rather than the Green Paper.

The positive comments include:

- It is a useful first step for stabilising the pensions system. It is a massive step forward.
- It is a positive contribution.
- It takes on board many of the recommendations of the Sandler and Pickering reports.
- People will be able to build up a bigger tax-free lump sum.
- They will also have greater choice and flexibility.
- Employers and pension providers will have lower administration. This could lead to lower costs and a better deal for the policyholders.
- It is good, common sense. Allowing people to work later means the workforce can benefit from the knowledge of these workers for longer.
- It makes saving simpler and easier.

The more negative comments include:

- It is over ambitious.
- The transition arrangements will be awkward.
- It may also be worse for high earners.
- It is a missed opportunity.
- It does not help people who feel they cannot afford to save for a pension.
- The MFR needs replacing as quickly as possible.

10. The Quinquennial Review of OPRA

OPRA gets reviewed every five years. This review "Report of the Quinquennial Review of the Occupational Pensions Regulatory Authority (OPRA)" was released along with the Government's Green Paper on pensions.

The main conclusions were:

- OPRA has performed well within the limitations of its' powers.
- It has the potential to take on new and different roles.
- It is open and accessible and would like to be more pro-active.
- A new kind of regulator needs to be set up.

The key considerations for new regulator will be:

- It should continue to work at arms' length from the Government.
- It should be pro-active.
- Its' objectives should be protected in law.
- It needs to focus on key risks to pension scheme members, rather than dealing with low value breaches.
- It should respond to whistle blowing from pension professionals.
- It should give support and advice for people with regards to compliance and legislation.
- It should give guidance to employers, trustees and pensions professionals.
- It should work with professional bodies in order to produce codes of conduct.
- A new kind of governing body should be set up.
- The Pension Scheme Registry should take on a wider role.
- It should send out publications to key audiences, but also continue with face-to-face communication.

11. Statutory Money Purchase Illustrations

The Government has introduced plans for all money purchase pensions to produce yearly illustrations. CP 134, a consultation paper for point-of-sale projections was issued on 26th April 2002. Consultation continued until 19th July 2002. TM1 : Statutory Illustrations of Money Purchase Benefits was issued in May 2002.

This is part of a bigger initiative whereby the Government wants all adults to get one annual statement showing the projected amount of all their pension provision added together. This will help people to know when they have to start saving more towards their retirement.

Each scheme will have a defined illustration date. Illustrations must be provided on that date each year.

The illustrations are designed so that people have a realistic view of how much pension provision they have and whether or not they need to increase this in the future.

These illustrations will be in real terms, and so will give the policyholders a good idea of how much money their pensions are really worth. They will also allow for an RPI linked annuity being bought. This means people will not be lulled into a false sense of security by distorted numbers.

The pre-retirement investment return assumption will be long term and equity based, unless that is unrealistic for the particular contract. The current maximum is 7% p.a.

Inflation and earnings growth are currently set at 2.5% p.a.

The annuity rates will be calculated using current investment conditions. Mortality rates will be from prescribed mortality tables and will allow for future improvements. The interest rate will be based on index linked gilt yields on the 15th February each year. Males will be assumed to be three years older than females, and that a 50% spouse's benefit needs to be included.

Future contributions will be allowed for.

It will be assumed that the current contracting out status continues.

These illustrations must be in force by April 2003 for existing business. The Government is also keen to see similar illustrations provided at point of sale for consistency.

All money purchase plans that currently receive an annual benefit statement must now also receive a SMPI. If the fund value is less than £5,000 and the plan is no longer being contributed to, then it is exempt.

The values in these illustrations will be quite different to the values in the current illustrations. They will be much lower, in some cases by up to 60%. The fact that they are on a prescribed basis should make it easier to compare one company's projections with another.

12. Defined Benefit switch to Defined Contribution

Reasons why

The poor investment returns and the increased cost of pensions funding seem to have pushed many pension schemes from being defined benefit schemes to being defined contribution schemes. The volatility of the stock market has also been a contributory factor.

With employees moving jobs more frequently employers are less likely to feel paternalistic towards their employees. They are less likely to care whether or not the employee has a decent standard of living in retirement, as they probably will not get a lifetime of work from the employee.

