FASS
Current Topics 2004

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1) Pensions

2003 was yet another year of significant changes in the world of pensions. These changes have had a material impact on all of the stakeholders in the industry.

- Scheme Sponsors were initially hit by negative equity returns, falling gilt yields, ever increasing longevity and increased compliance costs. These all served to reduce funding levels and increase long-term costs.

- Scheme Members began to realise the true value of a defined benefit 'promise' and the impact that negative equity returns and low gilt yields can have on defined contribution schemes.

- Scheme Trustees were faced with fresh challenges; new legislation, how to cope with sponsors unwilling to increase contributions and difficult investment decisions.

- The Press made 'Pensions Crisis' a common broadsheet (and even tabloid) headline – this covering a myriad of scenarios from FRS17 deficits to defined benefit scheme closures. This has probably brought pensions into the public consciousness more than ever before.

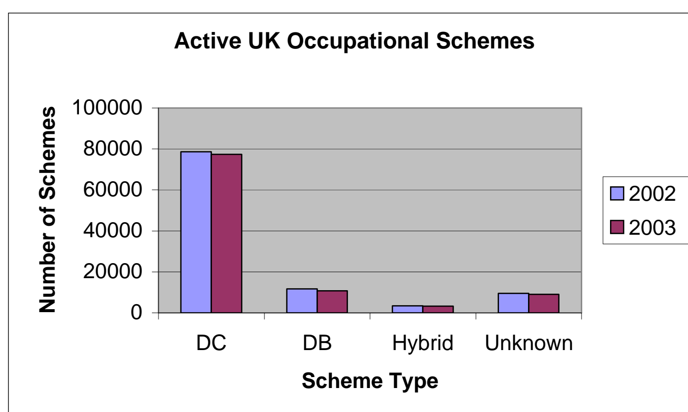
- The Government built on last year's Green Paper by proposing and introducing new legislation designed to reduce sponsor cost, reduce red tape, increase security and increase provision; a complex and often contradictory set of aims.

- In the insured market, many pensions providers struggled to remain technically solvent – caused in part by the lower charges taken from pensions business.

This all suggests that it has not been a good year for the pensions industry. This paper briefly summarises the main issues arising, positive and negative, and their impact.

1.1) UK Occupational Provision Statistics

The active UK occupational pensions market shrunk in 2003, continuing the trend from 2002. Opra's annual reports[1] show that the number of occupational schemes has fallen from 103,165 to 100,536, an overall fall of about 2.5%.



Opra's reports and the chart above show that:

- The reduction in the number of schemes has not been confined to defined benefit (DB) arrangements, as might have been expected.

- However, the number of DB schemes has fallen by the largest percentage – 7.0%. The reduction in defined contribution (DC) arrangements was just 1.5%.

- Hybrid schemes are, perhaps unsurprisingly, somewhere in between, showing a reduction of about 3.3%.

JP Morgan's Industry Survey 2003[2] provides more data about the largest sponsors in the pensions market. In general, this shows a change in method of provision from DB to DC.

- 31% of sponsors do not have an open DB scheme for new employees to join – staff are offered membership of DC arrangements instead.

- The incidence of DC schemes in the employers surveyed has increased from 39% to 51% from 2002 to 2003. This indicates sponsors' increased willingness to control costs and reduce balance sheet risk.

- The percentage of organisations with an open DB scheme for all members has fallen from 70% to 51%.

- 16% of the sponsors surveyed viewed it as 'likely' that they would have some form of shift from DB to DC within the next 5 years.

1.2) Comments on UK Occupational Statistics

These statistics reflect the current situation regarding occupational pension provision; the reasons behind these statistics can be summarised as follows:

Firstly, three years of negative equity returns (to March 2003) have reduced DB scheme funding levels on any chosen basis. At the height of the bull market, most schemes were very heavily invested in equities because of the enhanced returns already achieved and expected in the future. In effect, schemes sought to capture the equity risk premium available, usually without much regard to the downside risk of this strategy.

DB liabilities can be argued to be predominantly bond based in nature. As a result, this mismatching of assets and liabilities exposed the funds to significant losses – that is, bond yields (driving the liabilities) moved significantly ahead of equity returns (driving the assets).

The well-documented exception to this trend is The Boots Pension Scheme that switched almost fully from equity investment to bond investment over an 18 month period around 1999. Interestingly, this was not attributed to investment return issues (although it did lock in significant equity gains close to the top of the market, with the FTSE 100 averaging around 6000). Instead, it was a recognition of corporate finance arguments regarding risk control and the view that a pension scheme is not a disparate entity but part of the company's balance sheet.

The impact of these negative equity returns has been to increase recommended rates of contribution for scheme sponsors, in many cases from a contribution holiday. Many sponsors have simply become unwilling (or unable) to find an additional 20%-30% of payroll to fund their DB scheme.

Secondly, there has been downward pressure on bond yields – medium dated Government stock falling below 4.5% this year. This has been caused by high demand and lower expected future supply, especially on good quality debt such as gilts. The effect of this is to increase the cost of providing annuities and the overall scheme liabilities at valuation. This has then compounded the effect of negative equity returns in reducing scheme funding.

Thirdly, longevity continues to increase – this again places a higher value on pensions in payment and overall scheme liabilities. The Minimum Funding Requirement (MFR) basis (implemented in 1997 as a standard funding test) uses PA(90) rated down by 2 years as a mortality basis. A current more realistic estimate of future mortality[3] would be approximately PA(90) rated down by 12 years (for members retiring in the medium term). This would represent an increase in cost of about 30% in liability calculations over the MFR basis.

Finally, FRS17 is an issue for scheme sponsors. This is the accounting standard that dictates how companies must report the value of their pension scheme liabilities in their annual accounting disclosures. (It should be noted that FRS17 is unlikely to be the long term reporting standard but its replacement - IAS19 - is very similar.)

FRS17 regards the pension scheme as part of the sponsoring employer and takes account of any scheme surplus or deficit on the company's balance sheet. Additionally, the disclosures must use a prescribed discount rate (equal to the yield on AA bonds of appropriate currency and term. There is a wide spread of AA yields varying by coupon and duration. Currently, the average yield is between 5.0% and 5.5%).

This approach assumes that these bonds are the matching asset for the scheme liabilities. Many schemes still have significant equity exposure, therefore mismatching this liability valuation basis. This has become a very significant issue for employers who had FRS17 year ends close to the end of the tax year. At this point, equity markets were around their lowest, as were AA yields. This combination inflated the value of liabilities relative to assets and led to some massive deficits on the FRS17 basis.

Additionally, many Actuaries and Scheme Trustees are still happy to sanction use of an 'ongoing' discount rate which has some equity risk premium (above gilt yields) included. This gives a higher discount rate and a lower value of liabilities – making for a marked contrast with the figures produced under the FRS17 basis.

These issues indicate that DB schemes have two features that scheme sponsors are currently not keen to undertake. These are:

- Higher costs – driven by low investment returns and increased longevity.
- Variable costs – driven by reporting standards and asset and liability mismatching.

These factors are the main drivers behind the switch from DB to DC.

1.3) The Effect of Switching From DB to DC

DB schemes are often viewed as superior to DC schemes because of the supposedly guaranteed benefits they provide, without any investment risk for members. However, the nature of a DC arrangement is not necessarily inherently worse for members than a DB arrangement – it merely provides an alternative set of risks that members should consider.

The single most important source of risk for employees is arguably the level of contributions to the scheme (this directly driving the ultimate level of pension). JP Morgan[2] suggest that the average contributions into schemes were:

- Employer 15.1% and Employee 8.7% in 2003 (11.1% and 5.3% in 2002) for a DB scheme.
- Employer 5.9% and Employee 3.6% for a DC Scheme (based on a new entrant age 30).

This indicates two issues. Firstly, it evidences that employers and employees are having to increase their contributions to DB schemes because of low asset returns and increased longevity.

Secondly, these figures may not be **directly** comparable but indicate that on DB to DC switch, many employers are taking the opportunity to significantly reduce the level of contributions they make. Many DC sponsors do, however, increase contributions with age, grade or service to reflect the increasing cost of accrual with age.

In approximate terms, these statistics suggest that the cost to provide DB over a member's lifetime is about somewhere about 20% of salary (allowing for deficit spreads and other items). It seems unlikely, that the average contribution to a DC scheme will be close to that. Ultimately, this means that a member will probably retire with lower benefits from a DC arrangement than a DB one.

The other major risk for a member is that of investment. In the DC scenario, it is the member that has been hit by lower equity returns and higher gilt yields, not the sponsoring employer. This combination has reduced the funds available to buy benefits and increased the cost of their purchase. The long term effect of this remains to be seen, but it is likely that many members may end up with materially lower benefits under DC than they would have under a well funded DB scheme.

These effects have led to some industry comment that the switch from DB to DC is a transitory one. This trend may be reversed when the effect of lower contributions and investment returns provides significantly lower pensions for the cohort of members due to retire in the next 10-15 years. The extent to which this occurs in practice remains to be seen.

1.4) 'Action on Occupational Pensions'

The first major pensions document of the year was the publication of 'Action on Occupational Pensions'. This was published in June 2003. It built on last year's Green Paper and set out how the Government proposed to reform the pensions industry.

This document covered three specific areas:

- Improving Member Protection.
- Making Pension Provision easier for employers.
- Choice for all – planning for retirement.

Improving Member Protection – The Pensions Protection Fund

The Government was sensitive to accusations that it had not been seen to protect members with DB promises when an employer became insolvent or voluntarily wound up their DB scheme and refused to provide any funds beyond the statutory minimum required.

This minimum required was broadly 100% funding on the MFR basis, which would generally not even provide members with their Transfer Value entitlement. It certainly will not provide sufficient funds to buy a deferred annuity equal to the pension accrued in the DB scheme. A salutary lesson to the majority of DB members that believe they have a benefit 'guarantee'.

As a result, a Pensions Protection Fund (PPF) has been proposed (and subsequently confirmed by the Pensions Bill, published on 12 February 2004). The main facets of the PPF are as follows:

- It will offer protection to members of DB schemes where the sponsor becomes insolvent and their scheme in under funded.
- It will offer protection of 90% of accrued deferred pensions. The salary for this benefit calculation is likely to be capped but the exact detail of the cap has not yet been announced. A possible level is around £50,000. This is intended to act as a disincentive to Company Directors who are considering winding-up a company to avoid a pension scheme debt. To do so would mean that their benefits would be proportionately more greatly reduced than the other employees.
- It will offer protection of 100% of pensions in payment.
- The Government has stated that it will not support the fund with public money, indicating that it is intended to be self-sufficient.
- It is likely that it will come into force in 2005 and will not operate retrospectively for insolvent employers prior to that date.
- It is possible that the PPF's benefits may be based on a simple standard basis. As a result, the benefits provided under the PPF may differ to those originally promised under the scheme.
- The PPF will take over the existing responsibilities of the Pension Compensation Board. As a result, it will compensate members of both DB and DC schemes, where there has been fraud and misappropriation of scheme assets.

This begs the question 'How will it be paid for?' Employers of solvent schemes will have to pay an annual levy to the fund to support it. The levy will be split into three parts. These are:

- A 'Pensions Protection Levy'. This will be partially based on scheme factors (for example the number of active, deferred and pensioner members) and partially on risk factors, linked to the level of funding. It is intended that the 'risk' based levy will account for at least 50% of the total, in an attempt to avoid the risks of moral hazard.

- An 'Administration Levy'. To cover set up and ongoing costs.

- A 'Fraud Compensation Levy'. Which will replace the existing Pensions Compensation Board levy.

The Government is keen to get the PPF up and running as soon as possible but it recognises that the risk based levy will be difficult to calculate in Year 1. This is simply because schemes may not have had a suitable valuation. As a result, the risk based levy will not kick in until the second year. Even after this, schemes may not have to sign up until they have had a triennial valuation completed.

The PPF is not a new idea. The Pension Benefit Guaranty Corporation (PBGC) has operated in the USA along similar lines since the 1970s. However, in the words of its Executive Director 'the existence of the pensions insurance program creates moral hazard, tempting management and labour at financially troubled companies to defer their pension obligations. This unfairly transfers the cost of under-funded pension plans to responsible companies and their workers'.[4]

It remains to be seen how well the Government's risk based levy can avoid this and other such well-documented problems, within the UK model.

Improving Member Protection – Full Buyout Costs

On 11 June 2003, draft regulations (that in February 2004 still remain draft) were published. These stated that the Government will introduce retrospective legislation that means any solvent employer that winds up its DB scheme on or after 11 June 2003 will have to fund the difference between the scheme assets and the full cost of buying out all members' benefits.

This contrasts sharply with the position prior to the 11 June. Previously, the additional funds required ('the debt on the employer') was calculated in line with GN19 on the MFR basis. The difference between deferred annuity costs and MFR transfer values is likely to be significant, especially for young scheme members. It is possible that a scheme that is fully funded on an MFR basis may only be 50% funded (or less) on this buyout basis. This is partly due to the lack of life offices willing to write deferred annuity business; most are unwilling to take on the mortality risk that young deferred members represent.

However, there is currently an interesting 'window period'. If Trustees resolved to wind-up post 11 June 2003 and completed this before the draft legislation was enacted, then the maximum debt they could legally enforce from the sponsor could be calculated on the MFR basis. It would then almost certainly be in the scheme members' best interests to delay the wind-up until the draft legislation came into force. This could provide an interesting conflict of interest for any Trustee who was also the scheme sponsor or company Finance Director.

This legislation is likely to act as a significant deterrent to winding up a scheme. Other likely consequences of this piece of legislation are as follows:

- Solvent employers may cease future accrual (possibly even for existing members) in order to limit their future liabilities.

- Employers will not generally wind up schemes. It is likely that they will continue in paid-up form.

- Trustees will have to consider their investment strategy in light of this and for what target level of benefits that they should seek to fund.

The Government recognises that payment of this debt for some employers would bankrupt them. Trustees will have the discretion to accept a lower amount than the full buyout cost, if it would endanger the solvency of the employer. However, the Trustees still have a duty to maximise benefits for the members, so it will be a very difficult decision (and doubtless one challenged in the courts) for Trustees to accept a lesser amount. For lay Trustees, these sort of decisions may prove very difficult and indeed costly, due to the required investigations into the sponsoring employer's finances and ability to pay the debt.

Improving Member Protection – Changing the Priority Order

The Government also suffered criticism over the way in which scheme assets were shared out on scheme wind up, where a scheme was under funded. As a result, new proposals[5] have been put forward for the method of asset distribution.

The new priority order is currently under consultation and the government aims to have the regulations in place as soon as practicable. This is likely to mean in the first half of 2004. The new proposed priority order is as follows:

1) Scheme Expenses and Debts
2) AVCs
3) Pensioners' benefits (no indexation)
4) Non-pensioners – Category 1 (no indexation)
5) Non-pensioners – Category 2 (no indexation)
6) Pensioners indexation
7) Non-pensioners – Category 1 indexation
8) Non-pensioners – Category 2 indexation

The interpretation of this priority order is as follows:

- Items 1 and 2 are as per the current order.

- Pensioners will be slightly disadvantaged in comparison to the existing order. Currently they would have received the whole of their benefits including indexation in the third priority class. The reduction in priority of their indexation is intended to ensure there are greater assets for non-pensioners.

- Non-pensioners' benefits are now split into two categories dependent on length of service. Category 1 contains n/40 of their accrued liability where n is the number of years service credited to the member. Category 2 contains the remainder of their liability. This is a clear statement that the Government is keen that members with long service periods are not as disadvantaged as present.

- Contracted-out benefits now rank as the same priority as other benefits. This ties in with the Government's proposed aim of allowing schemes to convert GMPs to ordinary scheme benefit on 'actuarially fair' terms.

Overall, commentators' opinions are that this priority order will help to meet the Government's aims. These are stopping pensioners 'scooping the pool' leaving non-pensioners with very little and rewarding length of service with an employer. However, there are still a number of issues (such as appropriate credit for money purchase transfers) that will need to be resolved.

Improving Member Protection – Opra to NKR

The Government has recognised that Opra has generally done a good job in increasing standards of Trusteeship and levels of protection for pension scheme members. However, the current legal framework has meant that Opra has had to deal with many incidences of minor breaches of legislation.

Opra has gone some way to changing this with the revision of Opra Note 1 (which is explained below) and is consulting on changes to Opra Note 6 but a New Kind of Regulator (NKR) will ultimately take its place. The existence of NKR was confirmed by the 12 February Pensions Bill.

NKR's main aims will be to tackle the areas of fraud, bad governance and poor stewardship of schemes and will encourage best practice through an increased education and guidance role. NKR will inherit Opra's powers but will also have a range of new and increased powers which should help it to meet its aims. NKR will be able to do the following (that Opra could not):

- Issue 'improvement notices'. These will compel schemes (or third parties) to take specific action to remedy identified problems within given timescales.
- Freeze a scheme whilst it undertakes investigations which it feels may protect the scheme's assets or members' benefits.
- Increased powers to suspend and remove Trustees, combined with increased whistle blowing responsibilities.

NKR (hopefully with a better name) will be in place by April 2005, subject to the passage of the necessary legislation.

Improving Member Protection – Focus on Trustees

The Government has long been concerned about the ability and knowledge of Trustees to complete their duties to act in scheme members' best interests. As a result, there will be legislation to ensure that Trustees have the necessary knowledge over the full range of their responsibilities. The exact detail of this proposal is, as yet, unclear.

Improving Member Protection – Extending TUPE to Pensions

The Transfer of Undertaking (Protection of Employment) regulations (TUPE) protect employees when they change jobs, usually on a company sale or purchase. It is proposed that these regulations will be extended to Pensions.

The proposal is that, on a takeover, workers who already enjoy pension contributions will not have them withdrawn. This will be ensured by compelling the new employer to contribute to a stakeholder pension, matching employee contributions up to 6% of salary, if there are not other suitable pension arrangements in place.

Improving Member Protection – Protecting Early Leavers

Current legislation means that benefits in a UK pension scheme generally vest after two years' service. This means that members who leave with less than this service have accrued no scheme benefit and generally only receive a refund of their contributions.

The Government recognises that a highly liquid job market means that many employees do not remain with employers a sufficient length of time to accrue significant pension scheme rights. The Government therefore proposes that employees who have three months' service must have the choice of taking a Transfer Value. This will allow them to build up pension rights and benefit from the tax relief they have received. They will still have the option of a return of contributions as an alternative to this.

Improving Member Protection – Requirement to Consult

The Government has confirmed that it will require sponsors to consult with their employees before making significant changes to their pension scheme. The full detail of these proposals has yet to be seen although accrued rights will still be protected, as they are currently by Section 67 of the Pensions Act 1995.

Making Provision Easier – Scheme Specific Funding

Ever since the Chancellor announced that the MFR would be abolished in his 2001 budget, scheme specific funding requirements have been expected as the replacement. This is reconfirmed in the Government's proposals. The key elements of scheme specific funding will be as follows:

- Trustees will have to draw up a Statement of Funding Principles (SFP). This is likely to be analogous to (and probably more comprehensive than) the Statement of Investment Principles (SIP) that is already required for outlining investment strategy. This means that the SFP will give the basis of funding that the Trustees wish to employ; this could be to fund for transfer values, buyout costs or as most do currently, an 'ongoing' basis.

- Trustees will still be required to obtain a triennial valuation and put in place a schedule of contributions.

- Trustees will have increased powers. Where the Trustees and Sponsor cannot reach agreement on issues vital to scheme funding, Trustees will have a power of last resort to freeze or wind-up the scheme.

- The Scheme Actuary's duty of care towards scheme members will be clarified.

Making Provision Easier – Reduced Indexation

The Government has proposed that minimum mandatory increases on pensions in payment (accrued after A Day) will be reduced. The current requirement is that pensions must increase by the lesser of the increase in RPI and 5% over the year. The proposal is to make the minimum increase equal to the lesser of RPI and 2.5%.

This reduction reflects the reality of the current low inflation environment; current levels of inflation means that it is unlikely that the 5% cap will bite in the short to medium term.

This proposal is a compromise designed to reduce cost for sponsors whilst maintaining some form of inflation protection for scheme members.

Making Provision Easier – Section 67

Section 67 of the Pensions Act 1995 makes it difficult for Trustees to alter accrued benefits without member consent. This will be amended to allow changes if the following criteria are satisfied; scheme rules allow it, DB rights are not converted in to DC, Trustees approve the change, the actuarial value of benefits is maintained, pensions in payments are maintained and members are consulted.

This is a change that is likely to be welcomed by all parties. In particular, many Scheme Actuaries have seen conflicting legal advice over the provision of Section 67 certificates under the current regime and any attempt to simplify this would be helpful.

However, the key difficulty here may be 'maintaining actuarial value'. It is probable that this will be some sort of test of 'new benefits' versus 'old benefits' but it is not clear whether this will be broad brush (**on average** members are not worse off) or specific (**each individual** is not worse off). Furthermore, a prescribed actuarial basis has not been proposed – this could lead to bases being manipulated to demonstrate 'equivalence'.

Making Provision Easier – Other Issues

The other proposals under making provision easier are:

- Schemes will have to have one third of their Trustees as member nominated. It appears that the previous opt-out clauses will be removed.

- Schemes will no longer be required to provide AVC facilities for members. Most members will be able to use a stakeholder vehicle if an AVC option is not provided.

- GMPs will be simplified. In particular, there will be the ability to turn these into scheme benefits, if their actuarial value is not reduced. However, this may be held up or at least made more difficult by the unresolved issue of GMP equalisation.

Choice For All - Annual Benefit Statements

One of the Government's key aims is to educate the public about pension provision and their likely benefits on retirement.

Statutory Money Purchase Illustrations (SMPI) became compulsory in April 2003. This requires members of DC schemes to receive benefit statements showing their likely pension in **real terms** at their retirement dates. This is discussed in Section 7 below.