Another off-putting factor is the amount of regulatory red tape surrounding defined benefit schemes. The new Green Paper is aiming to simplify this and bring new flexibility to scheme design.

FRS17 requires that pension scheme assets and liabilities be looked at, at one point in time, and be shown on the company balance sheet. The low levels of the stock market have meant that many schemes are currently in deficit. This reflects badly on the company. Companies are also concerned about the volatility and unpredictability that this gives their balance sheet.

Recently, Ronald Bowie said to the Parliamentary Work and Pensions select committee that the only reason companies are moving from defined benefit to

defined contribution is as an excuse to cut the level of contributions they make to employees' pensions.

Throughout the year, there have been more and more companies realising this. For example, National Tyres and Autocare are closing their defined benefit scheme and starting a defined contribution scheme and Ernst & Young are freezing their defined benefit scheme and transferring members to a defined contribution scheme.

Consequences

This has led to increased demand for bulk buyouts. Scheme trustees are looking for insurance companies to buyout the defined benefits part of a scheme, while also providing an ongoing defined contribution scheme. Some schemes that are being wound up are solvent on an MFR basis, but insolvent when it comes to buying out the liabilities with an insurance company.

The insurance companies need to buy government bonds to back these liabilities. Unfortunately there are not enough government bonds to back all these liabilities. The government has recently announced plans for increased levels of borrowing. This increase in the supply of government bonds could lead to more insurance companies being in the market to offer these bulk buyouts.

Which is better?

There is this assumption that defined contribution schemes are better for the company and worse for the member. This is not always true. In times of good stock market performance a defined contribution scheme can provide better benefits. What the defined benefit scheme does provide is security. It provides a guaranteed level of income. Moving to defined contribution moves the investment risk from the employer to the employee. The reason why the move to defined contribution is worse for most members is because the companies are using it to hide the fact that they are now contributing less into the scheme.

13. Asset Allocation

Relative returns

The recent poor performance of equities has led many schemes and insurance companies to question whether they should maintain their high level of investment in equities.

Historically, bonds have been used to match liabilities for members close to retirement. So the level of bond investment depends on the number of people who are close to or in retirement. The MFR encourages this matching of liabilities. So a fully mature scheme would probably be 100% invested in bonds. However, for an active scheme, the asset allocation would normally be 75% equities and 25% bonds.

In November 2001 the Boots pension scheme moved its entire pension fund portfolio into bonds. The Boots scheme is an active one. This sent out a very strong message. Since then the debate has raged – are they very brave or

very foolish? The Boots scheme seems to think that bonds are the best investment for active members and pensioners.

Since then, several other schemes have followed by moving away from equities and into bonds.

The impact of FRS17

The Boots Pension Fund cited FRS17 as one of the reasons for the move from equities to bonds. This is because FRS17 uses a market value based approach with liabilities being valued using a current bond yield.

FRS 17 requires that companies have to include pension scheme assets and liabilities in their balance sheets. This makes any deficit immediately obvious to potential shareholders.

This means that companies may prefer more stable investments like bonds, rather than volatile investments like equities. This will make the balance sheet position more predictable.

The implementation of FRS17 has now been delayed until 2005. This is while the international accounting standard IAS19 is being considered.

Life expectancy

Improved life expectancy may mean that in the future pensioners outnumber active scheme members. This will require an increase in the percentage of bonds held.

Closure to new members

The closure of many defined benefit schemes to new members will also increase the demand for bonds. This is because as time goes on there will be more pensioners than active members. The new active members will, instead, be investing in a different defined contribution scheme.

14. The Impact of the Current Low Stock Market on Funding

The low levels of the stock market are having a huge impact on pensions scheme funding. Previously it has been assumed that equities give the best long-term returns. So schemes with long-term liabilities have been mainly invested in equities. This has proved disastrous in a year when the stock market has fallen drastically. Schemes that had an adequate level of funding in 2001 found that, without doing anything themselves, they were seriously under funded at the end of 2002. This has led to worries about the security of members' benefits. It has also led to concerns from employers over the cost of schemes. This has pushed many firms away from defined benefit schemes to defined contribution schemes. This gives the firm the certainty that they know what they need to contribute each year, rather than being subject to the vagaries of the stock market. It has also pushed many firms into lower levels of contributions. Both of these results have been bad for the pension scheme members.