This proposal will require DB schemes to do something similar. Members will have to receive an annual benefit statement showing their accrued entitlement and their likely benefit at retirement. In general, larger schemes will already distribute this information but smaller schemes may not.

Additionally, there is also a proposal to issue State Pension forecasts to workers, whether or not they request them. This is intended to let employees see the 'bigger picture' in terms of their likely retirement benefits.

Further to this, the Government will seek to encourage sponsors to provide 'combined forecasts' including detail from the occupational and state pension forecasts. This will initially be voluntary but it has been indicated that if the take up rate is poor, then the Government may legislate to make this mandatory.

Finally, there is a proposal that the Government will embrace the internet era by developing a so called 'web based retirement planner'. This is intended to provide a similar service to combined pension forecasts.

Choice For All – Changing the Retirement Age

The Government is committed to reducing age discrimination and encouraging employees to maximise their retirement benefits by working until later in life. As a demonstration of this, the Normal Pension Age in public sector schemes is to be raised to 65 (from the existing age of 60). Without this measure, it will prove difficult for the Government to appear serious about these measures.

Summary

There is a vast amount of change proposed in this paper for scheme trustees, sponsors, members and their advisers.

It seems likely that members' accrued benefits will be protected in a more meaningful manner whether or not there is still a sponsoring employer in place. However, it also seems that additional burdens are being placed on sponsors of DB schemes, in terms of levies for the PPF and the need to fund full buyout costs on wind-up. It is certainly possible that this will encourage all but the most keen sponsors to switch to some form of DC provision and as highlighted, this will probably reduce the overall level of benefit provision. This would be contrary to one of the Government's main aims.

1.5) Simplifying the Taxation of Pensions

The Government published 'Simplifying the Taxation of Pensions: The Government's Proposals'[6] on 10 December 2003 to coincide with the Chancellor's Pre-Budget Report. This was their response to the consultation process that has occurred after their initial high-level announcement of an intended reform of pension scheme taxation.

The document also followed on from the 'Simplicity, Security and Choice: working and saving for retirement' and 'Action on Occupational Pensions' papers, published in December 2002 and June 2003 respectively. The aim of this document is to give a more detailed outline of how the proposed new taxation system would operate.

The legislative changes are proposed to be introduced in legislation in the 2004 Finance Bill and be effective from 6 April 2005 (known as A-day). The Chancellor will announce in the 2004 budget whether or not the measures outlined below will be brought into law.

The main points of the new simplified regime are proposed to be as outlined below:

Eight Tax Regimes to One

The eight current pension taxation regimes will be simplified into one all encompassing 'super-regime', regardless of the current way in which they encourage pension provision. This should reduce administrative, regulatory and compliance costs for members, schemes and the industry as a whole. It will also meet the Government's aim of increasing members' understanding of pensions.

The 'Limits'

The current occupational and personal pension legislation limits abuse of tax privileges by the use of benefit and contribution caps. These would be replaced by a single lifetime allowance of £1.4 million that could be treated as tax privileged savings.

When proposed, this allowance drew widespread criticism as being too low. It is the lump sum equivalent of about £70,000 pension. Pension commentators expect that many tens of thousands of existing and future workers will be caught by this limit. The Government contends that many fewer will be. Indeed, the whole regime change has been brought into question by the numbers of people that are purported to be disadvantaged by the new tax regime. The Chancellor has been challenged over his statement that about 5000 people will initially be caught (with an additional 1000 per year). He has appointed the National Audit Office (NAO) to investigate his claims. If they report that it is more than he has claimed, then the Chancellor has threatened that the regime change will not go ahead.

Additionally, the Government has proposed to increase the allowance in line with RPI, as opposed to National Average Earnings. It is likely that this will mean that increasing numbers of high earners will be caught by the limit, since their salaries are expected to increase at a rate greater than RPI.

This allowance will only be tested at retirement (primarily to reduce additional administration costs). Additionally, on the proposal of the Association of Consulting Actuaries, the Government has proposed that a standard factor of 20:1 should be used in the test for DB schemes. This means that every £1 of pension should count as £20 cash towards the £1.4 million limit (implicitly giving the £70,000 pension allowable).

The 20:1 factor gives an interesting anomaly though. A DB scheme could provide a £70,000 pension increasing at RPI with a 66.7% spouse's benefit. However, the cost to provide this on the open market would currently be about £2 million. Hence, the DC scheme's £1.4 million could only buy 70% (about £50,000) pension on this basis. It remains to be seen if sponsoring employers favour DB schemes to maximise tax efficiency post A day.

Since the test is only applied at retirement, the Government recognises that individuals may accrue benefits (either consciously or unconsciously) in excess of this allowance. They have proposed a recovery charge to ensure that there is no abuse of the tax privileges. This will be set at 25%, equating roughly to the benefits of tax relief and tax free investment growth. Additionally, tax will be payable at 40% on funds above the limit, so the total tax rate will be 55% (= 100%- (60% x 75%)) on excess funds. The taxed amounts (that is above the £1.4M) may be taken either as pension or as a lump sum.

Furthermore, there would be an annual allowance of £200,000 for increases to defined benefits and for contributions in any given tax year. This limit will also be indexed annually with RPI. Tax relief would be offered in the greater of £3,600 or 100% of annual salary up to £200,000.

There would be a limit of 25% of the capital value of pension that could be taken as tax-free cash and this would apply equally to DB and DC schemes. This would remove the complex limits that exist for occupational schemes currently and bring them broadly in line with current personal pension regime.

This would mean that scheme members in the 87 and 89 tax regimes could see their maximum tax free cash increase from £150,000 (1.5 times salary, say) to £350,000 (25% of £1.4M). There is obviously a significant tax benefit here but it is unclear, given current poor terms for commutation offered by many Trustees, whether or not taking this increase would be in members' best interests.

Unapproved Pension Schemes (FURBS and UURBS) will be exempted from the recovery charge but, as the Government sees no place for these in the future of pension provision, they will no longer attract any tax advantages.

The Retirement Age

The Government reiterated its proposals to raise the minimum retirement age to 55 by 2010. However, there are three main exceptions to this. These are:

- Members with an existing right to retire at 50 will broadly retain this right.

- Professions with exceptional retirement ages (for example, sportsmen and women) will retain an early retirement right. However, their maximum lifetime allowance will be reduced by 2.5% for each year below 55 they retire (so, the limit would currently be £700,000 at age 35).

- Early Retirement through incapacity before age 55 will still be allowable.

Scheme Benefits

The rules for taking scheme benefits at retirement have remained broadly unchanged, However, the Government intends to introduce the concept of Alternatively Secured Income (ASI). This is an alternative method of providing benefits in retirement, principally for religious groups that object to the pooling of mortality risk.

ASI is a type of income drawdown arrangement but with a lower maximum limit on an annual benefits taken. It crucially, will allow some drawdown payments after age 75, the age at which an annuity currently has to be purchased.

The Government intends that this should be an inferior choice for the majority of pension scheme members (that is those who do not object to the mortality risk pool). This will be inferior because the maximum amount that can be drawn down will reduce dramatically at age 75 and there will be no lump sum available on death.

Furthermore, the Government will remove rules on concurrency; individuals will be able to join any number and type of pension schemes that they wish.

Finally, the Government has proposed that funds resulting from Pension Sharing on Divorce should not count towards the lifetime allowance of a member. This will ensure that an individual's allowance is not dramatically reduced by one or more divorces.

Transitional Issues

The Government has recognised that the proposals it has made may materially affect high earners. It intends putting in place mechanisms to protect these members; these are 'Primary Protection' and 'Enhanced Protection'.

Primary protection is available only for members who have funds greater that £1.4 million at A day. They can register the full value of their fund and this tax privileged amount will be indexed in line with the increase in RPI. This method still allows the member to contribute but it means that any investment performance in excess of RPI will be hit by the recovery charge.

Enhanced protection can only be invoked for members who cease active membership of their scheme before A day. In this case, all the member's funds are protected from the recovery charge. This does not allow future contributions but does exempt the member from any recovery charge on investment returns in excess of RPI.

In addition, protection can be given to members with pre A day accrued tax free cash in excess of the maximum £350,000 allowed.

Summary

The Government is seeking to simplify the issues surrounding occupational provision by removing a significant proportion of the current legislation and replacing it with a less onerous regime. The extent to which this is successful and encourages greater and simpler pension provision remains to be seen.

1.6) Statutory Money Purchase Illustrations (SMPI)

The Government introduced the SMPI legislation in 2002. This meant from 6 April 2003, pension schemes that provide any sort of DC benefits must give members a forecast of the benefits they will expect to receive in **real terms.**

Previously, projections only had to show the monetary value of the accumulated contributions and the pension that this was likely to buy at retirement. This was thought to be a little misleading because it allowed for inflation in the projection of assets and relied implicitly on those receiving the statements to allow for the reduction in purchasing power over the period to retirement. Of course, few members did (or could). SMPI addresses this anomaly.

- These requirements only apply to schemes with financial years that ended on or after 6 April 2003. This means that a scheme that has a year end date after 6 April 2003 does not have to provide SMPIs until 12 months after the end of its next scheme year after 6 April 2003.

- The regulations apply to: DC schemes, DB schemes with DC sections, occupational schemes with AVCs on a DC basis, occupational schemes that provide for transfers in on a DC basis, personal pension schemes and FSAVC schemes.

- The following schemes are exempt: Section 32 policies, Section 226 policies, unapproved schemes and schemes with fewer than two members.

- Additionally, hybrid schemes where the money purchase underpin is not expected to bite are not covered. Actuarial advice is required on whether or not this is the case.

- Trustees (or Managers) do not need to provide an SMPI projection for certain classes of members. These are broadly; where a member has retired, a member is within two years of retirement and where a member has a paid up fund of less than £5,000.

The Institute and Faculty produced a Technical Memorandum (TM1) setting out the method and basis for producing these calculations. The basis is intended to be reviewed at least annually, so the projected figures reflect current market conditions.

The assumptions in TM1 are outlined on a single, deterministic, basis. However, the Government is keen that the inherent investment risks in money purchase benefits are recognised. It is therefore permissible to show benefits on more that one basis or to offer some sort of stochastic projection tools to communicate these risks.

The prescribed basis used is broadly as follows:

- Price and salary inflation of 2.5%, in line with Treasury Targets.

- Investment Returns of 7.0% (less an allowance for contract expenses).

- Terms for conversion from cash to pension are based on index-linked gilt yields.

- Mortality is based on PMA(92) and PFA(92) suitably adjusted for a member's age. This recognises that longevity is increasing and is expected to continue to do so. In effect, this means that a 60 year old retiring in 2004 has a lower expectation of life than a 60 year old retiring in 2024.

The projections also require a raft of disclosures (for example, retirement age, allowance for future contributions) and a caveat that the projections are only one view of the future and the member should take financial advice before acting on the projections.

1.7) Opra

Opra Note 1

As indicated above, Opra will be replaced by NKR. However, under its current powers it has updated Opra Note 1 (ON1)[7]. ON1 offers advice to Scheme Actuaries (and Auditors) on reporting 'breaches' to Opra.

In essence, Scheme Actuaries have a duty to report to Opra (under Section 48 of the Pensions Act 1995), if they have cause to believe that proper administration of the scheme or any form of pension scheme law is not being adhered to and that this would be of material significance to Opra.

In practice, this has meant that Actuaries have reported nearly all breaches of law, even those that were trivial. This resulted in an onerous workload for Opra that did not increase member benefit security or quality of scheme administration levels.

ON1 now gives guidance that the level of material significance has increased and that breaches of law can be subdivided in to three classes: green, red and amber.

- Green Breaches are those that are likely to have little serious impact on a scheme. For example, late payment of member's contributions over a short period. Therefore these breaches would generally not be reported.

- Red Breaches are those of a serious nature, perhaps involving a fraudulent action or poor Trusteeship of a scheme. These breaches would be expected to be reported.

- Amber Breaches are those that are not so clear cut and where the Actuary must exercise his or her professional judgement whether to report. It is likely that Amber is a temporary state and after collection of the necessary information, an Amber breach will either become Green or Red.

Scheme Actuaries generally tend to be fairly cautious in their approach to reporting to Opra. It is likely that, at least initially, the majority of amber breaches will be reported, that is they will be deemed to be Red. This may change over the longer term, which is certainly Opra's intention.

Opra Update 3

Opra has switched some of its attentions to schemes in wind-up and is particularly keen to see such schemes wound-up in a timely and efficient manner. In order to provide some additional guidance to Trustees and Actuaries, it released 'Opra Update 3 – winding up'[8].

The main ideas contained in this document were the following:

- Trustees and the Scheme Actuary are encouraged to contact the Opra wind-up team to discuss the requirements relating to their scheme.

- Opra will not normally require continued preparation of MFR valuations for schemes in wind-up, although they will reserve the right to do so. This is because in wind-up, a Section 75 (of the Pensions Act 1995) debt is the mechanism to correct this underfunding, as opposed to the required Schedule of Contributions for an open scheme.

- Opra reminded Trustees about their duty to best look after members' interests when setting the 'applicable time'. The applicable time being the effective date, advised by the Trustees, at which the Scheme Actuary must calculate the shortfall in scheme assets payable by the employer. In general, Trustees should aim to maximise this debt (to maximise members' benefits) whilst bearing in mind the continued interests of scheme members with that employer.

- Opra also confirmed that they would generally not penalise Trustees who did not issue transfer values within normal deadlines, whilst the scheme was winding up, as long as they were working towards resolving the outstanding issues in the wind up. This reflects that there is sometimes large uncertainty as to the level of scheme funding during wind-up and hence the amount of transfer values that can be afforded.

Additionally, Opra commented on the issue of the equalisation of GMPs and the concerns that Trustees may have over this. The issue is broadly that male members of occupational schemes, contracted-out on a salary related basis, do not receive their contracted-out benefits until age 65. Female members receive their benefits at 60 and accrued GMP at a higher rate. This has been judged as unfair and that benefits should be equalised, however this decision is far from either clear cut or finalised.

Opra stated that Trustees should take a pragmatic scheme based approach to this issue and gave a list of possible ways to equalise these benefits (or not to equalise them). The chosen method is intended to be relevant to the scheme's funding level and materiality of the changes to benefits that is would make. Opra's main concern is that members' benefits should be secure and that significant legal and other costs should not be incurred trying to sort out this issue.

1.8) Defined Benefit Transfer Values

Transfer Values from DB arrangements again came under scrutiny this year and prompted some new legislation from the Government.

The principles for calculation of DB transfer values are laid down in GN11 but the actual basis employed is left to the judgement of the Scheme Actuary. The fundamental idea is that the transfer value should represent the actuarial value of the accrued benefits, that is, the expected cost within the scheme of providing the benefits[9]. Many Scheme Actuaries previously accepted the prescribed Minimum Funding Requirement (MFR) basis as suitably fulfilling this requirement.

However, in September 2002, the Chairman of the Pensions Board, Ronnie Bowie, wrote to all Scheme Actuaries. His letter made clear that the Pensions Board's view was, that to use the MFR as a basis for cash equivalents was 'close to untenable'. This was taken to be a clear signal from the profession that it considered MFR transfer values were too low, that is they did not represent the 'actuarial value of accrued benefits'.

As a result, Scheme Actuaries who still employed the MFR as a basis for calculation of cash equivalents began moving their basis to one that produced higher transfer values.

However, this created a problem for Trustees whose schemes were not sufficiently funded to meet transfer values for all members. The legislation current at the time, broadly allowed Trustees to reduce transfer values in proportion to MFR solvency; this was adequate to preserve funding, if the transfer value basis was the same as the MFR basis. However, with transfer values in excess of MFR, this meant that Trustees permitting transfers out would reduce benefit security for the remaining members. At this point, the Department of Work and Pensions (DWP) was consulting on new legislation that would circumvent this issue.

As a result of this, Opra published 'Update 1'[10] in February 2003. This reassured Trustees that Opra would not penalise them, if they did not issue transfer value statements, where among other steps, they were acting on the advice of the Scheme Actuary. This relaxation is application of legislation was intended to apply until the DWP legislation was finalised.

New Transfer Value legislation[11] came into force on 4 August 2003. This legislation allowed Trustees to seek a 'GN11 Report' from the Scheme Actuary, this report gives a funding level on the scheme's Transfer Value basis. Trustees may now reduce transfer values in line with the funding level disclosed (but individual transfers are still subject to the MFR minimum). This means that Trustees can generally pay transfer values without prejudicing the security of the remaining members' benefits. Opra then published 'Update 2'[12] which removed the relaxation describe above.

The proposed winding-up and PPF legislation that will mean that employers have to fund the full buyout of members' benefits may mean that Trustees may not feel a compulsion to reduce transfer values, even if underfunded on the transfer value basis. This could be the case, where there existed a strong employer covenant and the likelihood the remaining members being disadvantaged was small.

1.9) The Pensions Credit and Political Rhetoric

The Pensions Credit

The Pensions Credit was introduced on 6 October 2003 and it replaced the Minimum Income Guarantee (MIG) and Income Support. It is a new form of means testing designed to increase the income of the pensioners on lowest benefits, particularly those who have some savings.

One of its aims is to reduce the 'poverty trap' whereby pensioners with modest savings and income find their state benefits reduced by the amount that they have saved. The Government is, of course, keen to remove this disincentive to save.

The Pensions Credit has two components. These are the Guarantee Credit and the Savings Credit.

The Guarantee Credit is very similar to the MIG and is paid at the same rate. This 'guarantees' that everyone over aged 60 will have an income of at least £102.10 (if single) or £155.80 (with a partner). However, the guarantee is not absolute, as explained below.

The Savings Credit is an extra amount, payable from age 65 for those who have made some additional retirement provision. It offers up to an additional £14.79 if single and £19.20 for couples.

The Government claims that the calculations and conditions applying to this benefit are relatively simple for pensioners. However, it takes 112 pages to explain it to 'professional advisers'[13], so this seems unlikely to be the case.

The Government has claimed this a success, the pensions minister stated in October than 1.9 million pensioners were receiving the Credit. However, this belies the fact that 1.65 million of these were automatically transferred from the MIG. This was calculated as less than 39% of those eligible had applied, significantly lower than the Government's publicly stated expectations.

As with any means tested benefit, there are some problems with its implementation. These are as follows:

- It is claimed to be unfair on women. The calculations assume that all pensioners receive the full Basic State Pension (BSP). However, for females with incomplete National Insurance contribution histories, this will not be the case. Many female pensioners will not receive additional income.

- The Credit assumes a savings to income conversion rate of 10% - effectively proposing a risk free 10% interest rate is available – a risk free rate of about 3%-4% would be more realistic. This interest rate has the effect of inflating incomes for pensioners with some modest level of savings.

- The ‘guarantee’ referred to above does not apply. For example, a pensioner with full basic state pension and £38,000 in savings (accruing interest at a reasonable 3% per annum) will have a weekly income of less than £100, as opposed to the £102.10 guaranteed.

In conclusion, the Pensions Credit is a rebranded form of means testing and it is widely perceived to be a step in the right direction for the poorest pensioners. However, the usual issues with means testing seem that it is likely that it will not improve the incomes of a significant number of these pensioners.

Political Rhetoric

The Conservatives released ‘A Fair Deal for Everyone on Pensions’[14] (written by Stephen Yeo FIA). This paper is their vision of how to solve the problems associated with State provision of pension benefits.

The policy idea in the document is to restore the link to earnings for increases in the BSP (as opposed to the current link with prices). This is not without a touch of irony, given it was a Conservative Government that that initially broke this link.

This policy has two proposed advantages:

- Firstly, the Conservatives’ claim that this will increase the incomes of pensioners. This seems to be likely as the expectation is that earnings will continue to grow at a rate in excess of prices.

- Secondly, it will reduce the number of pensioners subject to means testing. This is because the Pensions Credit is linked to prices, not earnings. This, in turn, should ensure that pensioners have greater incomes and the administrative burden to maintain means testing is reduced.

The Government, of course, disputes the Conservatives’ claims and in his pre-budget report of 10 December, Gordon Brown, dismisses their idea. He claims that ‘to revert to the pre-1980 position – an earnings link with pensions, would….raise [public sector borrowing] deficits by 3 per cent a year just to cover this one item with the long term sustainability of public finances undermined. Instead this Government will proceed on a prudent and sustainable basis.”

The future of state provision is unclear. However, both parties seem to have a stated aim of targeting resources at the poorest pensioners. Their method and costs of implementing this aim do, however, differ.

1.10) Discrimination in Pension Schemes

European Union directives have already and will in the future, introduce new legislation limiting discrimination. This has particular interest to pension schemes in the following areas.

Age Discrimination

It is intended that the UK parliament will enact legislation by October 2006 to outlaw age discrimination. The main impact on pension schemes is that mandatory retirement ages will become unlawful. However, minimum entry ages and a normal retirement age (which obviously, by definition, cannot trigger enforced retirement) will remain.

Sexual Orientation Discrimination

New legislation effective from 1 December 2003 made direct or indirect discrimination on the grounds of sexual orientation unlawful. The main implications of this [15] for pension schemes are:

- Where a scheme provides benefits to unmarried partners of the opposite gender, then they must do so for partners of the same gender.

- It is still perceived to be lawful to discriminate on the grounds of whether or not a member is married. However, this is currently under challenge in the courts.

Disability Discrimination

From 1 October 2004, it will be unlawful to discriminate against disability. This will apply to pension scheme benefits accrued after this date. The main impact on pension schemes is that employers will not be able to refuse entry to a pension scheme or associated benefits (for example group life cover) purely because of disability. This will not, however, guarantee the terms under which any insurance contracts will be available and primarily, the issues of discrimination may pass from the employer or trustees to the insurer.

Religious Discrimination

Legislation on religious discrimination enacted on 2 December 2003 is perceived to have two impacts on pension schemes.

Firstly, schemes which refuse to pay benefits on polygamous marriages may be acting unlawfully. This is not believed to have a significant impact in the UK.

Secondly, Islam does not allow the concept of ‘interest’ in financial affairs. This may lead to a pension scheme investment policy or fund choices open to challenge of indirect discrimination if it precludes membership. This is a grey area, however Trustees may wish to investigate acceptable funds to mitigate this issue.

1.11) Case Studies

EdF – A New Final Salary Scheme!

‘The first new final salary scheme in living memory’[16] was announced in November 2003. EdF is a French state owned electricity company and has committed to launch this scheme for its British subsidiary in 2004.

It will provide benefits for employees, some of whom have existing DB accrual, some of whom have DC accrual and some of whom have no existing pension arrangements. The aim of this scheme is to provide benefits on a similar level to the their French colleagues, who enjoy considerably better benefits than UK employees.

The Chief Executive was quoted as saying “we decided that we should look at a bigger picture than mid to short term issues. Pensions are a long term investment and we are determined to make a long term commitment to our employees.”

This demonstrates that sponsors do still consider that DB schemes are viable in the current economic climate. However, the fact that a new DB scheme merits newspaper column inches demonstrates that this is a rare occurrence and probably will not be repeated many times in the coming year.

Maersk and Sealand – A Victory for Opra or a Victory for the Members?

The case of the Sealand pension scheme has been generally regarded as one of the main drivers behind the Government's new legislation on scheme wind-ups where there is a solvent employer in place. It has generated a lot of press coverage about the sponsors' treatment of members.

About 18 months ago, the UK subsidiary of the Danish shipping company AP Moller Maersk decided to wind up its pension scheme. In doing this, it chose to fund its scheme to the minimum legal requirement. This meant bringing the scheme up to 100% funded on the MFR basis, as outlined in GN19 and the deficiency regulations. In doing this, the sponsor did nothing wrong in the eyes of the law. However, the weakness of the MFR basis meant that some members would have only received about 40% of their accrued benefit (as calculated on a buyout basis).

This led to significant level of protests from members who had had their benefits reduced. This then led to a complaint to Opra who used their powers to appoint a Trustee to this scheme.

This final outcome of this case, was that Maersk decided to buyout members' benefits in full, thus providing benefits well in excess of their legal requirements. It is unclear whether or not this was a result of Opra getting involved but in all probability it had more to do with protecting the company's brand and reducing the negative press publicity that it was receiving.

In the future, the new legislation will not make it possible for employers to 'walk away from their pension commitments' as Maersk originally intended to do. As outlined above, solvent employers are now required to fund benefits in full on a buyout basis.

Allied Steel & Wire (ASW) and Blyth & Blyth (B&B)

ASW and Blyth and Blyth are another two examples of DB pension schemes that have not provided scheme members with their expected scheme benefits.

ASW went into receivership in 2002 and a large number of workers were made redundant, this being bad enough in itself. Most of these workers, however, believed that their accrued pension rights were safe because they were members of the company's DB scheme. However, this was not the case. The company had not been funding the scheme to buyout members' benefits on wind-up.

Similarly to the original situation under the Maersk case, members seem likely to receive a small proportion of their accrued pensions. However, in this case there is no solvent employer to relent and release assets to fund the scheme. This is the type of situation that the Government is seeking to avoid by putting in place the PPF. However, this will not be a solution for these members because the PPF will not be in place until 2005 and the Government has refused to act as a guarantor of last resort in this case.

This case is not yet complete. Trade Unions are suing the Government on the basis that it has failed to properly implement an EU directive protecting members' pensions. If this action were to be successful, then it would likely lead to many similar actions against the Government.

B&B was taken over in a management buyout and the new employer did not take over any responsibility for the existing pension arrangements, a situation that is likely to become ever more common under the new rules for buyout solvency on wind-up. The Independent Trustee in this case is quoted as saying:

"This, as far as I am aware, is the first case that has such a large hole and whereby the actual members are likely to get nothing."

He is referring to deferred members; it is likely that current pensioners will receive most, if not all of their benefits (including escalation). This is an example of the effect of the existing priority order and one of the reasons that the Government is seeking a more equitable distribution of scheme assets on wind-up.

Credit Suisse First Boston (CSFB)

From leaving DB, employers are increasingly looking for innovative ways to provide for pension benefits. CSFB is going to use an American type model to do this, which will replace a number of its existing DB schemes. The features of this scheme (called 'DC Plus') will be:

- A DC base with age related contribution levels, these range from minimum employer contribution of 7.5% for employees below 40 to 12.5% for those over 50.
- An additional employer 'bonus' contribution would also be made.
- This bonus would be based on CSFB's return on equity (ROE). For every percentage point that the ROE was above 11%, an additional 0.5% pension contribution would be made (to a maximum of 7%).
- So, for example, if CSFB obtained ROE equal to 25%, then a 55 year old would enjoy a 19.5% employer contribution in that year.

This is the first such scheme in the UK. However, as scheme sponsors seek to tie their cost base to profitability and cashflow, it seems likely that such profit sharing designs will become more widespread.

1.12) Guidance Note Changes

The following changes have been made to the actuarial Guidance Notes (GNs) relevant to Pensions over the year. All GNs that were amended also had a reference to the Professional Conduct Standards added.

GN3 - Retirement Benefit Schemes – Contracting Out Certificates for Schemes Where Wind Up Commenced Before 6 April 1997

Version 3.4 came into effect on 13 January 2003. The changes made in GN3 reflected the following:

- The DWP and Inland Revenue confirmed that there is no longer a requirement:

  - To renew any Certificate T when one expires.

  - To monitor the validity of a Certificate T in force.

  - For new contracted-out scheme, with a final salary element ,to submit a Certificate T after completion of its first MFR and Schedule of Contributions.

GN4 - Insolvency of Employers – Safeguard on Occupational Pension Scheme Contributions.

Version 2.4 came into effect on 15 December 2003. The changes were mainly cosmetic and the meaning and use of the GN was not really altered.

GN9 – Retirement Benefit Scheme – Actuarial Reports

Exposure Draft 51 (EXD51) has been released for consultation. This document will form the basis of Version 7.0 of GN9. The main proposals in EXD51 are as follows:

- The application of GN9 has been clarified.

- The funding objectives borne in mind when completing the report and additionally the party that set the objectives, must be stated.

- The actuary must describe or illustrate how valuation results will differ if the assumptions are not borne out.

- The report must confirm the compatibility of asset and liability valuations (as opposed to just commenting on it).

- The 'Discontinuance' section has been retitled as 'Solvency'. This now broadly requires an estimate of the proportion of liabilities that could have been secured on a deferred and immediate annuity basis at the valuation date. It will no longer be acceptable to base the liabilities for deferred members on transfer values.

- There will no longer be any requirement to state an ongoing funding level.

- The actuary will be required to set out and certify, a pattern of contributions that is expected to meet the liabilities of the scheme over the long-term based on the assumptions used.

GN11 – Retirement Benefit Scheme – Transfer Values

Version 9.0 of GN11 was issued as both a Fast Track GN and an exposure draft. It came into effect on 4 August 2003. It was updated to offer guidance to Scheme Actuaries on the new Transfer Value legislation as outlined in Section 9 above.

The changes reflect that the Trustees of a Salary Related scheme may request a report from the Scheme Actuary on the funding level of the scheme on a transfer value basis. The note outlines the following points:

- In broad terms, the report will compare the sum of the full transfer values, in respect of members not yet in receipt of pension, with the scheme's assets.

- That the first charge on the scheme assets should be the expenses of wind-up (normally the MFR expenses) and liabilities in respect of other members (for example PAYGO pensioners).

- That the liabilities of the scheme should be sub-divided into elements receiving different priorities on wind-up.

- The actuary will provide a report to the Scheme Trustees or Managers on the level of reduction that may be applied to different priority classes.

- The valuation can be completed on approximate values of assets and liabilities.

- That, where cash equivalents are reduced, a new report must be completed at the next formal actuarial valuation.

Additionally, it was made clear that the GN applies to calculations of the recoveries of the proceeds of crime from pension schemes.

Further to this, Version 9.1 was published in January 2004 with an implementation date of 1 March 2004. This revision contains the following amendments:

- That in completion of a GN11 report, an insurance policy may be treated as having a higher value than its market value, if this is appropriate.

- There are a few other minor changes that do not significantly alter the meaning or substance of the guidance.

GN27 – Minimum Funding Requirement

Version 2.1 of GN27 came into effect on 13 January 2003. This implemented a number of minor changes. These were changes recommended by the profession to the Government to clarify certain aspects of the calculations.

Firstly, Annual Certification; the Pensions Act dictates that to ensure that the MFR is being met between triennial valuations, Trustees must obtain actuarial certification to this effect. This does not apply if the scheme met the MFR conditions at the most recent effective date **and** seven days before the initial certification of the Schedule of Contributions (called the calculation date in GN27).

The GN now refers to the **estimated** position at the calculation date, indicating that the Scheme Actuary need not make additional detailed calculations at this point.

Additionally, the detail regarding the Gilt Matching policy for certification of the contribution schedule has been clarified. Originally, the gilt matching policy had to be applied to all scheme members before the gilt-matching basis for calculation of a contribution schedule could be used. This was not appropriate for schemes that had declared a gilt matching policy for pensioners and deferred members but not for actives. GN27 has been updated to allow for the case where there are no active members. This reflects the original intention that was to apply equally to schemes where there were former active members who retained a salary link in relation to past service or where they were entitled to deferred pensions.

GN28 – Retirement Benefit Schemes – Adequacy of Benefits for Contracting Out

Version 1.3 of GN28 was published in January 2004 with an effective date of 1 March 2004. The Guidance Note has been updated to reflect that the Inland Revenue and DWP have:

- Confirmed that there is no longer a requirement to submit fresh Reference Scheme Test Certificates every three years, although Scheme Actuaries must continue to supervise the scheme's ability to meet the tests of equivalence.

- Clarified the requirements in relation to widows' and widowers' benefits. It is made clear that the spouse's pension has to be paid to any legal surviving spouse (with some small exceptions in Contracting Out Regulation 26).

GN29 – Actuaries Advising the Trustees or a Participating Employer

Version 5.0 of GN29 came into force on 1 March 2003. GN29 outlines the responsibilities of actuaries who are appointed to give advice to the Trustees or Employer of an occupational pension scheme.

This Guidance Note has been updated to reflect the following changes:

- A requirement for an outgoing Scheme Actuary to advise the Trustees of the legislative requirements relating to the timescales for appointment of a replacement Scheme Actuary and the need to provide a copy of the resignation statement to both the Scheme Auditor and incoming Scheme Actuary. There has been no legislative change in this respect but this aims to remind Trustees of their legal duties in this respect.

- A requirement for an outgoing Scheme Actuary to advise the Trustees of any statutory deadlines that fall within four months after the date of removal or resignation.

- References to contracting out certificates (Supplementary Certificate A and Certificate C) have been removed, in line with the updates to legislation reflected in GN3.

GN34 – Illustration of Defined Contribution Pension Scheme Benefits

Version 1.1 of GN34 came into force on 13 January 2003. This clarified the following:

- Illustrations in accordance with Technical Memorandum 1 (outlining the principles for Statutory Money Purchase Illustrations) are not covered by GN34. However, the actuary should make clear the limitations of the advice presented in accordance with GN34.

- There have also been some cosmetic changes to ensure that this Guidance Note is in line with the others.

EXD52 – Compliance Review - Pensions

EXD52 was published on 11 February 2004 and it will become a new GN in due course.

The main purpose of EXD52 is to ensure that advice given by Scheme Actuaries under practice standard GNs is subject to a process of review by their peers. The main drivers behind the draft are as follows:

- The profession wishes to reinforce existing good practice.

- The profession wishes to maintain and strengthen confidence in actuarial advice.

- The profession believes that having work reviewed contributes to achieving a high quality of advice.

There will be two possible types of review that a Scheme Actuary may be subject to. These are:

- Audit Review, in which a random sample of actuarial advice that has been given in the period since the previous audit review is scrutinised. This aims to pick up systematic errors and some one-off errors.

- Peer review. This is the review of advice before a client has seen the advice (or possibly before the client has had time to act on the advice).

Scheme Actuaries will have to confirm that they have been subject to at least one of the review types when they apply for or renew their Scheme Actuary certificate.

The new GN will only be Recommended Practice initially to give time for the new review process to settle down. It is intended that it will become Practice Standard at some point in the future. A likely date is in 2006.

1.13) References

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[12] Opra Update 2 – www.Opra.gov.uk/pdf/up2.pdf
[13] www.pensions.gov.uk/pdf/pctechsept03.pdf
[14] www.conservatives.com/getfile.cfm?file=Pensions-full-Oct2003&ref=POLICYDOCUMENT/1664&type=pdf
[15] Tolley’s Guide to Anti-Discrimination legislation and Pensions – John W Wilson
[16] Financial Times – 12 November 2003

2) Life

Regulatory Issues

2.1) CP 195 – Capital Requirements For Life Insurers

The FSA stepped up its deforestation program in August 2003 with the publication of Consultation Paper 195, all 329 pages of it.

It has long been recognised that the FSA's existing rules do not adequately reflect the risks to which insurers are exposed, particularly in respect of options and guarantees. CP195 develops themes previously introduced in CP97 and CP136 relating to realistic reserving and capital requirements. The FSA proposes to introduce the new rules in late 2004 as part of its implementation of the integrated Prudential Sourcebook. It heralds a major shift from the current rather artificial regime to a more market consistent basis, and will have a significant impact on life offices.

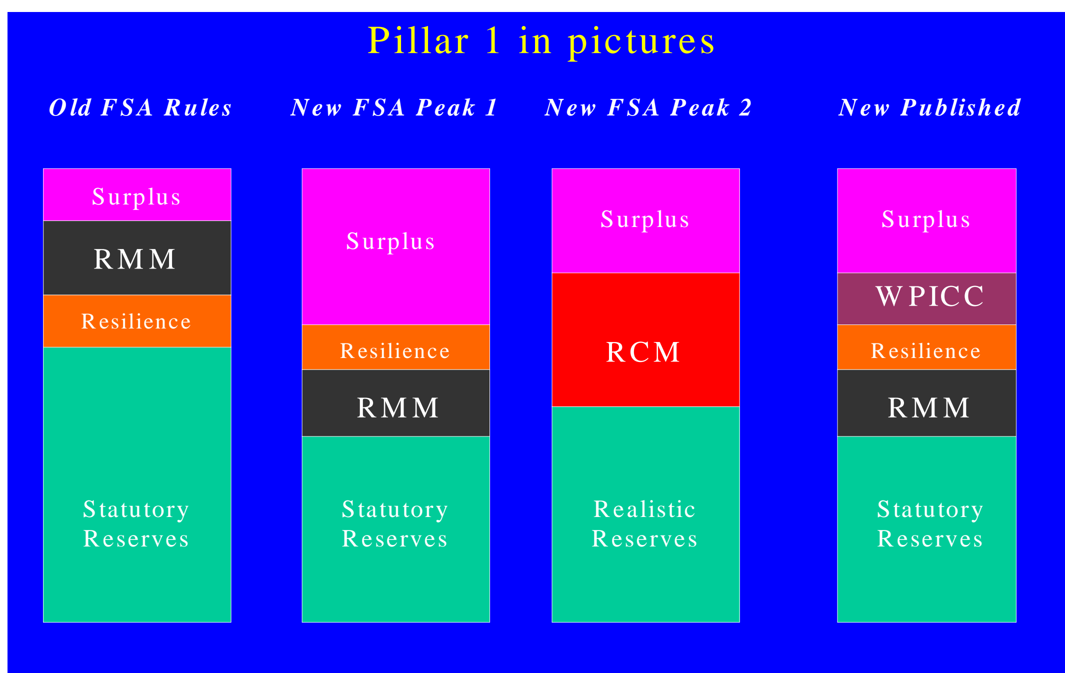
Indeed its impact has already been seen in the recent changes announced by Standard Life. In part because of the likely impact of the new realistic reporting regime, Standard has initiated a strategic review of its mutual status. It has also greatly reduced its exposure to equities (selling £7.5bn in early 2004), introduced explicit charges for the cost of guarantees and announced intentions to raise additional debt capital.

CP195 develops the "Three Pillar" approach used in banking supervision, reflecting the FSA's desire for a more consistent regulatory approach across different types of financial institution. Pillar 1 is an adaptation and extension of the current public reporting in the FSA Returns. Pillar 2 relates to private interaction between the office and the FSA with a view to agreeing the true level of capital required to cover all risks. Pillar 3 is more vague in concept, and refers to the pressure on offices, through the effects of disclosure and competition, to aspire to best practice.

Pillar 1 - The 'Twin Peaks' Approach

Somewhat confusingly Pillar 1 has two peaks (as distinct from Pillar 2 which has only one). The Pillar 1 "Twin Peaks" approach applies to the with profits funds of firms which have at least £500m of with profits liabilities. In short, the office must measure its surplus in two different ways and then report the lower of the two results.

Peak 1, the Statutory Peak, is largely similar to the existing reserving regime, where liabilities are generally calculated on a deterministic basis which contains implicit margins for prudence. There are some changes compared to the current system – in particular there is a relaxation of some of the more artificial requirements (eg allowance can now be made for lapses, a gross premium method can replace net premium). A further technical change is that the capital required to withstand a shock under the resilience test is now classified as capital rather than as part of the reserves. This removes any need to hold a solvency margin on the resilience capital itself. As a result of these changes, Peak 1 reserves should be lower than under the old system.



In Peak 2, the Realistic Peak, liabilities are to be calculated on a market consistent basis. This is often described as the economic cost of hedging an office's exposure (for example through the purchase of appropriate derivatives). Allowance is also to be made for terminal bonus. One way of expressing the Peak 2 realistic reserve is asset share + market consistent cost of guarantees. Offices are generally using stochastic simulation techniques to assess the cost of guarantees.

Risk Capital Margin (RCM)

The RCM in Peak 2 is similar in concept to the resilience capital under Peak 1. It represents the additional capital required to withstand a shock. If the liabilities were perfectly hedged the RCM would in theory be zero, so in a sense it represents a mismatch reserve.

The Peak 1 stress tests cover market risk only. The Peak 2 tests cover market, credit and persistency risks.

The credit test as currently drafted is peculiar. For all bonds within a particular credit rating class (AAA, AA etc), the credit spread must be increased to a specified level, with a resultant fall in the bonds' market value. This creates an incentive for offices to move to lower quality bonds **within** a credit class, to minimise the effect of the shock. The shocks are also not necessarily comparable in severity between different credit classes. It is believed that the shocks may disadvantage offices holding higher quality bond portfolios, and thus encourage a move down the credit spectrum. Presumably neither of these effects is what the FSA desires. The FSA appears to recognise that the current tests may have shortcomings, as they are working with actuarial consultants to calibrate the tests, so we may find they are revised in due course.

With Profits Insurance Capital Component (WPICC)

The WPICC knits the twin peaks together. The office is required to measure its surplus capital under each of the peaks, and to then report the lower of the two surpluses. If the Peak 2 surplus is lower than the Peak 1 surplus, then the office must hold a capital requirement equal to the difference (see picture above). This capital requirement is known as the WPICC.

Treatment of Non Profit Business in Pillar 1

It's important to note that the Twin Peaks only apply to with profits funds. Perhaps oddly, there is no requirement to measure a market consistent value for non profit/unit linked liabilities outside the with profit fund. Exposures under NP/UL are to be picked up under Pillar 2.

This can lead to anomalies. One (presumably unintended) consequence of the treatment of non profit business in CP195 is that differences in corporate structure can have a profound effect on the results. Where NP business resides within a WP fund, the office can take credit for the expected value of future profits on such business (perhaps by recording its embedded value as an asset on the balance sheet). However where the NP business sits outside the WP fund, no credit can be taken for future profits. Several offices have a single long term fund which is operationally split into a mutual-style WP fund and a shareholder owned NP fund – such offices are at a disadvantage, even though legally there may only be one long term fund for solvency purposes. The twin peaks approach is relatively complex, and it will take time for it to be understood and accepted. Arbitrary differences such as the treatment of future profits on NP business are unfortunate as they undermine the credibility of the new regime.

Comparability of results between offices will be difficult, due to the variety of business mixes, corporate structures, stochastic models, calibrations, management decision rules etc.

Pillar 2 - Internal Capital Assessment

Pillar 2 is much wider in scope than Pillar 1. Whereas Pillar 1 is focused primarily on with-profits business, Pillar 2 covers the entire risk exposure of the life office. Pillar 2 reporting is confidential between the FSA and the office. The FSA has given very little detailed guidance on how to calculate Pillar 2 capital. This is deliberate. The onus is on the office to assess its own risk exposures and to come up with a suitable level of capital (the Internal Capital Assessment, or ICA). The FSA will assess whether this is adequate, and then supply the office with Internal Capital Guidance (ICG), the FSA's opinion of the required level of capital. In practice the ICG is likely to equal or exceed the ICA. While the ICG is not legally binding, if the office disagrees with the FSA's assessment the FSA has various powers under the Financial Services and Markets Act to exert pressure.

Pillar 2 will require the office to assess capital requirements for all types of business and all risks. Even for with profits business the office will need to consider risks not explicitly examined in Pillar 1 such as changes in the volatility of equities or interest rates. Quantification of operational risk will pose a challenge. Comparability between offices is an even bigger issue here as there are several valid methodologies, and no guidance on what to use.

Regulatory Arbitrage

Under the current regime there's a temptation for offices to seek regulatory arbitrages ie take actions which reduce regulatory capital requirements even if the actions are detrimental in economic terms. Pillar 2 is intended to capture "the truth" and so should make such arbitrage plays obsolete. However the temptation will still exist as long as Pillar 1 results are made public while Pillar 2 submissions are private. For example, some investment banks are advocating changes to asset allocations which would improve the Pillar 1 result, but the impact on Pillar 2 is less clear.