15. Wind-ups and the High Cost of Bonds – Discontinuance Funding

New regulations for winding-up schemes came into force on 1st April 2002. They were designed to speed up the winding-up process and make it more efficient. The changes are being phased in.

The main changes were:

- Trustees must make regular progress reports to OPRA.
- OPRA can take action if delays are unreasonable.
- OPRA must be told if there are no trustees so that it can then appoint some.
- Trustees can apply for an order to modify the scheme if it means the scheme can be wound up properly.

16. Current UK Market Statistics

The following figures are from the ABI.

Net Premiums

There was £25bn paid into Individual Pensions, £29bn paid into Group Pensions, £0.2bn paid into annuities.

Benefits

£51bn was paid out in benefits for pension policies and £1.0bn was paid out for annuity policies.

Household Expenditure

Only 16% of households purchase personal pensions. The average annual expenditure per household is £1,529.

Amount Invested

£210bn is invested in occupational pensions and £350bn is invested in personal pensions.

New Business

Summary of New Business from the ABI. All figures are in £m.

	New Individual Regular Premiums	New Individual Single Premiums		Group Business	
	Pensions	Pensions	Pension Annuities and Income Drawdown	Regular	Single
1997	1292	7219	5517	848	3783
1998	1611	5557	7563	965	3186
1999	1474	6999	7569	978	4723
2000	1593	7329	7911	940	4250
2001	2403	8741	8542	1107	7114
Up to Qtr3 2002	1747	8532	6776	810	5828

Distribution Channel

Summary of New Business split by Distribution Channel, by the ABI.

Individual Regular Premium Pensions:

	IFAs (%)	Direct Salesforce (%)	Tied Agents (%)	Direct Marketing (%)	Telesales (%)	Other (%)	Total New Premium (£m)
1997	55.3	40.7	3.6	0.4			1292
1998	49.5	46.2	3.2	0.4	0.5	0.2	1611
1999	57.8	38.1	2.9	0.4	0.6	0.2	1474
2000	66.1	30.7	1.6	0.7	0.6	0.3	1593
2001	76	19.1	1.7	1.5	1.5	0.3	2404
Up to Qtr3 2002	76.4	20.8		2.4		0.4	1747

Group Regular Premium Pensions:

	IFAs (%)	Direct Salesforce (%)	Tied Agents (%)	Direct Marketing (%)	Telesales (%)	Other (%)	Total New Premium (£m)
1997	72.8	24.4	2.5			0.3	848
1998	67.6	29.0	2.2			1.1	965
1999	67.7	29.3	2.3			0.8	978
2000	78.5	18.7	1.3	1.0		0.6	940
2001	88.7	9.7	0.8			1.5	1116
Up to Qtr3 2002	91.1	8.3				0.6	810

Individual Single Premium Pensions (including DWP rebates received):

	IFAs (%)	Direct Salesforce (%)	Tied Agents (%)	Direct Marketing (%)	Telesales (%)	Other (%)	Total New Premium (£m)
1997	67.9	30.1	1.3	0.7			7219
1998	73.6	22.6	1.5	0.4	0.4	1.6	5557
1999	66.9	25.9	3.2	0.5	0.3	3.3	6999
2000	73.1	21.0	2.0	0.7	0.3	3.0	7329
2001	78.6	15.9	1.1	0.8	0.7	2.8	8741
Up to Qtr3 2002	77.2	15.9		3.4		3.5	8532

Pension Annuities and Income Drawdown:

	IFAs (%)	Direct Salesforce (%)	Tied Agents (%)	Direct Marketing (%)	Telesales (%)	Other (%)	Total New Premium (£m)
1998	61.6	33.0	0.7	0.6	0.7	3.4	7563
1999	63.5	29.3	0.7	0.4	0.7	5.4	7569
2000	64.8	28.9	0.5	0.4	0.3	5.2	7911
2001	75.3	19.2	0.4	0.2	0.2	4.8	8545
Up to Qtr3 2002	72.5	14.1		0.2		13.1	6776