Implementation Timetable

The first formal publication of Pillar 1 results will take place in the end 2004 FSA Returns. However, those offices which applied for a relaxation of some of the valuation regulations (a solvency waiver) during 2003 were required to publish a slightly modified version of the Pillar 1 numbers as supplementary information within their end 2003 FSA Returns.

The timescale for Pillar 2 is still unclear. It appears likely that the larger offices will be asked for Pillar 2 assessments towards the end of 2004. The issuance of Individual Capital Guidance and resulting dialogue between the FSA and the office is then likely to take a considerable time, as the FSA gets to grip with the various methodologies across the industry.

Overall CP195 is to be welcomed as a significant step towards more meaningful financial reporting. Concerns remain over some of the detail, and how valid comparisons between offices can be achieved.

2.2) CP 207 – Treating Customers Fairly

There has been a largely hostile response from the industry and the profession to this controversial CP issued in December 2003.

The FSA clearly has reservations concerning the exercise of discretion in the management of with profits business. This CP represents an attempt to improve the disclosure of the way in which discretion is exercised, and in some instances to limit that discretion.

There is much to welcome in CP207:

- Elaboration of the principle of treating customers fairly
- Greater transparency
- Guidance that with profits fund assets should not normally be used to finance other business activities
- Restrictions on the types of charges that can be applied to asset shares

However some of the proposed measures would appear to alter the nature of the contractual relationship between policyholder and office. Some commentators have questioned the legality of the FSA's approach as it effectively imposes revisions to existing contractual terms.

Constraining Discretion

It's hardly surprising that the FSA is suspicious of the discretionary powers available under with profits. However discretion is a fundamental feature of with profits business and indeed is key to its successful operation.

There are serious concerns about some of the proposals which threaten to reduce the office's discretion, and as a side effect may increase capital requirements. The FSA is putting the concept of asset share on a pedestal, whereas in practice it's only a broad guide to help establish payouts. The FSA proposes 2 major restrictions on an office's discretion to set with profits payouts:

a) Payouts must be within a specified target range around unsmoothed asset share.

b) Payouts must vary by no more than a certain percentage from year to year.

These are mutually contradictory. The first reduces smoothing (by tying payouts more closely to unsmoothed asset share) while the second increases smoothing (by limiting the change in payouts from year to year). It's not clear which takes precedence when the inevitable conflict arises. It won't always be possible to satisfy both conditions.

The second condition is particularly onerous, if an office does not already apply such a rule. Placing a floor under payouts effectively creates a guarantee and would mean higher capital requirements.

There is a further proposal in section 4.12 of the paper that in order to achieve neutrality of smoothing over the long term, payouts should be at least 100% of unsmoothed asset share. This is another onerous condition, although it is permitted to depart from this over the short term, or if the fund's financial condition is weak.

The proposals are rules rather than merely guidance, but in section 4.14 the FSA say (somewhat confusingly) that they are to be regarded as objectives rather than obligations. So the rules seek to limit discretion but offices have some discretion over how to apply the rules...

Measures Specifically Affecting 90:10 Funds

a) There are restrictions on proprietary 90:10 funds in terms of distributions to policyholders and shareholders unless the costs of the distributions can be met from surplus.

b) The split of surplus 90% to policyholder, 10% to shareholder has traditionally been calculated using the valuation basis. The FSA is concerned that the conservatism inherent in this basis results in the shareholder effectively receiving more than one tenth of the surplus on a realistic basis. CP 207 thus proposes that the split of surplus should be calculated in a more realistic way, so that 90:10 means 90:10 not 88:12, say. While this might seem reasonable, it does seek to alter the nature of the existing relationship between policyholder and shareholder.

Other Possible Consequences of the Proposals

- Pressure to sell equities as offices try to reduce payout volatility - thus leading to likely lower long term returns for policyholders.

- The proposals are due to come into effect from 31 March 2005, and will probably be significant enough to necessitate revisions to the PPFM.

- Extra reserves could result from the proposal that market value reductions should only apply following a significant market fall or a high volume of surrenders.

- For funds in runoff, a plan must be submitted to the FSA describing how the estate will be distributed.

Other Issues Covered in CP207

- Proposals for the reattribution of inherited estates.

- Proposals for the consumer friendly version of the PPFM and for discontinuing the requirement to produce With Profits Guides.

- Proposals that seek to impose controls on management in respect of the volumes and terms of new business that can be written in a with profits fund. The FSA's concern here is that new business does not adversely affect the interests of existing policyholders.

- Feedback on Discussion Paper 20 *Issues for with profits business arising from the Sandler Review.* The FSA appears to have rejected the option of imposing the Sandler model as the future of with profits. They feel that the concerns raised by Sandler are largely addressed by the CP207 proposals.

- Proposals for the charging of tax to with profits funds.

Conclusion

Given the imminent publication by each office of its detailed PPFM as well as a consumer friendly version later in 2004, it is unfortunate that the FSA is raising the ante still further in CP 207. One might have thought that an existing contractual relationship freely entered into by both parties, together with a (perhaps long overdue) explanation in the PPFM of the how the office will manage this relationship is sufficient. The proposals in CP207 could be the death knell for with profits unless radically altered.

The FSA may be amenable to change on some of the proposals; a constructive approach from the industry and profession is more likely to bear fruit than a purely negative response.

2.3) Tiner Waivers

In response to substantial falls in equity markets during the first quarter of 2003, FSA indicated that it would be prepared to relax certain of its solvency rules if companies could demonstrate that they had greater surplus on a realistic basis than under existing solvency rules.

A number of companies successfully applied for waivers of the solvency rules on this basis, on the understanding that the waivers would expire on 30 June 2003 and companies would need to reapply at this time. Companies who applied for such waivers during 2003 are required to publish details of their realistic solvency positions within their 2003 FSA Returns.

FSA's rationale behind the waivers was that the Prudential Sourcebook due to be implemented in 2004 would require companies to maintain solvency levels reflecting the more stringent of a realistic result and a statutory result, with the statutory result reflecting existing FSA rules, amended in certain areas where they are currently too stringent. In essence, the waivers merely attempted to accelerate Prudential Sourcebook implementation.

There has been much commentary recently on the stringent nature of the new FSA rules, which is in stark contrast to the positive statements made by FSA early in 2003 about the solvency impact of the new regime. Indeed, it now looks as if many waivers granted early in 2003 may have been given incorrectly. In particular:

- Without exception, all companies have had to develop (and will still be developing) substantial stochastic modelling capabilities in order to calculate realistic liabilities for Prudential Sourcebook implementation. Early in 2003 the stochastic capabilities of many offices were limited and, consequently, their assessment of realistic liabilities may not have been robust.

- FSA may have underestimated the amount of risk based capital required (the 'risk capital margin'); their thinking on appropriate stress tests has moved on greatly in the last year. Additionally, there was no formal recognition of the risk capital margin in realistic balance sheets 1 year ago.

It will be interesting to compare statutory and realistic solvency results as at 31 December 2004 when all companies will be required to publish results on both bases and stochastic techniques have become fully embedded. In particular, does the significant excess of realistic solvency above statutory solvency across the industry really exist, as indicated by FSA early in 2003?

2.4) With Profits Governance and the Role of Actuaries

In June 2003, FSA published its Policy Statement 167 (PS167) on With Profits Governance and the Role of Actuaries in Life Insurers. The key requirements of PS167 are as follows:

- All firms writing with profits business are required to implement and make public their Principles & Practices of Financial Management (PPFM) with effect from 31 March 2004. Publication of the PPFM has recently been deferred by FSA until 30 April 2004.

- Associated with the PPFM are some substantial changes to the roles of actuaries, in particular the role of the Appointed Actuary, which is to disappear later in 2004. Two new roles have been created, the Actuarial Function Holder and the With Profits Actuary, which broadly cover the old responsibilities of the Appointed Actuary between them.

- PS167 confirmed that subsequent proposals would follow (confirmed in CP202 on Regulatory Reporting) requiring the actuary advising the auditors (the Reviewing Actuary) to provide a named sign-off of the adequacy of a firm's mathematical reserves.

Principles & Practices of Financial Management (PPFM)

The firm's Board must approve the PPFM, with the principles expected to be 'enduring statements of the firm's overarching standards'. The Principles are not expected to change often but changes to the Practices are likely to be made more frequently.

Any changes to the Principles require written notice to be given to policyholders 3 months in advance of the change; changes to the Practices must similarly be notified in writing to policyholders, but this can be up to 12 months after the actual date of change (eg through annual statements). Policyholders need to be made aware through their annual statements that the PPFM is available on request.

The broad rationale underpinning the PPFM is to demonstrate the framework within which discretion will be exercised in the management of with profits business.

The firm must produce an annual report for its with profits policyholders stating whether it believes the obligations relating to the PPFM have been complied with and setting out the firm's reasons for that belief. This report must be made available within 6 months of its financial year-end.

The firm's With Profits Actuary is also required to produce a report for the with profits policyholders, confirming whether in his/her opinion discretion has been properly exercised in the context of the PPFM framework. This report must be annexed to the firm's annual report.

An independent judgement on compliance with the PPFM must also be given. There are a number of possibilities here, which include :

- An independent With Profits Committee (this may or may not be a committee of the firm's Board).
- Asking an independent person with appropriate skills and experience to produce a report.
- For small firms in particular, asking a non-executive member (or members) of the firm's Board to provide an independent opinion.

The independent With Profits Committee is likely to be the most common route taken by sizeable firms.

The PPFM must detail the firm's principles and practices in the following areas :

- Determining payouts to policyholders
- Annual bonus policy
- Final bonus and market value reduction policy
- Smoothing policy
- Investment strategy
- Business risk
- Charges & expenses
- Management of the inherited estate
- Closure to new business
- Equity between policyholders & shareholders

In constructing their PPFMs, firms need to be sure that the resulting framework has no adverse capital implications in the context of Prudential Sourcebook implementation later in 2004. For example, the management actions open to a firm in stressed investment scenarios and/or the decision rules relating to asset rebalancing can have a significant impact on the level of capital that needs to be held. If the PPFM were to restrict the actions available to firms, there could be adverse capital implications within the Prudential Sourcebook rules. This obvious disconnect between PPFM implementation (30 April 2004) and Prudential Sourcebook implementation (later in 2004) is not helpful.

Matters are exacerbated by CP207, which is covered elsewhere in this paper. As it currently stands, CP207 could well require a fundamental PPFM rewrite in 2005. Some people believe that much of the content of CP207 is clearly flawed and that FSA does not seem to have appreciated the practical implications of the proposals (eg administrative & cost issues for firms, credibility issues for the industry in general in changing PPFMs so soon after implementation, potential legal challenges).

The level of detail of the PPFM is such that it should enable a 'knowledgeable observer to understand the material risks & rewards' of the with profits business of the firm. While this is an admirable aim, there is no doubt that firms see the main audience for the PPFM as the FSA, with a key focus being on the capital implications of the content of the PPFM. Given the detailed rules & guidance from FSA on what should be contained within the PPFM, it is hard to escape this conclusion.

It is more than likely that PPFMs, once in the public domain, are perceived as being too detailed by industry commentators. Indeed, the document will almost certainly be far too technical for the average policyholder. FSA seems to have recognised this within CP207, where they propose that a 'user friendly' version of the PPFM should be made public with effect from 30 November 2004. This is one of the less controversial sections of CP207.

A question to ponder is why FSA has decided not to address the issue of discretion in business other than with profits (eg annual management charge levels on unit linked business), the financial impact of which could be highly significant to policyholders. Post-Equitable Life, they clearly see with profits as a special case that merits special attention and are highly sensitive to any potential adverse with profits publicity in future.

The Future Role of Actuaries

PS167 confirms that the role of the Appointed Actuary is to disappear with effect from the point of implementation of the Prudential Sourcebook, which is expected to be around 1 October 2004. Two new roles are created : the Actuarial Function Holder and the With Profits Actuary.

The role of the Actuarial Function Holder is to advise the firm's Board on the day to day financial condition of the fund and the risks being run. In particular, he/she has responsibility for the calculation of the mathematical reserves, including with profits reserves. The Actuarial Function Holder may not be the chairman or chief executive of the firm.

The role of the With Profits Actuary is to advise the firm's Board on the use of discretion in respect of with profits business within the framework of the PPFM. The With Profits Actuary may not be a director of the firm although he/she must have direct access to the Board.

Both the Actuarial Function Holder and With Profits Actuary will be designated FSA controlled functions. In theory, the same person can occupy both roles, but this may be constrained by the fact that the With Profits Actuary cannot be a director. The FSA would clearly like different individuals to occupy the two roles.

It will be imperative that close liaison is maintained between the Actuarial Function Holder and With Profits Actuary. The potential for conflict exists, but such a liaison should help ensure that it does not arise.

The actuary advising the auditors (the Reviewing Actuary) will be required to formally sign off on the adequacy of the mathematical reserves derived by the Actuarial Function Holder (as opposed to the Appointed Actuary under the existing regulatory regime). This is a substantial change as, at present, the auditors rely on the Appointed Actuary's certificate within their audit statement and could significantly increase the scope (and cost) of the audit.

Perhaps the most significant potential conflict is likely to arise between the Actuarial Function Holder (who is an employee of the firm) and the Reviewing Actuary (who is not). In the litigious world that has arisen post-Equitable Life, any actuary who is providing a named sign-off of adequacy of reserves will undoubtedly require a substantial amount of work to be carried out. This may be fraught with difficulties for someone who is external to the firm; in particular, what may be viewed as straightforward by the Actuarial Function Holder or indeed the old Appointed Actuary, both of whom will have an intimate knowledge of the firm's workings, may be viewed quite differently by the Reviewing Actuary.

The ultimate question is whether or not the new structure represents an improvement on the Appointed Actuary regime. The creation of separate Actuarial Function Holder and With Profits Actuary roles in conjunction with an independent review on PPFM compliance will make the fair treatment of with profits policyholders more visible, but this is unlikely to result in a different position from that under the old regime with a strong Appointed Actuary at the helm. It is also difficult to see how an external Reviewing Actuary is better positioned to comment on the adequacy of mathematical reserves than an internal Appointed Actuary, particularly for large firms. Interestingly, many other countries, particularly within the European Union, are embracing the Appointed Actuary regime at the same time as the UK is abandoning it.

It should be noted that ultimate responsibility for the financial position of the firm, including compliance with the PPFM, rests with the firm's Board

Whistle Blowing

The Financial Services and Markets Act 2000 (Communications by Actuaries) Regulations 2003 came into force on 1 September 2003, reinforced by a new actuarial professional guidance note GN37. The regulations require the Appointed Actuary (and, in due course, the Actuarial Function Holder and With Profits Actuary) to communicate certain specified matters relating to his/her firm to FSA.

Examples of specified matters referred to in 1.4.1 are as follows:

- Where there is a significant risk that the assets of the long-term insurance fund are, or may become, insufficient to meet the liabilities of the fund.

- Where there is a significant risk that the firm did not, or might not, take into account the interests of policyholders in a fair and reasonable manner.

It should be noted that those with whistle blowing obligations are required to report matters even if they have been rectified and even if the firm has already reported them to FSA.

Those with whistle blowing obligations are not required to seek out matters to report beyond the exercise of his/her normal duties. However, any notification to FSA will normally require to be copied to the firm's auditors.

The regulations reinforce the responsibilities of the Actuarial Function Holder and With Profits Actuary in the new regulatory environment. It is clearly important that Boards of Directors are fully aware of the obligations placed on the two new positions.

Peer Review

The Corley Report into the role of the actuarial profession in the Equitable Life saga recommended that peer review should be introduced. This is currently being driven forward by the profession's Life Board, with mandatory peer review likely to coincide with the implementation of the Prudential Sourcebook later in 2004. The Actuarial Function Holder and With Profits Actuary would both be subject to peer review.

One train of thought is that the world has changed since the Corley Report was published, which was before FSA announced their changes to the Appointed Actuary regime. In particular, the role of the With Profits Actuary is essentially seen as a reviewing role by FSA and some could see peer review as inappropriate.

Associated with the likely requirements for peer review will almost certainly be the requirement for an extension of the practising certificate regime in the life sector beyond the current certificate required by an Appointed Actuary. This could in fact extend beyond the Actuarial Function Holder and With Profits Actuary, with all practising life actuaries requiring a practising certificate. Further details on this topic should emerge later in 2004.

Penrose Report: Review of the Actuarial Profession by Sir Derek Morris

The Penrose Report into Equitable Life was published on 8 March 2004. As a result of this, the Government has announced a review of the actuarial profession to be conducted by Sir Derek Morris. The review is to begin on 1 May, when Sir Derek completes his term of office as Chairman of the Competition Commission. The Government has asked Sir Derek to deliver his final report with recommendations by Spring 2005. The terms of reference of the Morris Review, as set out in the government's announcement, are reproduced below.

The Morris Review will be taking place in a profession where there is already recognition of the need to change. The Councils of the Faculty and the Institute have jointly been conducting reviews as a result of events at Equitable Life. In his report on Equitable Life, Lord Penrose acknowledges some of the steps we have already taken and says that the Profession "should be encouraged in this task."

Some weeks before the publication of Penrose, the profession wrote to all members outlining further changes that had been decided to be made in the way actuaries operate: from the way standards are set and practising certificates issued through to reviewing professional advice and disciplinary action.

Another recommendation made by Lord Penrose is for the Profession "to accept responsibility for direct intervention where it was thought that the administration of life funds was likely to threaten the legitimate interest of policyholders." Lord Penrose invites ministers "to offer encouragement and support for initiatives the profession might take in this direction."

This proposal is both interesting and completely new. Currently, the Profession has no legal power to intervene in the operation of life offices and does not seek such powers. The Profession does not regulate the life industry; that is the job of the FSA. The profession has powers only in relation to individual members. It is reasonable to suppose that a suggestion as specific as this will be considered by Sir Derek Morris as part of his review.

Terms of Reference of the Morris Review

"Consider what professional and/or other regulatory framework would best promote recognised, high-quality and continuously developing actuarial standards, openness in the application of actuarial skills, transparency in the professional conduct of actuaries, accountability for their actions and an open and competitive market for actuarial advice in the UK.

In doing so:

- Take into account developments in the actuarial profession, in regulation, and in the financial services market, in the UK and abroad;
- Examine the role of actuaries in the financial services sector, including in providing actuarial opinions in relation to audited accounts;
- Build on the work of recent government and regulatory initiatives;
- Examine the relationship between the Government Actuary's Department and the actuarial profession and with other parts of government.

Recommend a framework that will be independent in representing the public and consumer interest, and be accountable, flexible, transparent, and no more burdensome or restrictive than is clearly justified.

Make recommendations on the future role of the Government Actuary, the functions of his Department and its future institutional status."

Sarbanes-Oxley

A significant piece of US legislation (the Sarbanes-Oxley Act) became law in July 2002 that has implications for UK insurers who are part of insurance groups with US listings. The Act is essentially a response by the US to the Enron and Worldcom scandals.

The Act provides new standards for accountability and penalties for corporate wrongdoing and requires key certifications to be made in the financial reports of appropriate UK companies by the Chief Executive and Finance Director. The certifications include significant detail on the controls and procedures in place within the company.

The impact of the Act for appropriate UK companies is that they have had to substantially re-evaluate their internal systems & controls. This represents a significant additional layer of corporate governance for affected companies.

2.5) Implementation of EU Solvency I Directives

In September 2003, FSA published Policy Statement 181 covering the implementation of the EU Solvency I Directives with effect from 1 January 2004. The key points to note are as follows :

a) Changes to the calculation of the EU Required Minimum Margin (RMM) for Class IV long-term insurance business, in addition to the 4% of mathematical reserves requirement. The changes are akin to a General Insurance RMM calculation and could generate significant RMM increases.

b) Changes to the calculation of the RMM for unit-linked Classes III, VII & VIII that offer no guarantees. Prior to 1 January 2004, the RMM was zero for such business but must now reflect 25% of "net administrative expenses". In arriving at "net administrative expenses", FSA has encouraged companies to use definitions consistent with Schedule 9A of the Companies Act and the ABI SORP.

c) Companies need to recalculate their RMMs at their most recent financial year-end (31 December 2003 in most cases) under the new requirements. If this generates a significantly different result to that previously calculated, an updated Form 60 must be submitted to FSA within 4 months of the financial year-end (30 April 2004 in most cases).

d) With effect from 1 January 2004, a future profits implicit item may only cover 2/3 of the RMM as opposed to 5/6 of the RMM previously. From March 2007, the maximum coverage will fall further to 25% of the lower of a firm's RMM and total (eligible) capital resources. Notwithstanding this overriding cap, a reduction in the number of years of future profits that may be counted is also to be made from March 2007. From March 2009, firms will no longer be able to count implicit items towards their RMMs.

2.6) Sandler Review Update

In 2002 Ron Sandler presented his paper reviewing the long term savings industry on behalf of the Government. Sandler made various recommendations including; a simplified suite of products with a charge cap and streamlined sales process, a new model for with profit funds, and more stringent investment qualifications for financial advisors.

On 15 July 2003, the Government issued its response to the consultation on Sandler 'stakeholder' products. Simultaneously, the Financial Services Authority published its Feedback Statement on DP 19 covering the options for regulating the sale of 'simplified investment products'. These documents provide some more detail on where we are heading, but leave many significant issues for later consultation. The implementation date for the new products has been moved back till April 2005, which is likely to coincide with the changes to pensions taxation and the introduction of the Child Trust Fund.

The Sandler 'Stakeholder' Product Specifications

The Treasury/Department for Work and Pensions response confirms a number of details of the Sandler suite of products which it refers to as 'a new suite of simple, investment-restricted, low cost, investment products to be sold via a simplified sales process'.

It restates the Government's aims of driving competition in the retail financial services industry and of increasing access to financial services for those on lower incomes. While the target group continues to be lower income consumers, the Government is relaxed about those on higher incomes purchasing such products.

Price Caps

The Government remains committed to having a price cap on these products, and restates its 'high threshold for persuasion' for moving away from a flat 1% charge. However, it has deferred a decision on any change in the level or shape of price cap until the year end, by which time the FSA will have finalised the design of the sales process. It plans to publish the findings of the independent research it commissioned into price caps and it appears that further research will be undertaken into consumer demand for such products.

The Products

The suite will consist of 4 products; a short-term cash deposit, a medium term savings vehicle, a pension and the child trust fund. These will all come under the 'stakeholder' brand and the Government is considering developing a logo or symbol. Guaranteed products, term assurance, annuities and generic financial health checks have all been ruled out, although the FSA is pursuing the generic health check concept separately.

Short Term Cash Deposit

This replaces CAT-mark cash ISAs. This will provide a non-equity option for those considering investing in a stakeholder product. This immediately means that the lighter touch sales process will have to help consumers choose between equity and non-equity investments.

Medium Term Savings Vehicle

This will replace CAT-mark equity and insurance ISAs. Both collective investment and life funds will be permitted and the Treasury will consult on how to bring both within the current ISA regime on a consistent basis. A prescribed form of with-profits (or smoothed fund) will also be permitted (see later).

There will be restrictions on the investment holdings within the product (whether smoothed or not). The investment strategy must be designed to be meet the needs of a relatively cautious investor aiming to invest for 5 to 10 years. There will be a maximum combined equity/property content of 60% with additional 'principles based' diversification requirements across asset classes, markets, sectors and securities. NB this rule will exclude index tracker funds from the stakeholder suite.

With Profits

The medium term savings vehicle may use a form of with-profits as its underlying fund. This will be referred to as a 'smoothed investment fund'. (While the paper is not explicit on this point, we assume the pension product can also use a smoothed investment fund.) The smoother investment fund must meet a number of conditions:

- It must follow a 100:0 structure, i.e. with all 'profits' owned by the policyholders.
- Shareholder will receive their return from an explicit management charge which must be within the price cap.

- Smoothed unit prices must be published on a daily basis.

- Smoothing will be funded from a separate account within the policyholders' funds. The provider must aim for the account to be neutral over time.

- There will be enhanced disclosure to policyholders in yearly statements.

- When a policy is surrendered, providers will be required to disclose the unsmoothed asset share, which the policyholder will then be able to compare with the amount they received (ie the smoothed amount adjusted where applicable by any Market Value Adjuster). This could to lead to a sharp increase in complaints and could lead to policyholder selection.

- The fund will not be allowed to invest in a company owned by the provider. This rules out the with-profits policyholders funding 'connected company' acquisitions such as banks or IFAs.

The Pension

Stakeholder pensions as we currently know them will be brought into the suite, subject to some modifications. In particular, the default fund will, in future, have to adopt a life styling approach allowing for the anticipated retirement date of the policyholder. Unlike the medium term savings plan, there will be no restriction on the equity content.

Where a stakeholder pension is bought through lighter touch advice, the consumer must invest in the default fund. However, the stakeholder scheme can continue to offer a wider range of funds, available to those who purchase or subsequently switch after full advice or on an execution only basis.

The Child Trust Fund

This is a new initiative under which children will receive payments of £250 (+ extra £250 for those receiving Children's Tax Credit) into their account from the Government at birth with a top up at age 7. Additional payments of up to £1200 p.a. can be made into these accounts by the child, parents or others. The child will be able to access the account at age 18. All income and gains on this will be exempt from personal tax.

Sales Regulation – FSA Feedback Statement

This document is largely a summary of responses received by the FSA to Discussion Paper 19 and a progress report on what the FSA plans to do next. There were three options for the simplified sales regulation discussed in DP 19:

- Self-help and warnings (Option 1)

- Guided self-help and warnings (Option 2)

- Focussed advice (Option 3)

Option 1 gained little support and appears to have been ruled out. Both of the other options gained support from different parts of the market, but the FSA continues to favour Option 2 and is now to undertake consumer testing of how guided self-help through a set of filtered questions might work in practice.

Significantly, the FSA has also repeated that it remains unconvinced of the need for an 'RU64' approach to the new stakeholder suite. This hopefully means advisers offering full advice in future will not be faced with demonstrating why a non-stakeholder suite product is better than one within the suite before recommending it. This should limit the contagion of charging structures from Sandler products to non Sandler products. This was a major problem for Stakeholder contracts, whereby the 1% AMC charging structure filtered through to the whole pension market.

2.7) Point of Sale Disclosure and Transparency

There was significant interest in point of sale disclosure and transparency of products in 2003. The most notable instance came when the FSA fined Lloyds TSB over the mis-selling of high income bonds. This cost the bank around £100M in fines and compensation payouts. The issue here was not that the products were flawed, but that the risks were not adequately explained to the policyholders.

The FSA has responded by issuing Consultation Paper 188 (CP188). This paper relates to the information that a prospective customer must be given at the point of sale for any products offering income, capital growth, or capital security. CP188 states that its Fact Sheet: 'High Income Products – Make sure you understand the risks' should be included in any direct offer promotions, and that policyholders in these products should receive periodic statements.

In addition, CP188 states that financial promotions should include a fair and adequate description of the nature of the investment, the commitment required and the risks involved. This should include a proper explanation of counter party risk and should also include information showing the likelihood of loss.

2.8) Mortgage Endowments

In April 2000 the industry started mailing policyholders about the projected values of their mortgage endowment policies indicating whether the policies were likely to be sufficient to repay the mortgage. As investment markets started to decline in September 2000 the proportion of policies on target to repay mortgages also started to decline.

Endowment mortgage policies increasingly came under bleak media exposure due to the high volume of policies with significant projected shortfalls. This consequently generated a lot of alleged mis-selling complaints. Complaints were also generated by the Consumers Association encouraging people to complain about their mortgage endowment policy.

The industry is about to commence the third phase of mailings to policyholders. CP158 sets out changes to the time limits for making complaints. This means that for many policyholders who received bad news in the first or second phase this third letter will limit the amount of time they have left to complain about the sale of their policy.

There is some uncertainty as to how the media and the consumer association will react to complainants running out of time. The time remaining for many policyholders however is already counting down.

International Accounting Standards (IAS)

2.9) International Accounting Standards

The International Accounting Standards Board (IASB) published Exposure Draft 5 (ED5) on 31 July 2003 covering Phase I of its project to develop an international accounting standard for insurance contracts. Comments were required by 31 October 2003 and feedback from the IASB is now awaited. The key points arising from ED5 are as follows:

Definition of Insurance Contracts

In a new addition to the implementation guidance, the Board suggests that a pure endowment is 'not an insurance contract unless there is a significant probability that the holder will not survive'. One consequence of this interpretation is that some temporary annuities might not classify as insurance.

In general, it is unclear how negative survival risk should be treated. ED5 classifies as insurance those contracts where the death benefit is higher than the benefit available on surrender or maturity, but does not address the reverse situation where the death benefits are lower. This affects certain contracts where death benefits can be freely chosen to be lower than surrender values.

Embedded Derivatives

The unbundling requirement will be mostly limited to guaranteed surrender values on equity-backed non-traditional (unit-linked) contracts. The fair valuation of these options to auditable standards will require a significant amount of work for companies.

Disclosure

The qualitative and quantitative information requested, in particular on risk exposure and risk management, will be a significant problem for data collection procedures and systems. There is an onerous new requirement: the disclosure of aggregate projected cash flows in a number of future time brackets, a sensitivity analysis on these amounts (sensitivity to surrender assumptions) and the average effective interest implicit in the liability measurement.

The fair value of all insurance liabilities will not have to be disclosed until 2006, but there are a number of fair value disclosures that will be required in 2005. For example, IAS 39 requires the disclosure of fair values of investment contracts, and the implementation guidance suggests that the disclosure on material exposures to guaranteed annuity options and guaranteed minimum death benefits may also take the form of fair values.

Unbundling

The lack of concrete guidance on unbundling of deposit elements means that it is still unclear what proportion of unit-linked contracts is affected.

Loss Recognition

ED 5 requires companies to perform a loss recognition test conforming to IAS 37 on insurance liabilities and associated deferred acquisition costs and intangible assets, unless an insurer's current accounting policies already require such a test.

The loss testing is likely to be relevant in territories where reserving is based on a prescriptive set of parameters which are 'locked-in' or based on the policies' original pricing bases, or where non-unit reserves on unit-linked contracts are not mandatory.

Reinsurance

ED5 aims to limit an insurer's ability to create book profits by entering into a financial reinsurance contract that does not substantially transfer any risk, although the proposed approach seems harsh for basic financial reinsurance.

Unallocated Surplus

In those jurisdictions with book value accounting, the introduction of ED5 results in an allocated surplus from the re-measurement of assets at market value while with-profit liabilities (which have a claim on this surplus) continue to be measured at local GAAP. ED5 leaves companies free to classify this amount as either equity or liability, or a combination of these two.

For companies currently applying US GAAP, or a combination of IAS and US GAAP, the issue will already have been addressed. Others will face a number of choices. A definite way of avoiding volatility in equity is to view all unallocated surplus as a constructive obligation and so to classify it as a liability (albeit not allocated to individual policyholders). An alternative is to remove the present value of future shareholders' margins included in the surplus.

Thought needs to be given to the effect on policyholders' reasonable expectations of any classification, and the mechanism of releasing this surplus into the profit & loss account. Other considerations include the possibility of an unallocated 'loss' if market yields move above the average yields at issue of the bond portfolio.

In January 2003, the IASB reached the following initial conclusions regarding Phase II of its IAS project :

- The general approach should be one of ‘fair values’ rather than deferral and matching.

- Assumptions used for setting provisions can be entity specific when market-based information is not available without cost and effort.

- The interpretation of ‘fair value’ should be to an ‘entry’ rather than an ‘exit’ value.

- Provisions must be subject to discounting.

- Except where policyholder liabilities are directly dependent on investment returns from a defined asset pool, discounting should be at a ‘risk-free’ rate rather than a rate that has regard to the backing assets.

- Fair value should incorporate ‘market value margins’.

- Future premiums should only be recognised if policyholders hold uncancellable continuation or renewal rights and those rights will lapse if policyholders stop paying premiums.

- Fair values should reflect the credit standing of the insurance company.

It should be noted that insurers will be required to disclose fair values of assets and liabilities from 31 December 2006.

Profitability & Pricing Issues

2.10) Insurers' Profits

Insurers profits have taken a battering over the last few years, with most insurers reporting losses in 2002. The two most significant reasons for these losses are:

- Sustained stock market falls.
- The 1% Stakeholder charge cap and its impact on other products.

Stock Market Falls

The stock market fell for 3 straight years from 2000 to 2002, resulting in substantially reduced income from fund related charges (which make up the bulk of an insurer's charges). As most of an insurer's expenses are non fund related, eg premium related commission and per policy administration expenses, this means that reported profits will be reduced. In addition, many insurers will have had to reassess their assumptions for future investment growth, which will have a negative impact on present value of future profits.

Another by product of falling stock markets is reduced investor confidence, leading to lower new business volumes and therefore less coverage of fixed expenses. Unfortunately, lower new business volumes from new policyholders also means that salesmen and intermediaries have to look elsewhere to generate income. For this they may turn to existing business.

This could mean rewriting of existing business in order to generate more upfront commission (ie the market is paying upfront commission more than once for the same piece of business). This rewriting has been made easier to justify due to the '1% world' (see below), and means that the average term in force for a life insurance or pension product has reduced. This will have a direct impact on profits.

The 1% Charge Cap

In 2001 the government introduced the new Stakeholder Pension, whereby the only type of charge that the insurer could take from the policyholder is an Annual Management Charge (AMC). The AMC is defined as a percentage of the fund value and the maximum AMC is set at 1%.

In theory this charge cap is confined to the stakeholder pension market. However, Regulatory Update 64 states that when an IFA sets up a non stakeholder pension contract they must justify why they did not advise their client to take out a Stakeholder pension.

This is known as 'reasons why not stakeholder' and makes it very difficult for an IFA to justify advising on a product that has anything other than a 1% AMC. For this reason there has been mass contagion of the 1% charge cap into the non stakeholder pension market, so that most pensions sold in the current market have a 1% AMC and no other charges. In addition, there has been pressure on insurers to reduce charges on existing contracts down to 1% AMC, even although much higher commission was paid out on these existing contracts.

This charge cap has two distinct problems:

a) The shape of charges

b) The level of charges

Shape of Charges

The theory of product development is that the incidence of charges and expenses should be as closely matched as possible. An insurer's expenses are predominantly weighted upfront, as the selling process is a significant expense outgoing (both sales and marketing costs, and IFA commission). However, the effect of the single fund related charge is to skew the insurer's income to the back end of a policy, particularly for a regular premium contract where it takes a number of years before the fund has built up to a significant level.

This means that it is more and more important that the policyholder continues to pay premiums for as long as possible (allowing the insurer to earn enough money to pay back the upfront costs). In fact the average payback period on regular premium pension contracts is now well in excess of 10 years.

As mentioned, retention of business (or persistency) becomes more crucial, but paradoxically the new shape makes business less 'sticky', as it is easier for an IFA or salesman to justify moving business from one insurer to another. This is because there is no impact on the policyholder's charges (either through upfront charges when it arrives at the new insurer, or by surrender or exit charges when it leaves the old insurer).

Insurers now must concentrate on retention of business, meaning that they must ensure that there is no reason that a policyholder would want to change company. This means ensuring investment performance and service levels are constantly maintained. This risk of policy rewrites has been compounded by the falls in stock markets (as explained above), and is also compounded by the level of the charges (see below).

This problem would be substantially reduced if less upfront commissions were paid (ie an IFA is either remunerated via a fee paid by the policyholder, which is both tax inefficient and is unattractive to the policyholder, or remunerated via fund based commission). Unfortunately, IFAs are finding it difficult to make the move from upfront commission to fees or fund based commission, as their costs are generally upfront too. The demand for upfront commission will therefore be high, and if there is any supply of initial commission (ie one credible insurer is prepared to pay commission upfront) it will be difficult for any insurer who is not prepared to pay upfront commission to win any business.

Level of Charges

The 1% charge cap means that the insurance industry has had to become more efficient by reducing expenses. Whilst this has to be a good thing for the end consumer and will have been an aim of the Government, this has already led to significant job losses in the financial services industry, with many insurers cutting costs.

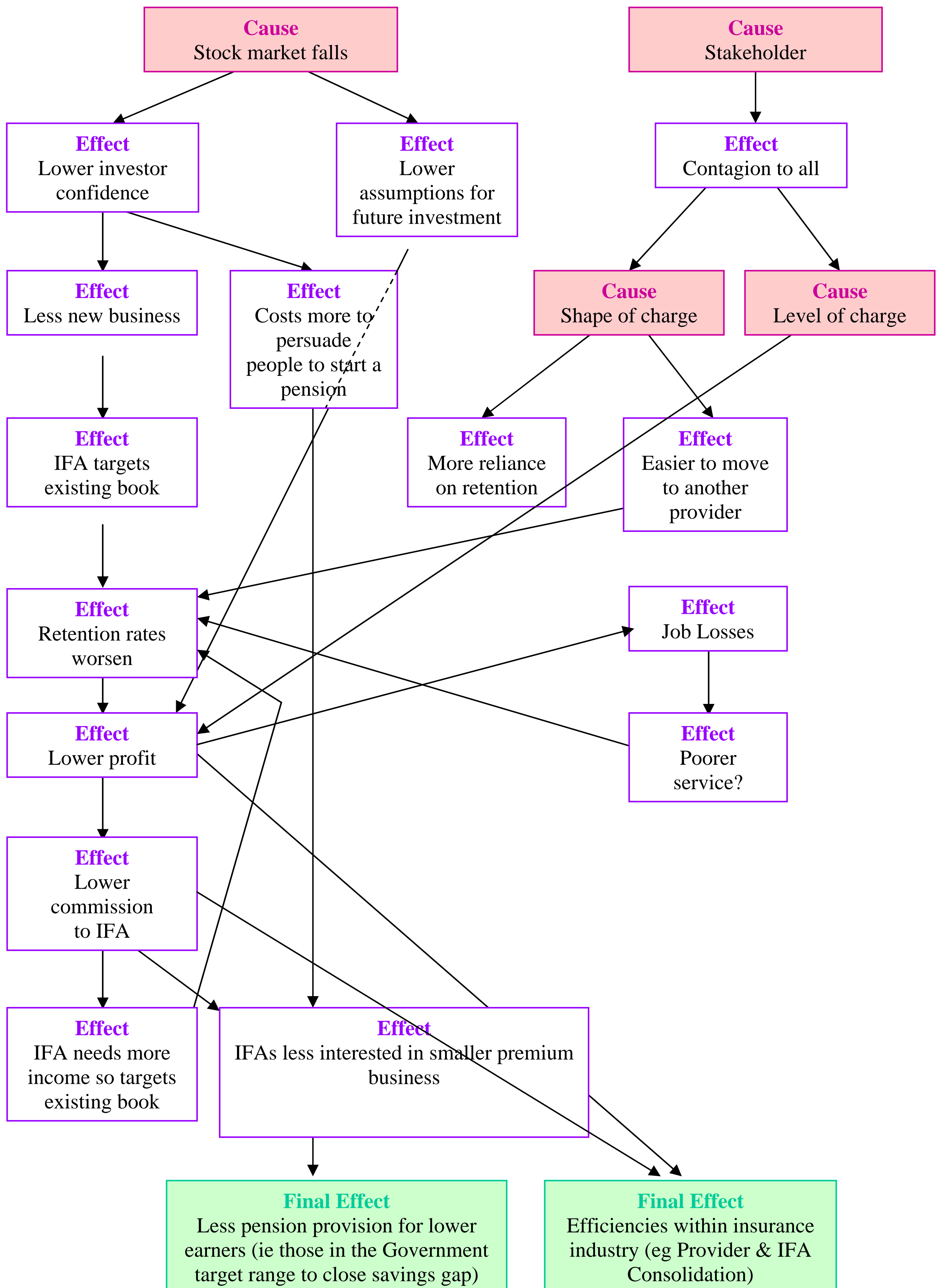
As well as an insurer reducing costs through expense savings and improved efficiency the 1% charge cap has had a huge impact on affordable commission rates. IFAs have seen their commission levels fall by more than 50% on pension contracts over the last few years since the 1% charge cap was announced. In fact many predict that as insurers' profit margins continue to reduce, these commission rates will have to fall even further in the near future. Whilst this will inevitably lead to increased efficiencies in the IFA market it will also mean that an IFA will need to generate more sales to cover their fixed costs.

If there is not enough new business in the market (eg caused by low investor confidence), then an IFA may turn their attention to their existing book of business (or some other IFA's existing book of business). This will mean that they can generate further upfront commission to ease their cashflow concerns.

As discussed above, the new shape of charges makes it much easier for an IFA to justify moving business from one insurer to another. In fact, by giving up some of their upfront commission entitlement and rebating this to the policyholder via lower AMC, an IFA can easily justify the move (ie the policyholder and the IFA are both better off, with the insurance industry losing out).

One other unfortunate by product of the charge cap is that, as an IFA's commission has reduced, they may no longer proactively target new business at the smaller end of the premium scale. This is because the premium levels are so small that the premium related upfront commission payments will not be enough to cover the IFA's costs. This actually means that this makes it harder for the Government to attain its goal of closing the savings gap by targeting those in the lower earnings bracket.

2.11) Summary of Issues Affecting Insurers Profits



2.12) The Future of Guaranteed Funds

In the current volatile investment market investors are seeking more assurance than ever before in terms of guaranteed minimum payouts. However, with equities at relatively low levels many investors also want to participate in any equities recovery. As such, a fund that offers equity exposure with a guaranteed underpin is an attractive proposition.

The main options in the current market to provide policyholders with guaranteed minimum returns coupled with potentially high equity exposure are:

- With Profits
- Structured Products
- CPPI (Constant Proportion Portfolio Insurance)

With Profits

'Traditional' Unitised With Profits funds allow investors potentially high equity exposure and provide guaranteed minimum payouts at certain points (eg on death, maturity, on regular withdrawals up to pre specified limits, and, less frequently now, on pre specified dates).

However, the reputation of these funds has taken a severe knock over the last few years, and sales have declined sharply. The main reasons for this are:

- Increasing applications of Market Value Reductions (MVRs) by insurers, brought about by a sustained period of poor stock market performance. This has led to IFAs and policyholders feeling aggrieved, as they get back less than they thought they were entitled to. Much of the problem lies in the fact that these funds have been misunderstood and were thought to give guaranteed minimum returns in all circumstances, which is clearly not true. It is a worrying fact that intermediaries have been advising clients for years to invest in these funds, without truly understanding how they work.

- Increased accusations of a lack of transparency of how these funds operate, eg from the Sandler Report and from the press. This lack of transparency claim is something that the industry will find difficult to argue against.

- Increased pressure on with profit funds to switch out of equities into fixed interest and cash for solvency reasons, again brought about by a sustained period of poor stock market performance.

- Reducing instances of policyholder guarantees applying on new contracts. This is because of the increasing cost of these guarantees, which is due to increased equity volatility and lower interest rates.

Sales of these with profit contracts have reduced substantially in the last few years **(sales of with profits bonds fell by around 95% in 2003)**, and a number of life offices have brought out new 'Next Generation With Profit' funds.