Group Single Premium Pensions:

	IFAs (%)	Direct Salesforce (%)	Tied Agents (%)	Direct Marketing (%)	Telesales (%)	Other (%)	Total New Premium (£m)
1997	75.7	15.7	8.2			0.4	3783
1998	83.0	10.6	5.8			0.7	3186
1999	80.7	7.3	10.5			1.5	4723
2000	82.9	9.5	0.5	0.2		6.9	4250
2001	57.8	3.9	0.3	0.1		37.9	7252
Up to Qtr3 2002	59.4	5.4		0.1		35.2	5828

17. Changes to Guidance Notes

GN3 : Retirement Benefit Schemes – Contracting-out Certificates for Schemes where Wind-up Commenced before 6 April 97.

Version 3.4 came into effect on 13/1/2003.

It was updated due to a change in regulations. This change meant that:

- There is no longer a requirement to renew any Certificate T when the period covered by such a certificate expires.
- There is no requirement to modify the funding position of a scheme specifically in relation to Certificates T that are currently in force.
- There is no requirement for new contracted-out schemes with a final salary element to submit a Certificate T after completion of the scheme's first MFR valuation and the certification of the associated Schedule of Contributions.
- A reference to the Professional Conduct Standards (PCS) has been added.

GN27 : Retirement Benefit Schemes – Minimum Funding Requirement.

Version 2.1 came into effect on 13/1/2003.

The following changes were made:

- The requirement to ensure that the MFR is being met by schemes between valuations now only applies to schemes that did not meet the MFR at their most recent effective date or the date seven days before the initial certification date of the schedule of contributions. The trustees must then obtain periodic certificates signed by the actuary.
- Gilts matching now applies to schemes with no active members. They can use gilt-based calculations for the schedule of contributions.

GN34 : Illustration of Defined Contribution Pension Scheme Benefits.

Version 1.1 came into effect on 13/1/2003.

The following changes were made:

- Illustrations in accordance with TM1 are not covered by GN34.
- The ordering of the first two sections of the note has changed
- A reference to the PCS has been added.

GN13 : Actuarial Statements Required in connection with the US Statements of Financial Accounting Standards No.87, No.88 and No.132.

Version 3.2 came into effect on 14/10/2002.

The following changes were made:

- The title has been clarified.
- References have been updated.
- Examples have been removed.
- The paragraph order has been altered.

GN36 : Accounting for Retirement Benefits under FRS17

This came into effect on 1/4/2002.

It is a new guidance note. It is designed to assist members with providing details of pension costs in their accounts in line with FRS17.

GN19 : Retirement Benefit Schemes – Winding-up and Scheme Asset Deficiency

Version 4.2 came into effect on 19/3/2002.

The following changes were made:

- Unnecessary examples have been removed.
- Existing guidance has been clarified.
- The requirements for schemes winding up without an insolvent employer have changed. These relate to the apportionment of assets to certain classes of liabilities and to the determination of any deficiency falling on the employer.

GN29 : Occupational Pension Schemes – Advisers to the Trustees or a Participating Employer.

Version 4.0 came into effect on 1/3/2002.

The following changes were made:

- GN29 only applies to Affiliates of the Faculty or Institute of Actuaries who hold a qualification with an overseas actuarial body.
- An exception has been added to Paragraph A4.3 to cover the situation where a Scheme Actuary has already been notified of the matter and the Adviser has nothing to add.
- The Section on Significant Events has been reworded.

18. Bibliography/References

- ABI
- A Simpler Way to Better Pensions
- CP134
- Current Topics 2002
- Faculty of Actuaries web site
- FSA Press Releases
- Gray Matter
- Medium and Long-Term Retail Savings in the UK
- Modernising Annuities
- Money Marketing
- Pensions World
- Report of the Quinquennial Review of the Occupational Pensions Regulatory Authority (OPRA)
- Scottish Mutual Tech Talk
- Simplicity, security and choice : Working and saving for retirement – Government Green Paper and technical paper
- Simplifying the taxation of pensions : increasing choice and flexibility for all – Inland Revenue review
- TM1