These new funds have tried to address the transparency issue (without introducing the risk of policyholder selection) and have generally shifted the focus from guaranteed payouts to smoothed payouts. Whilst these funds will have an important part to play in the future, they do not provide the solution for investors who want high equity exposure coupled with guaranteed minimum returns.

Structured Products

These products usually have a fixed term and a defined payout structure, which depends on market conditions. They use derivatives to structure the policyholder payouts, and the variations of payouts are endless. For example:

- A policyholder might be guaranteed to get their capital returned after 6 years **and** will also receive 100% of the capital growth in the FTSE 100 over the 6 year period. This structure has a capped downside risk (100% of investment), but the investor gets no dividend payments from the FTSE 100 (which will make up a large proportion of expected equity returns).

- A policyholder might get a guaranteed income of 10% per annum for 5 years and at the end of the period receive their capital back if and only if the FTSE did not fall by more than x% during the 5 year period.

The market for structured products is worth several billion pounds per annum and is extremely competitive.

However, the fixed term nature of these products means that they are inflexible if policyholders' circumstances change, and are not suitable for long term investment.

CPPI

- The aim of a CPPI product:

  The aim of a CPPI (Constant Proportion Portfolio Insurance) product is to provide a guarantee on a fund at some point in the future, whilst allowing the fund to have a potentially large Equity Backing Ratio (EBR).

- The basic principle behind CPPI products:

  These funds use a dynamic investment strategy to ensure that the fund always has enough to cover the value of the guarantee (ie the present value of the guarantee at risk free rates). The basic principle behind these funds is when markets are falling, the investment is moved from risky assets (such as equities) to risk free assets. Similarly when markets are rising, the investment is moved from risk free assets to risky assets.

- How these funds work:

  The fund would have a unit price (in a similar way as a unit linked fund). This unit price could go up and down depending on the performance of the assets, and would be published daily. There will be a guaranteed minimum price which will apply on the guarantee date, but at any other time there would be no minimum price.

  The guarantees can be defined at a fixed point in time (eg 1st Jan 2010), or can be a continuous (next day) guarantee. Moreover, the assets in this fund can be split into 2 types:

- Risk free assets; these are the assets which provide a perfect match for the guarantee liability (eg gilt strips with a redemption date the same as the defined guarantee date, or cash for a next day guarantee).

- Risky assets; these can be any asset which doesn't provide a match for the liabilities (eg an actively managed equity fund, FTSE 100, etc).

The traditional method of providing for these guarantees is to invest enough of the fund in the risk free (matching) asset to cover the cost of this guarantee. The remainder of the fund can be invested in risky assets, such as equities. This means that the risky assets can lose all of their value in one day and the fund will still have enough to meet the guarantee. This is a bit of an extreme scenario, and would result in a fund with a very low Equity Backing Ratio.

If instead we assume a realistic maximum daily fall of, say, 30% (rather than assuming that the risky assets can lose 100% of their value in one day) it means that we can afford to invest more in the risky assets and still have confidence that the fund will have enough to cover the guarantees.

The key is to hold the minimum required amount in the risk free matched asset, with the remainder in the risky assets, such that even if the risky assets fall by the 'maximum' amount (eg 30%) the fund will still have enough to cover the guarantee. If the risky assets fall by more than this 'maximum' amount the fund would have a shortfall. This shortfall would be made up by a third party (eg reinsurer, or investment bank). The fund will then rebalance at the start of the next day, such that the fund can still withstand a further 'maximum' fall in the risky assets and still have enough to cover the guarantee. However, if the fund ever falls by more than the maximum amount in any day then the fund will have to fully disinvest from the risky assets into the risk free assets. Unfortunately, this fund would then never be able to get back into risky assets and would become a risk free fund.

So when the fund performs poorly and the guarantee becomes onerous the fund has to switch out of the risky assets into the risk free assets. If the fund performs well it can afford to invest more in the risky assets. This is the same principle behind the 'traditional' style With Profit funds; selling equities in poor times and buying fixed interest assets. The only differences are that the level of matching is higher, the pace of this asset switching is much quicker, and the switching process follows a defined (and more transparent) formula.

An investor can switch in and out of these funds at any time, at a transparent unit price, without any selection risk to the insurer.

- How popular are CPPI products now and how important will they be in future?

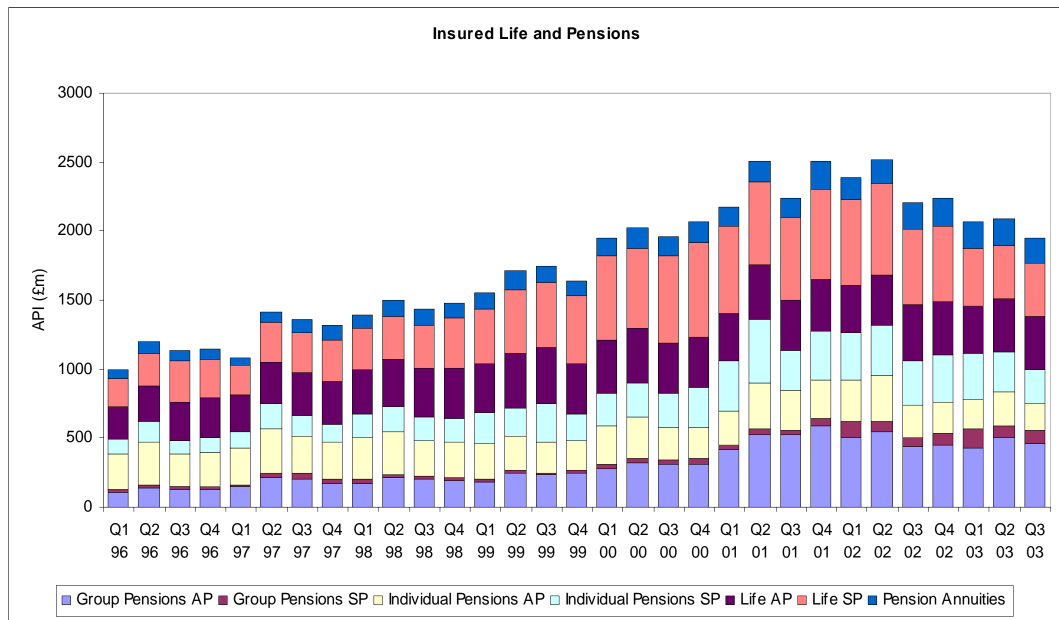
CPPI funds are currently very popular in Europe and are increasing in popularity in the UK. A number of large providers have launched CPPI funds in the UK in the last year with many insurers expected to follow in 2004. As IFAs seek to find guaranteed returns for investors in a way that ensures maximum flexibility, many believe that the CPPI market will become the natural replacement for With Profit funds.

Other Issues

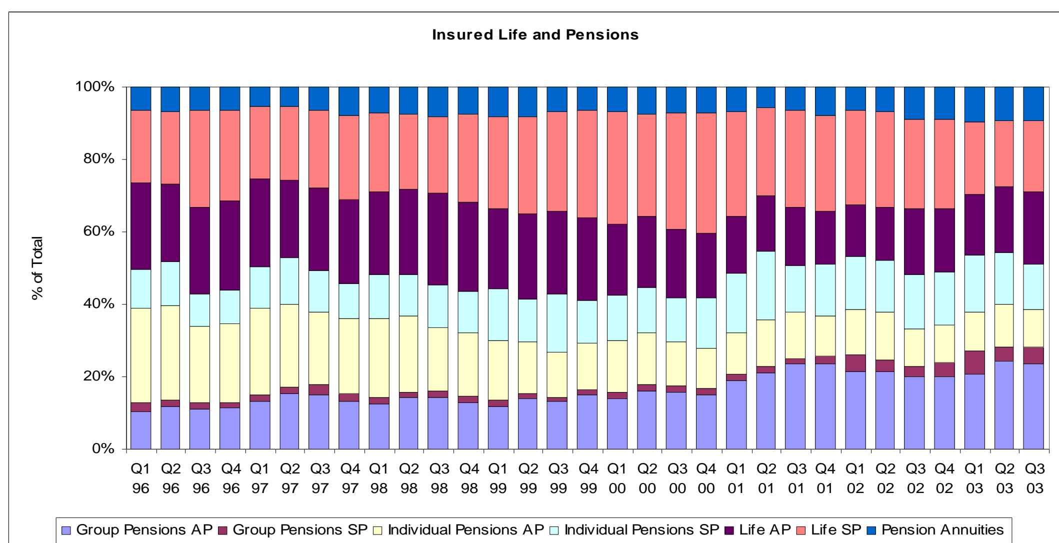
2.13) New Business

Current Sales Volumes and Past Trends

The following graph shows new business figures produced by the Association of British Insurers (ABI) from 1996 Q1 to 2003 Q3, excluding Collective Investment Schemes. Single Premium figures are divided by 10 to give an annual premium equivalent (API).



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

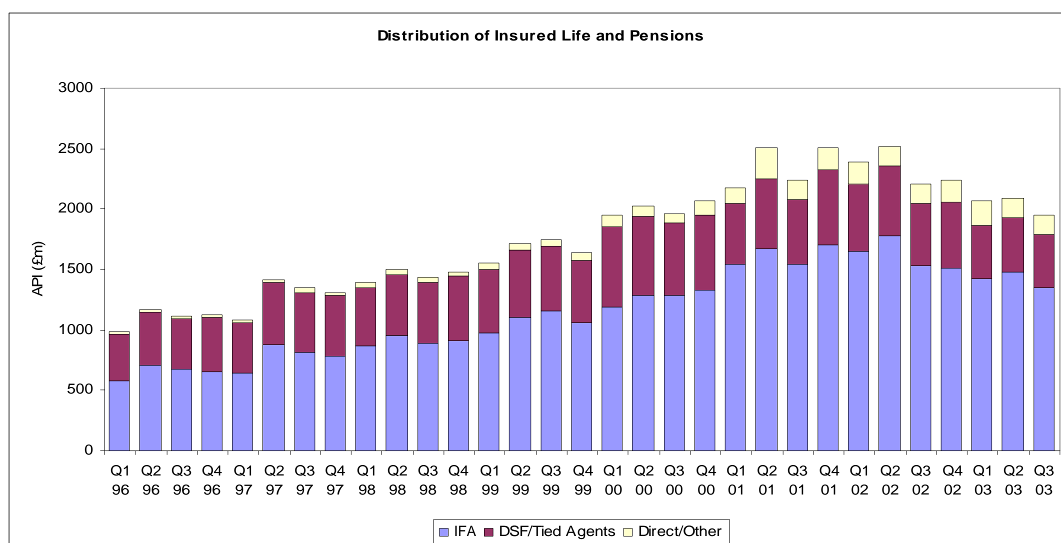


The main points to note are:

- The market has significantly increased in size since 1996, with volumes rising from roughly £1Bn per quarter in 1996 to roughly £2Bn per quarter in 2003.
- The upward trend was reversed in 2003, which has seen total market volumes drop by around 15% compared to 2002.
- 2003 saw a significant decrease in life bond sales (particularly SPs). The volumes of Life SPs dropped by over 30% from 2002 to 2003. The predominant reason for this is the declining sales of with profits bonds.
- In the period from 1996 to 2003 the share of the market made up by Group Pension has increased significantly. The Group Pensions share of the market has increased from under 15% to nearly 30% in the 8 year period. In the same period the Individual Pension share of total market volumes has decreased from over 35% to under 25%.
- Group SPs volumes have increased significantly in the last few years. This is because of increased group transfer business. The main reason for this increase are the move from defined benefits to defined contribution pensions

Distribution Channels

The following graph shows the distribution of total volumes by distribution channel. It is based on ABI data over the same period.



This graph clearly shows that the volumes sold through the Independent Financial Advisor (IFA) market have increased substantially, while the volumes sold through direct sales forces and tied agents have remained relatively flat. The volumes sold through the 'other' distribution channel (which includes direct mail campaigns, internet, telesales, etc) have increased significantly since 1996.

2.14) Financial Strength

Equity Backing Ratios

2003 witnessed further reductions in equity backing ratios (EBRs) across the industry in response to solvency pressures. While it can be difficult to compare EBRs between companies (for example, many companies have a range of with profits funds with different guarantee and EBR characteristics), it is clear that many with profits funds now have EBRs of 50% or less. It will be interesting to see if the new solvency requirements within the Prudential Sourcebook drive EBRs down yet further.

In response to falling EBRs of with profits funds, the FSA wrote to all companies in mid 2003 requiring them justify the projection bases being used within their with profits funds, particularly in the context of mortgage endowments.

Their broad rationale was that an EBR of around 70% was required in current economic conditions to justify the standard FSA projection bases of 4/6/8% (life) and 5/7/9% (pensions).

Interestingly, FSA chose not to focus on the justifiability of projections within unit-linked funds, even though a fund with a significant fixed interest content might have similar future return expectations to a with profits fund. However, a number of companies have chosen to use projection bases that vary by unit-linked fund. This is not a straightforward exercise given the freedom policyholders generally have to switch between different unit-linked and with profits funds.

Ratings

Another measure of financial strength of insurers is the ratings given by ratings agencies such as Standard and Poors.

In recent years stock market falls and increases in liabilities (eg Guaranteed Annuity liabilities) have resulted in the ratings for insurers being steadily downgraded. Whilst 2003 was a good year for stock markets much of the damage done in the previous few years has been reflected in the fact that most insurers have suffered further downgrades in 2003.

The following table shows a sample of current ratings (as at March 2004):

Company	S&P Rating
Friends Provident	A+
Legal & General	AA+
Norwich Union	AA
Prudential	AA+
Scottish Equitable	AA
Standard Life	A+

Financial Strength

Significant reductions in published free assets were generally witnessed over 2002, as indicated in the following tables. The tables also show the degree to which companies have an increased reliance on implicit items. Clearly the substantial falls in equity markets witnessed during the first quarter of 2003 must have placed severe solvency pressures on a number of companies.

£m	31 December 2002				
	Incl Implicit Item		Implicit Item	Excl Implicit Item	
	Free Assets	FAR		Free Assets	FAR
Abbey National	146	6.0%	-	146	6.0%
AXA Sun Life	577	4.8%	200	377	3.1%
CIS	818	4.9%	-	818	4.9%
CGNU Life	784	7.2%	573	211	1.9%
Clerical Medical	799	3.9%	110	689	3.4%
Equitable Life	356	1.9%	200	156	0.8%
Friends Provident	835	4.1%	600	235	1.1%
Guardian	186	2.7%	70	116	1.7%
GE Life	34	2.2%	-	34	2.2%
Legal & General	2,782	7.1%	1,220	1,562	4.0%
MGM	61	4.7%	50	11	0.9%
Norwich Union L&P	2,154	7.7%	977	1,177	4.2%
Pearl Assurance	394	2.6%	500	(106)	-0.7%
Phoenix Assurance	416	24.6%	-	416	24.6%
Prudential	3,153	4.2%	-	3,153	4.2%
Royal London	790	4.2%	830	(40)	-0.2%
Royal & Sun Alliance	296	2.9%	250	46	0.5%
Scottish Equitable	610	5.4%	400	210	1.9%
Scottish Mutual	245	1.7%	250	(5)	-0.0%
Scottish Widows	1,589	7.3%	400	1,189	5.5%
Standard Life	2,198	3.4%	1,500	698	1.1%
Sun Alliance & London	577	0.6%	-	577	0.6%

£m	31 December 2001				
	Incl Implicit Item		Implicit Item	Excl Implicit Item	
	Free Assets	FAR		Free Assets	FAR
Abbey National	97	3.5%	-	97	3.5%
AXA Sun Life	30	0.2%	-	30	0.2%
CIS	1,979	10.1%	-	1,979	10.1%
CGNU Life	1,190	10.6%	565	625	5.6%
Clerical Medical	2,039	9.5%	470	1,569	7.3%
Equitable Life	566	2.4%	500	66	0.3%
Friends Provident	1,775	7.7%	600	1,175	5.1%
Guardian	430	5.7%	100	330	4.4%
GE Life	91	2.0%	-	91	2.0%
Legal & General	2,757	7.1%	-	2,757	7.1%
MGM	45	3.3%	-	45	3.3%
Norwich Union L&P	2,866	8.9%	1,038	1,828	5.7%
Pearl Assurance	758	4.6%	900	(142)	-0.9%
Phoenix Assurance	496	23.0%	-	496	23.0%
Prudential	5,672	7.3%	-	5,672	7.3%
Royal London	1,185	5.6%	830	355	1.7%
Royal & Sun Alliance	681	6.1%	380	301	2.7%
Scottish Equitable	803	6.9%	400	403	3.5%
Scottish Mutual	503	3.3%	300	203	1.3%
Scottish Widows	1,521	6.6%	-	1,521	6.6%
Standard Life	3,356	5.0%	-	3,356	5.0%
Sun Alliance & London	194	2.1%	-	194	2.1%

Free Asset Ratio (FAR) = Form 9 Line 44 / (Line 21 + Line 22) [including implicit item]
Free Asset Ratio (FAR) = Form 9 (Line 44 - Line 31) / (Line 21 + Line 22) [excluding implicit item]

While 31 December 2003 results are not yet available, equity market rises over 2003 should result in improved results for most companies relative to 31 December 2002.

2.15) Corporate Activity

2003 was quite a year for mergers and acquisitions of Insurance Companies. However, many insurers continued to purchase stakes in IFA firms, particularly AEGON UK, who purchased majority stakes in a number of large IFAs.

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

Sun Life Financial Services

12/03/2003 Sun Life Financial celebrates successful integration of Clarica Life Insurance

03/21/2003 Sun Life Financial increases ownership stake in CI Fund Management

01/28/2003 E*TRADE Canada announces agreement to acquire Sun Life Securities brokerage accounts

01/13/2003 Sun Life Financial announces sale of U.K. group business to Unum Limited

01/07/2003 Sun Life Financial closes sale of Clarica's U.S. operations to Midland National Life Insurance Company

Prudential

Prudential UK and Zurich Financial Services enter into strategic alliance

Wesyleyan

Wesleyan announces partnership with NASUWT - One of the largest teachers unions: May 2003

AVIVA

UK: Norwich Union to close its national broker subsidiary Hill House Hammond:
05 February 2004

India: Aviva Life Insurance enters insurance broking: 20 January 2004

UK: Norwich Union increases stake in 'Lifetime' IFA wrap service: 05 December 2003

Netherlands: Completion joint venture Delta Lloyd and ABN AMRO Insurance: 08 May 2003

UK: ASDA Insurance has it covered with Norwich Union: 30 March 2003

Royal & Sun Alliance

22.10.2003 Royal & SunAlliance announces the sale of Sequence (UK) Limited

09.06.2003 Royal & SunAlliance announces the sale of its Puerto Rican operation.

09.06.2003 Royal & SunAlliance Sells RSUI to Alleghany Insurance

04.04.2003 Royal & SunAlliance Sells Healthcare & Assistance Business

Liverpool & Victoria

24 March 2003: Britannia links with Liverpool Victoria

2.16) References

- FSA website
- Standard & Poors website
- Actuarial Profession website
- 2003 current topics paper
- Martin Muir and Richard Waller: 'Twin Peaks', paper presented to Staple Inn Actuarial Society 5 November 2003
- Commentaries on consultation papers by various consultancies

3) Investment

3.1) 2003 Review

General Overview

2003 finally saw equity markets break their three year losing streak with impressive returns being posted in all of the major markets. The first quarter started badly with further falls in equity markets but early March saw a dramatic turnaround. Equity markets turned more or less overnight and set off on a path towards the impressive returns detailed in the following table.

	Local	**£**
FTSE All Share	20.9	20.9
S&P 500	28.7	15.7
FTSE World Europe ex UK	21.6	29.7
Japan Nikkei 300	23.0	22.5
MSCI Asia Pacific Free ex Japan	31.8	33.7
FTSE-Actuaries Govt All Stocks	2.1	2.1

In contrast bond markets sold off. The following table of 10 year government bond yields highlights the change in yields in the major markets.

10 year yields	**31/12/2002**	**31/12/2003**
UK	4.37	4.79
US	3.79	4.26
Germany	4.22	4.26
Japan	0.88	1.34

Economic Growth and Monetary Policy

2003 saw the benefits of the early stages of an economic upturn, fiscal and monetary stimuli finally having the desired effect. Short term interest rates in most countries remained low, as did inflation. The fears about deflation that had been a feature of the equity bear market melted away.

Preliminary indications are that US real GDP growth will turn out to be 2.8% in 2003 up from 2.3% in 2002 and consumer price inflation (CPI) was 2.0% versus 1.0% in 2002, The Federal Reserve cut interest rates by 0.25%, taking the Fed Funds rate to 1%, a 45-year low. This was the level that rates ended the year and this low level of interest rates was a factor behind the improvement in the economy. The budget and current account 'twin' deficits in the US are running at around 5% of GDP and no doubt contributed to the weakness of the dollar but otherwise have had limited impact. The one doubt about the improving economy throughout 2003 was the weakness of labour markets.

In the UK preliminary indications for real GDP growth in 2003 are 2.0% against 1.8% in 2002. Inflation indicators seem to multiply and confuse. For the year RPI came in at 2.8%, RPI ex mortgages at 2.6% and the government' preferred measure of consumer price inflation (CPI) at 1.3%. A section from the National Statistics Office Q&A regarding the differences between CPI ad RPI follows this section. The Monetary Policy Committee cut the base rate by 0.25% in February and July taking the rate to 3.5%, but in November raised rates to 3.75%.

Eurozone real GDP growth remained sluggish in 2003, with preliminary indications being that growth will come in at 0.5% after 0.8% in 2002. Eurozone inflation at 2.0% is down from 2.3% in 2002. Like the Monetary Policy Committee in the UK the European Central Bank (ECB) cut rates twice during the year, by 0.25% in March and 0.5% in June. In making the June cut the ECB stated 'decision is in line with our monetary policy strategy, including the aim of maintaining inflation rates below but close to 2% over the medium term. At the same time, this interest rate reduction takes into account the downside risks to economic growth'. The key Repo rate ended the year at 2.0%.

Japan, at least in the short term, appears to have picked up, with real GDP growth expected at 2.4% following a decline of 0.6% in the previous year. Inflationary pressures remain absent with CPI inflation of –0.3%. Depositing your Yen in a Japanese bank remained an unrewarding prospect with overnight rates at 0%.

What are the Differences Between the CPI and the RPI?

In terms of commodity coverage, CPI excludes a number of items that are included in RPIX, mainly related to housing. These include council tax and a range of owner-occupier housing costs such as mortgage interest payments, house depreciation, buildings insurance, estate agents' and conveyancing fees.

The CPI covers all private households, whereas RPIX excludes the top 4 per cent by income and pensioner households who derive at least three quarters of their income from state benefits. The CPI also includes the residents of institutional households such as student hostels, and also foreign visitors to the UK. This means that it covers some items that are not in the RPI, such as unit trust and stockbrokers fees, university accommodation fees and foreign students' university tuition fees.

Although the same underlying price data is used in most cases to calculate the two indices, there are some specific differences in price measurement. For example, different methods are used in the CPI and RPI to quality adjust prices for new cars and personal computers.

Finally, individual prices are combined in the CPI and RPIX within each detailed expenditure category according to different formulae. The CPI uses the geometric mean whereas the RPI uses arithmetic means.

Markets

During the first quarter of 2003 equity markets fell sharply and there was widespread concern over “forced” equity sales by insurance companies that were struggling to maintain their solvency margins. The UK equity market turned on the 13th of March, 2003. The Financial Times that morning had the yield on the All Share Index at 4.21% and the yield on over 15 year gilts at 4.08%, the first time in decades that the yield on the equity market had exceeded the yield on long gilts. Other catalysts were there, the imminent start of the war in Iraq and the emerging economic upturn.

This was evident in market leadership, with the UK led higher by depressed margin cyclical companies that had much to gain from the improving economic backdrop. There was a vast difference in the returns of the size indices with FTSE100 returning 17.9%, the mid-cap FTSE250 returning 38.9% and the FTSE Small Cap returning 39.7%. It was also evident from sectors in the UK with Information Technology and Basic Industry groupings leading the market and the Utilities and Non Cyclical Consumer Goods groupings producing the lowest returns albeit still positive.

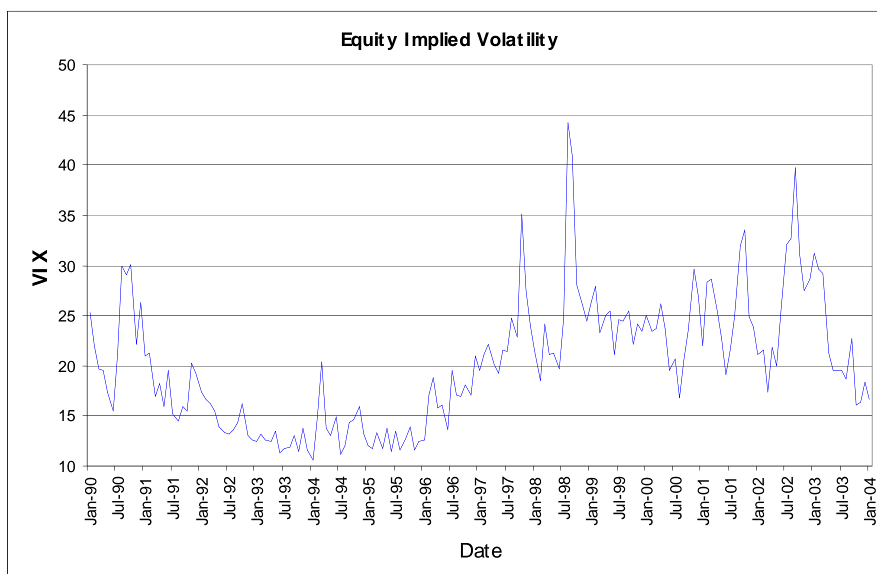
In the US the picture was similar with the market faltering as the threat of the war with Iraq began to dominate the headlines, but shares rallied as hostilities began. As in the UK, small and mid-capitalisation stocks outperformed large caps. Improving corporate earnings were supportive for the market especially later in the year. Despite the strength of the Euro versus the dollar, European equity markets made gains over the year encouraged by the strength of the global economic recovery. The collapse of the Italian food group, Parmalat, at the end of the year re-ignited some fears about the corporate scandals that dominated the US in 2002.

Bond yields edged higher over the year. Inflation fears generally remained subdued and this served to limit the downside for bonds. Pressure on life company solvency and defined benefit pension funds remained a support for bond markets.

This is perhaps most evident in corporate bonds where the spread on the lowest investment grade rating band corporate bonds, BBB rated, over their government equivalent narrowed by around 100 basis points.

Currency markets saw marked volatility in 2003. The US Dollar fell sharply over the year, £1 would have bought U$1.61 at the start of 2003 but by the end of the year it would have bought U$1.79. The EUR/GBP rate moved from 1.53 at the start of the year to 1.42 at the end of the year. The GBP trade weighted index declined from 104.5 at the start of the year to 100.6 at the end of the year, as the strength of the pound against the dollar was outweighed by weakness against the Euro in particular.

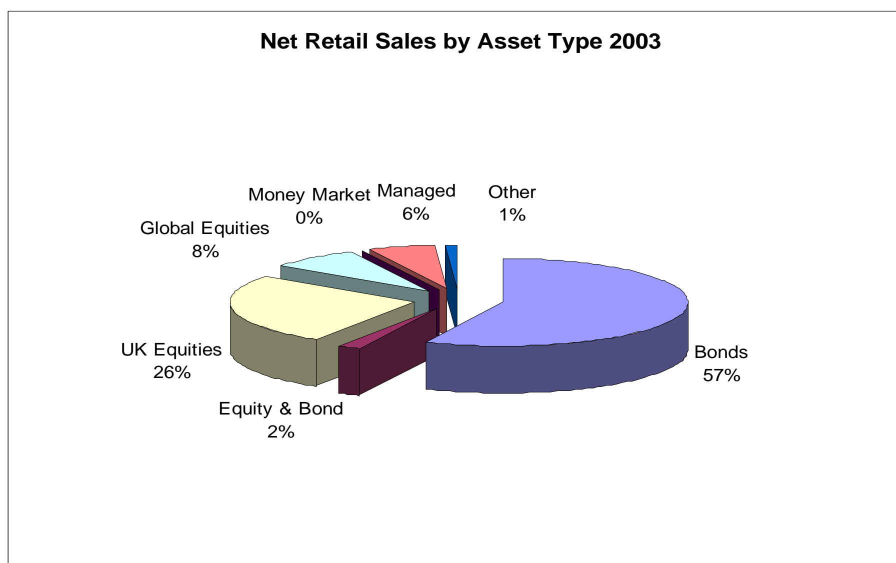
One feature of 2003 was the decline in implied volatility of equity markets. The equity implied volatility (VIX) index fell through out the year bringing it into the territory that it occupied before the tail end of the Technology boom in 1999 and the long equity bear market from 2000 to the first quarter of 2003. This is demonstrated by the following chart covering the period from 1990 to early 2004.

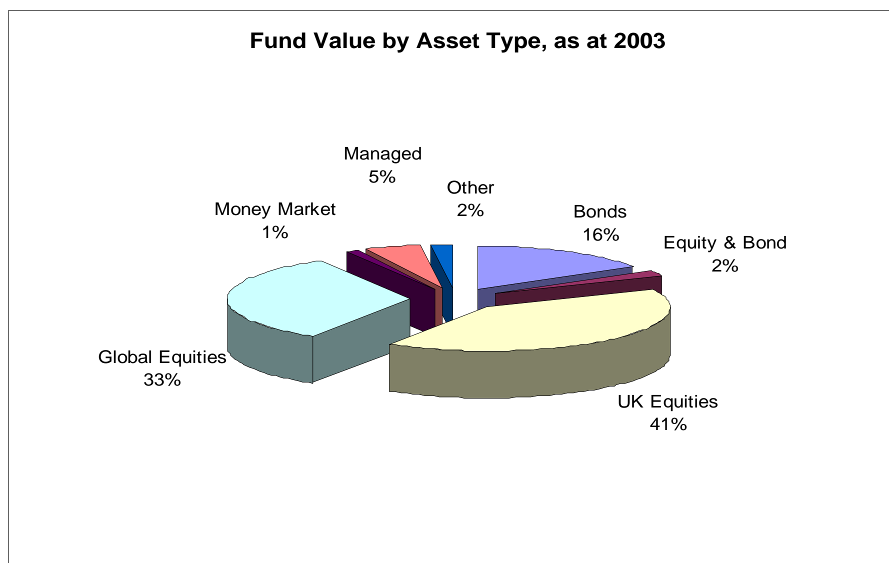


Retail Fund Sales

Data from the Investment Management Association gives a useful insight into the investing public. Gross sales for retail funds in the fourth quarter of 2003 averaged £2.3 billion per month versus £2.0bn for 2002. Net retail sales averaged over £624 million per month in the fourth quarter of 2003 compared to £418m for the same period of 2002.

In each month in the fourth quarter of 2002 the UK Corporate Bond sector had the highest percentage share of gross retail sales, 21% in October, 22% in November and 25% in December. This high share was maintained for most of the year but by the fourth quarter of 2003 the UK All Companies sector had risen back to the top of the sales league table with 21% of gross retail sales, and the UK Corporate bond sector had slipped into second place with 15% of gross retail sales in the quarter. The comparison between the fund values by asset / sector type and net retail sales by asset / sector type in 2003 highlights the point.





3.2) 2004 The Year Ahead

Coming into 2004 economic data continues to indicate that the US economy is growing very strongly and a good corporate earnings season suggested that corporate spending should continue to gather pace. Recent durable goods data has backed this up, with strong orders for computers and other equipment. So far the bulk of business investment has been in capital, not labour. This is reflected in the lack of improvement in the labour market as reflected in non-farm payroll data, although household survey data continues to show a greater degree of improvement in the labour market.

The January 2004 press release from the Federal Open Market Committee said:

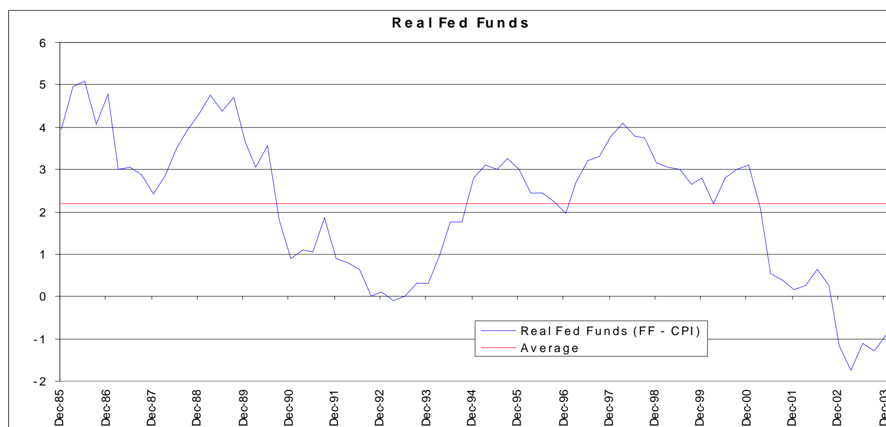
"The Federal Open Market Committee decided today to keep its target for the federal funds rate at 1 percent.

The Committee continues to believe that an accommodative stance of monetary policy, coupled with robust underlying growth in productivity, is providing important ongoing support to economic activity. The evidence accumulated over the intermeeting period confirms that output is expanding briskly. Although new hiring remains subdued, other indicators suggest an improvement in the labor market. Increases in core consumer prices are muted and expected to remain low.

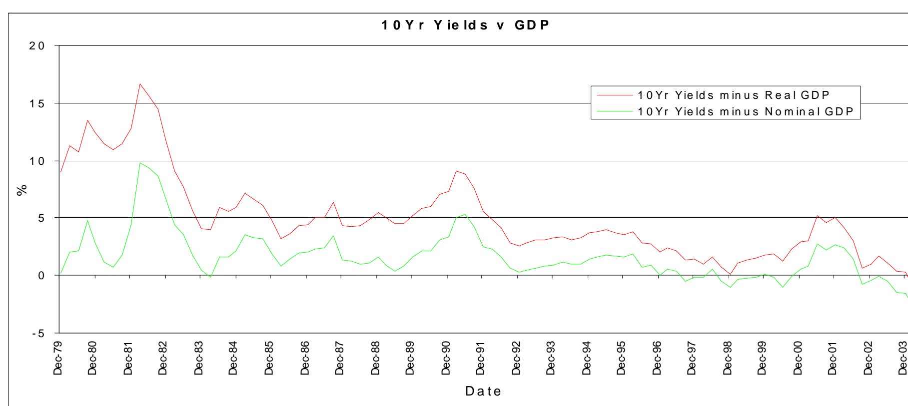
The Committee perceives that the upside and downside risks to the attainment of sustainable growth for the next few quarters are roughly equal. The probability of an unwelcome fall in inflation has diminished in recent months and now appears almost equal to that of a rise in inflation. With inflation quite low and resource use slack, the Committee believes that it can be patient in removing its policy accommodation. "

The final sentence of this compares to the equivalent sentence from the December press release: *"However, with inflation quite low and resource use slack, the Committee believes that policy accommodation can be maintained for a considerable period."*.

The change in emphasis led markets to anticipate that the long period of loose monetary conditions may be coming to an end. A chart of real fed funds rates indicates just how accommodative the monetary policy has been.



The bond market gives a similar picture. Comparing US 10 year treasury yields to nominal and real GDP, it can be seen that real GDP growth is now exceeding 10 year yields, a fairly extreme position for US treasuries.



This will be a challenge for the bond market during 2004 and may have an impact on the equity market too.

In the UK the main driver of stronger growth in 2004 should be a recovery in business investment, as the outlook for global growth improves. Relatively healthy balance sheets and strong profit growth should permit a strong recovery in private sector investment as the economic outlook improves. The turning point in the interest rate cycle implies tougher times for the consumer, given the high levels of consumer debt.

Another key issue for the UK economy is the outlook for public spending, given the deteriorating trend in the overall public finances. In the recent pre Budget report, the Chancellor made substantial upward revisions to his borrowing forecasts for the next three years. This invited speculation that his prudent borrowing ‘rules’ would be breached or that rises in taxes would be necessary to fund the Government’s ambitious spending plans.

Despite reaching the turn of the interest rate cycle, there is little that is new or alarming about the inflation outlook. RPIX fell back to 2.5% in December, the first time it has been at the targeted rate since October 2002. The newly targeted HICP remains well below its target at 1.3%.

Producer prices remain subdued and should be helped by the recent appreciation in sterling. The only worrying inflationary indicator is public sector pay growth, currently running at 5.4% year on year, but recent trends suggest even this has now peaked. The Monetary Policy Committee (MPC) is not likely to be dissuaded from raising interest rates, in spite of the improved inflation data. Rates have generally been changed in response to growth data, not inflation data, and this is likely to be the case in 2004.

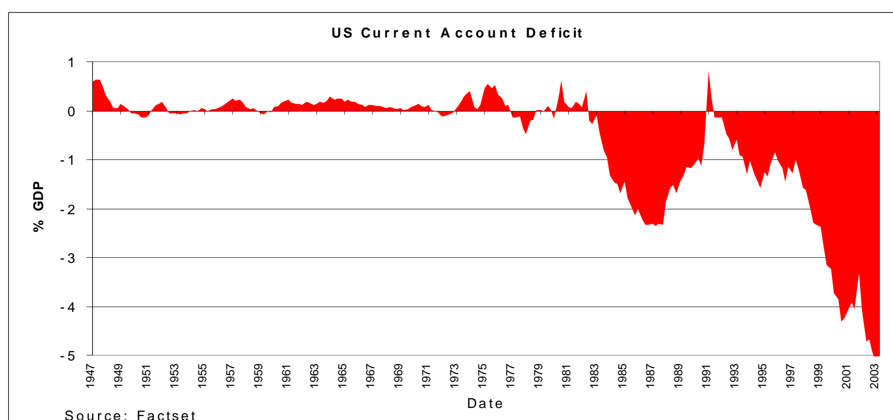
Within the euro-area Italy continued to struggle (flat GDP results), while Germany grew at an annualised basis of 0.8% reflecting weak domestic demand, with France grew at 2%, corroborating recent evidence from strong survey data.

The strong Euro impacts the export competitiveness of the euro-area. Italy is particularly exposed to export weakness because of its high labour costs and unfavourable terms of trade. The Netherlands will also suffer, although its recent wage freeze should help to recover some competitiveness. Germany is better placed because of its deeper restructuring efforts and the limited price sensitivity of exports. France and Spain have the lowest share of non-EU exports as percentage of GDP, at 11% and 9% respectively, and as a result should suffer less from currency strength.

Help for European economies could come from the euro area consumer to spend if they spend more over the coming quarters. Euro-area households have saved more than their UK and US counterparts in recent years. Just as UK and US households are likely to rebuild savings over the coming years, euro-area households could run down their savings to boost spending. A stronger currency should also reduce prices, boosting real incomes and wealth. This should allow consumers to buy more goods than before. These supportive arguments, are countered by a weak labour market and the effect of higher indirect taxes should offset the effects of lower income taxes. Lack of job creation means that the consumer will curtail spending as they increase 'precautionary savings' in the face of economic uncertainty. Key risks to European growth are a greater rise in interest rates and a stronger euro.

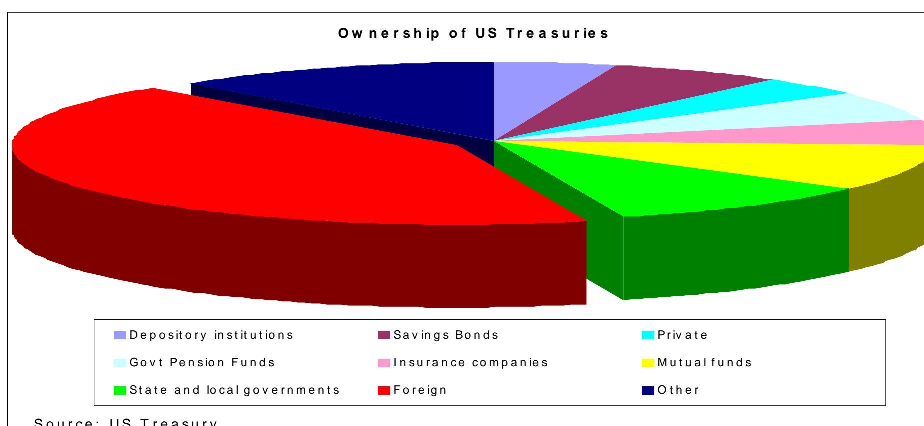
3.3) The US Twin Deficits

The US has issues to solve with its budget and current account deficits. The development of the current account deficit is shown in the following chart.



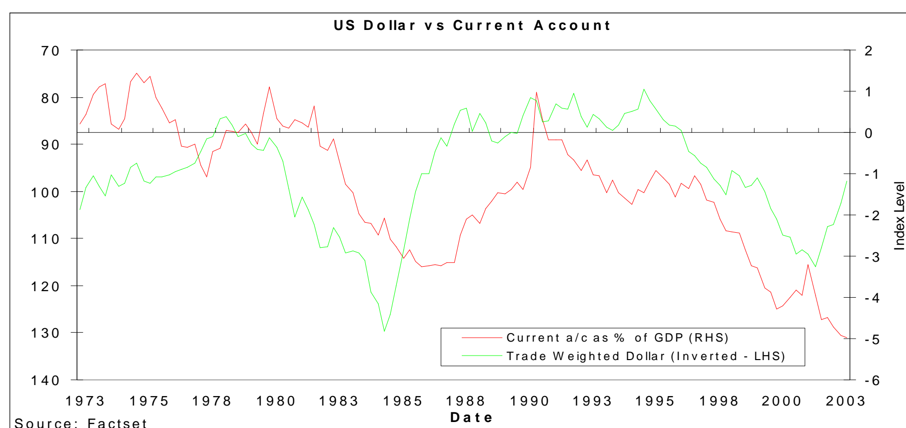
During the eighties and early nineties this deficit was largely financed by capital flows from abroad into the US equity market. Today the picture is very different. Equity purchases from foreign investors have fallen steeply, with the $1.5 billion per day current account financing requirement instead coming from purchases of US Treasuries (Government Bonds).

Capital flow data from the US Treasury recently highlighted that foreigners bought $16 billion of equities in the year through to September 2003. That buys just 11 days of current account financing! By contrast, the same data showed that foreigners bought $525 billion of bonds over the same period – enough to cover a whole years' worth of financing. In fact, foreigners are now the largest investing entity in the privately-held US Treasury market (see chart below), owning nearly 50% of privately-held marketable Treasury securities.



These foreign investors are mostly foreign Central Banks, and within that category, mostly Asian Central Banks. Why are they buying so many government bonds? The simple answer is that they are recycling their quickly accumulating foreign exchange reserves (from export sales to the US) back into dollars in an attempt to stop their own currencies appreciating too fast.

Traditional economic analysis suggests that a weaker dollar is the cure-all policy towards current account stability. This has proved true in the past. But this time it is different, as can be seen from the chart below.



Whilst the current account returned to balance in the early nineties, following a period of dollar weakness from the Plaza Accord in September 1985, the early nineties was also a period where domestic consumption slowed materially. What has differentiated the present current account deficit is that even though the US economy was in recession in 2001, there was no associated slow-down in consumption. As such, the current account worsened at a time of a significant domestic economic slowdown.

Furthermore, it appears from the above chart that a weaker dollar has a more muted impact on the current account position right now than that in previous cycles – note that the green line continues to show a weaker dollar whilst the red line shows a worsening current account deficit. John Taylor, undersecretary for International Affairs at the US Treasury, has argued that this is due to limited pricing power from corporates. This has lead to margin erosion, as higher import costs have been met by the domestic retailers' margins, and not by consumer prices as in previous cycles. Normally, higher consumer prices dampen demand for imported goods and help improve the current account – but this does not appear to be happening this time around.

This is important because it suggests that a weaker dollar will not be sufficient to bring the current account back to balance. To achieve balance, a significant slowdown in US consumption is also required. It is arguable that the political will for this is not present. Therefore - at least in the near term - the current account position will continue to worsen, whatever happens to the dollar.

Current account financing will have had an impact on the dollar. However, that interest rate differentials can and do affect currency valuations. The fact that outside Japan the lowest interest rates on offer are in the US may suggest that those low interest rates have also affected the value of the dollar. To the extent that the US consumer continues to suck in imports, and that there is pressure on the dollar to weaken because of that, this trend of a weakening dollar and a worsening current account could continue for some considerable time. Remember, Asian exporters do not want their currencies to appreciate significantly – if stopping currency appreciation requires huge purchases of US Treasuries, so be it. This is vendor financing by another name.

Having twin deficits, each of 5% of GDP, is plainly not a sustainable position in the long term. But given the dynamics of US consumption, and the cheap supply of finance from Asian Central Banks to sterilise their own domestic financial systems from huge foreign exchange reserves, the trend can continue for some time.

The crunch comes when the rest of the world stops financing the US consumer. At that point, a substantial slowdown in domestic consumption should bring the current account back into balance. But there are no imminent signs of waning foreign demand for US treasuries, and therefore there's only a limited risk of global financial instability in the short term. But, as the peak and subsequent deflating of the tech bubble showed in 2000, vendor financing cannot continue unabated for ever.

3.4) 2003 The Year in Charts

Charts of the markets in 2003 follow.

The equity charts are total return with data from Factset:

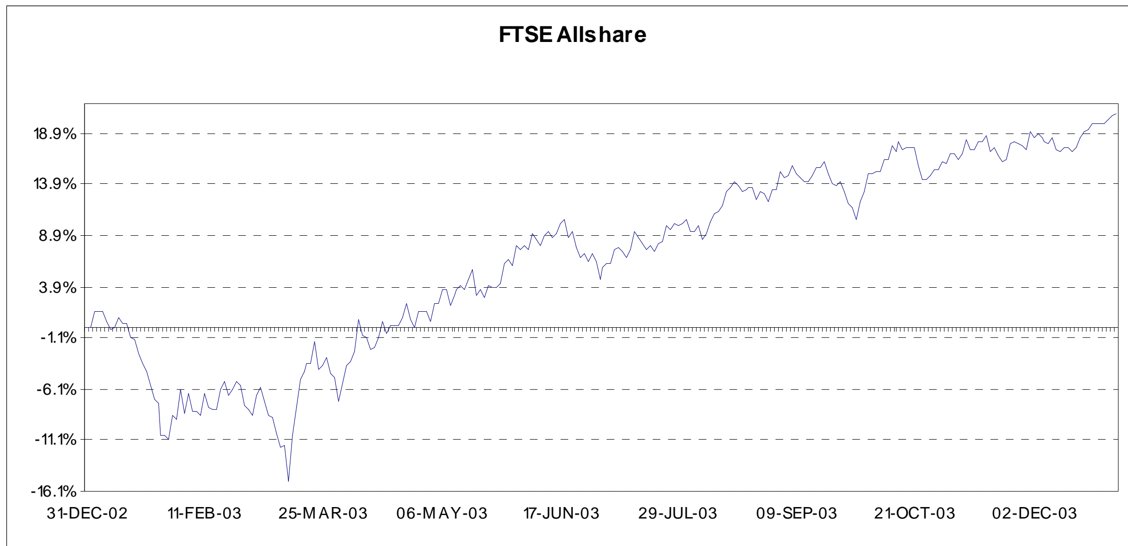
- FTSE All Share
- FTSE250
- FTSE Small Cap
- S&P 500
- FTSE World Europe ex UK
- FTSE Japan
- MSCI Asia Pacific Free ex Japan

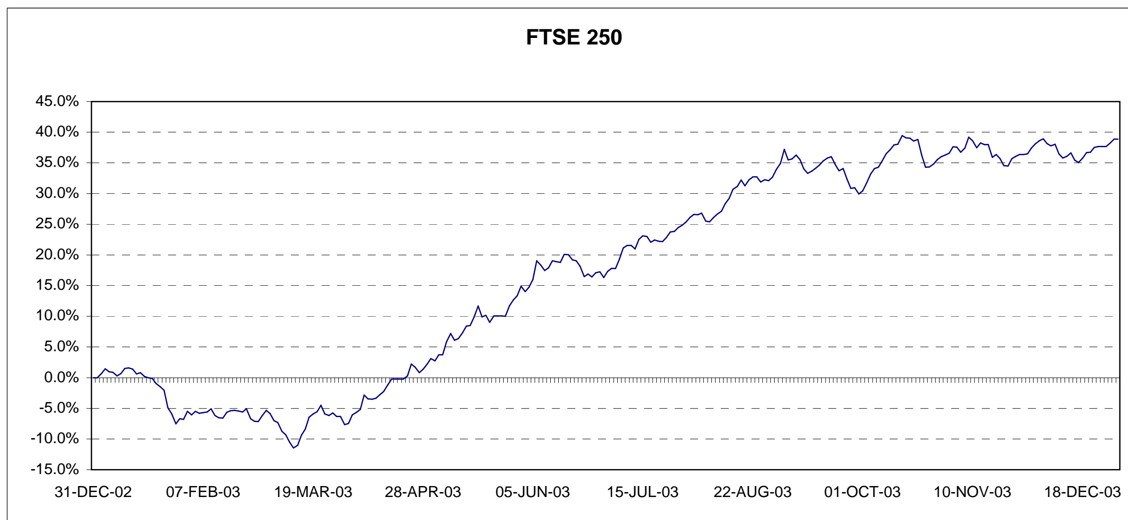
The exchange rates charts are:

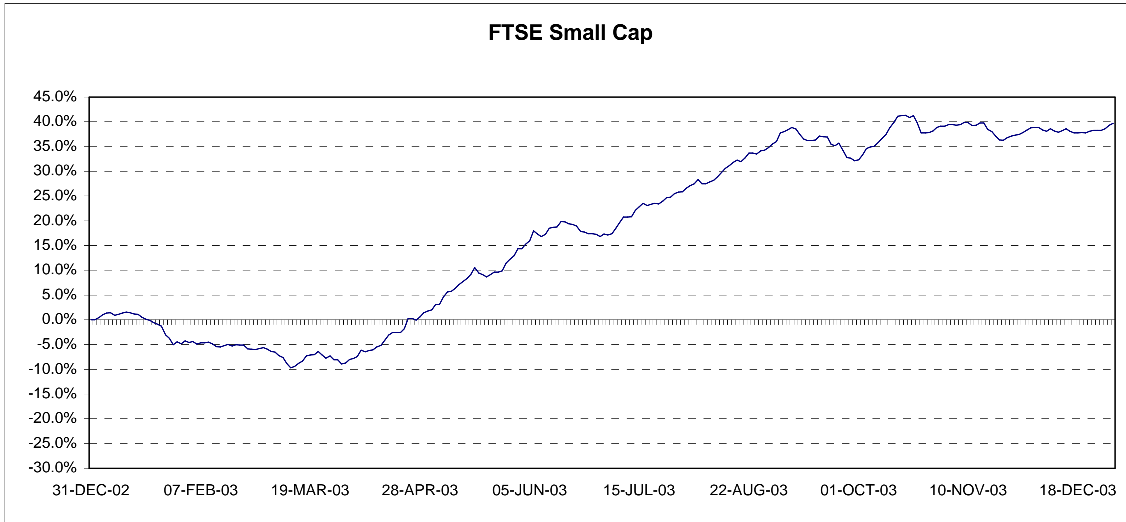
- USD/GBP
- EUR/USD

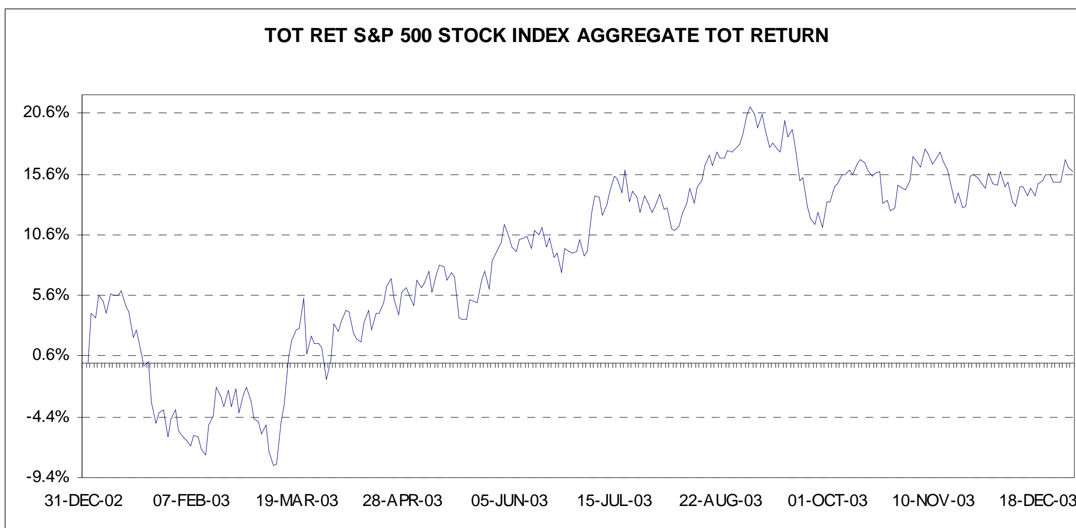
The bond yield charts are:

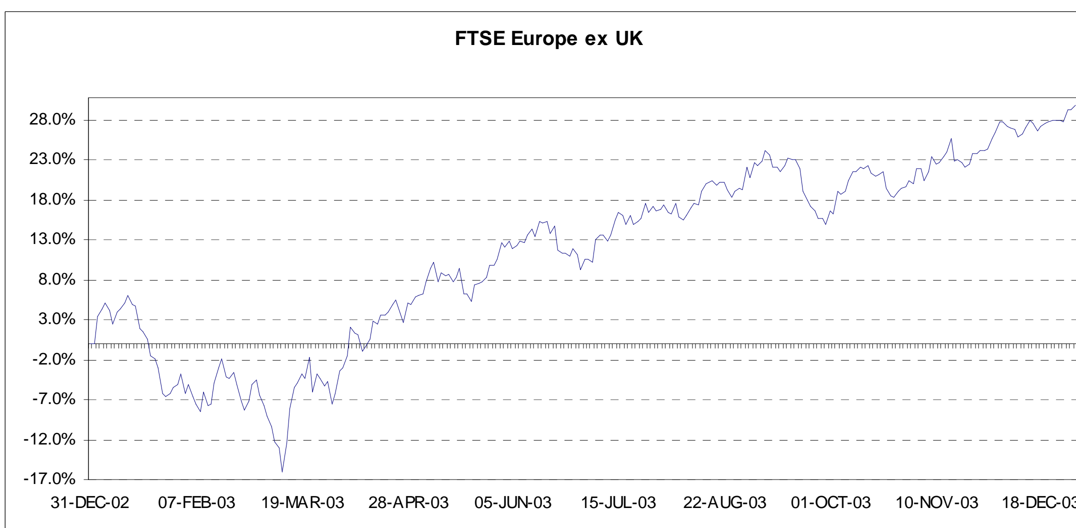
- UK Government Bond 10 Year Yield
- UK Index Linked Bond 10 Year Yields
- US Government Bond 10 Year Yields

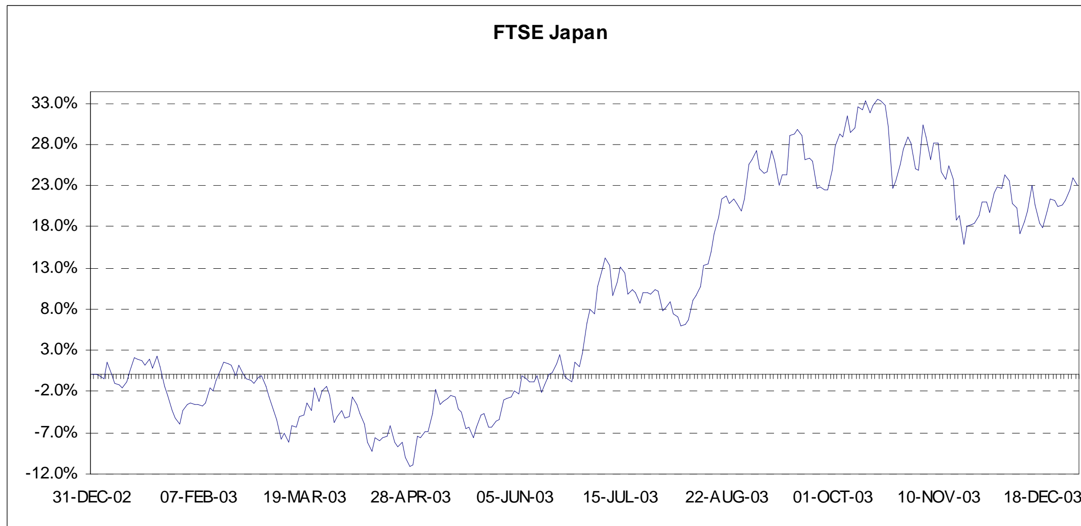





FTSE Small Cap
45.0%
40.0%
35.0%
30.0%
25.0%
20.0%
15.0%
10.0%
5.0%
0.0%
-5.0%
-10.0%
-15.0%
-20.0%
-25.0%
-30.0%
31-DEC-02
07-FEB-03
19-MAR-03
28-APR-03
05-JUN-03
15-JUL-03
22-AUG-03
01-OCT-03
10-NOV-03
18-DEC-03


TOT RET S&P 500 STOCK INDEX AGGREGATE TOT RETURN
20.6%
15.6%
10.6%
5.6%
0.6%
-4.4%
-9.4%
31-DEC-02
07-FEB-03
19-MAR-03
28-APR-03
05-JUN-03
15-JUL-03
22-AUG-03
01-OCT-03
10-NOV-03
18-DEC-03


FTSE Europe ex UK
28.0%
23.0%
18.0%
13.0%
8.0%
3.0%
-2.0%
-7.0%
-12.0%
-17.0%
31-DEC-02
07-FEB-03
19-MAR-03
28-APR-03
05-JUN-03
15-JUL-03
22-AUG-03
01-OCT-03
10-NOV-03
18-DEC-03


FTSE Japan
33.0%
28.0%
23.0%
18.0%
13.0%
8.0%
3.0%
-2.0%
-7.0%
-12.0%
31-DEC-02
07-FEB-03
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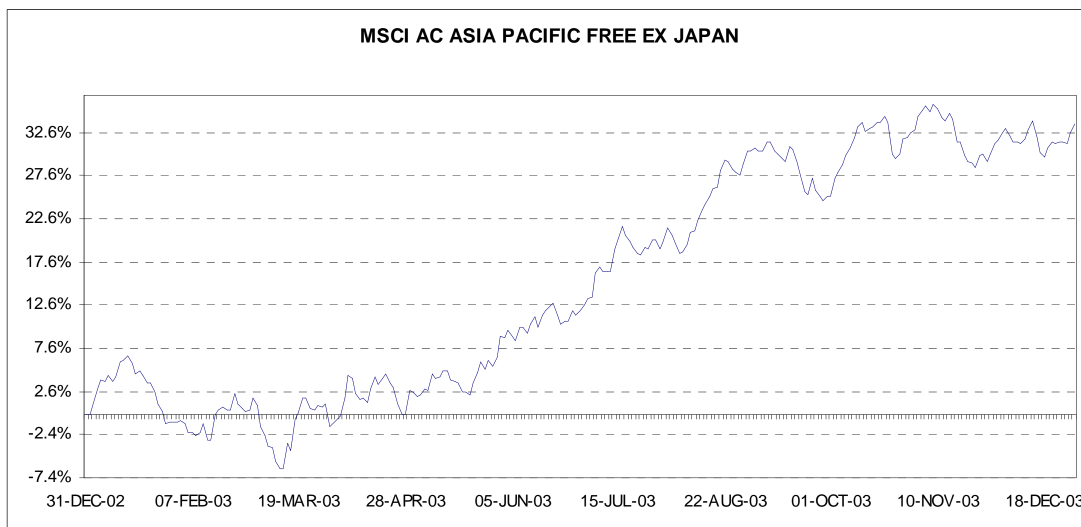
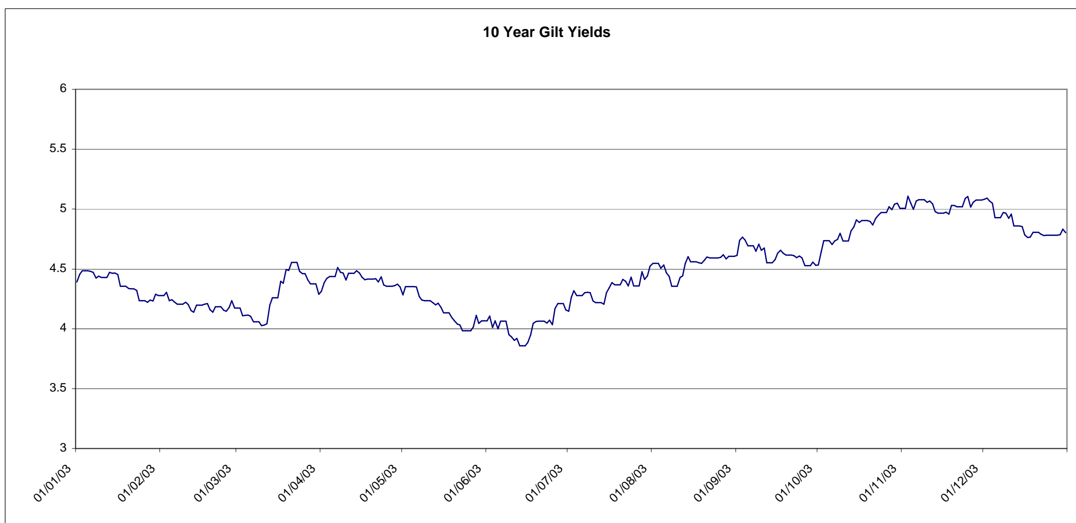
22-AUG-03
01-OCT-03
10-NOV-03
18-DEC-03


MSCI AC ASIA PACIFIC FREE EX JAPAN
32.6%
27.6%
22.6%
17.6%
12.6%
7.6%
2.6%
-2.4%
-7.4%
31-DEC-02
07-FEB-03
19-MAR-03
28-APR-03
05-JUN-03
15-JUL-03
22-AUG-03
01-OCT-03
10-NOV-03
18-DEC-03

Exchange Rate
U.S. Dollar per British Pounds
Weekly: Jan 3, 2003 - Dec 31, 2003
High: 1.7902
Low: 1.5611
Last: 1.7902
1.8000
1.7500
1.7000
1.6500
1.6000
1.5500
Jan
Feb
Mar
Apr
May
Jun
Jul
Aug
Sep
Oct
Nov
Dec

Exchange Rate
Euro per U.S. Dollar
Weekly: Jan 3, 2003 - Dec 31, 2003
High: 0.9600
Low: 0.7928
Last: 0.7928
0.9600
0.9400
0.9200
0.9000
0.8800
0.8600
0.8400
0.8200
0.8000
Jan
Feb
Mar
Apr
May
Jun
Jul
Aug
Sep
Oct
Nov
Dec


10 Year Gilt Yields
6
5.5
5
4.5
4
3.5
3
01/01/03
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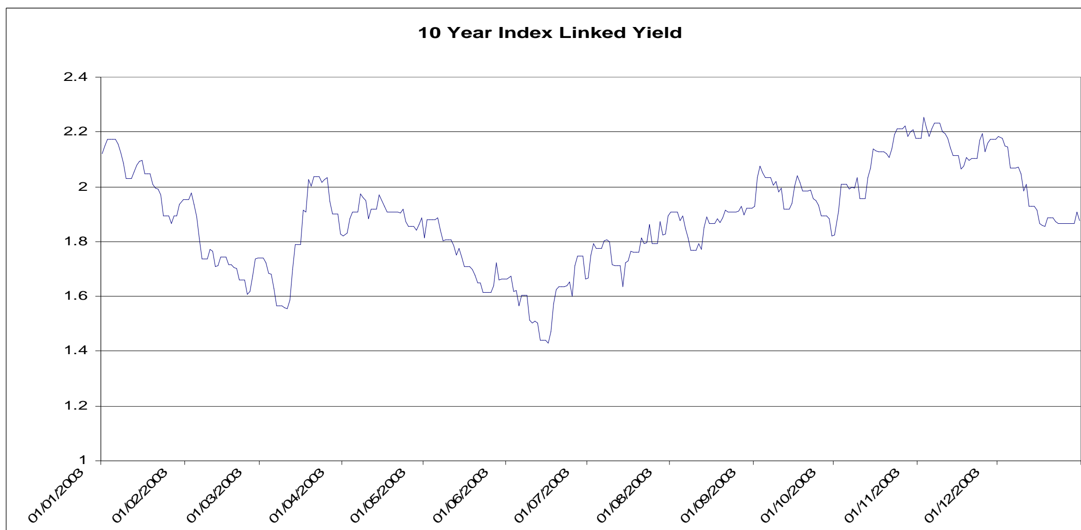
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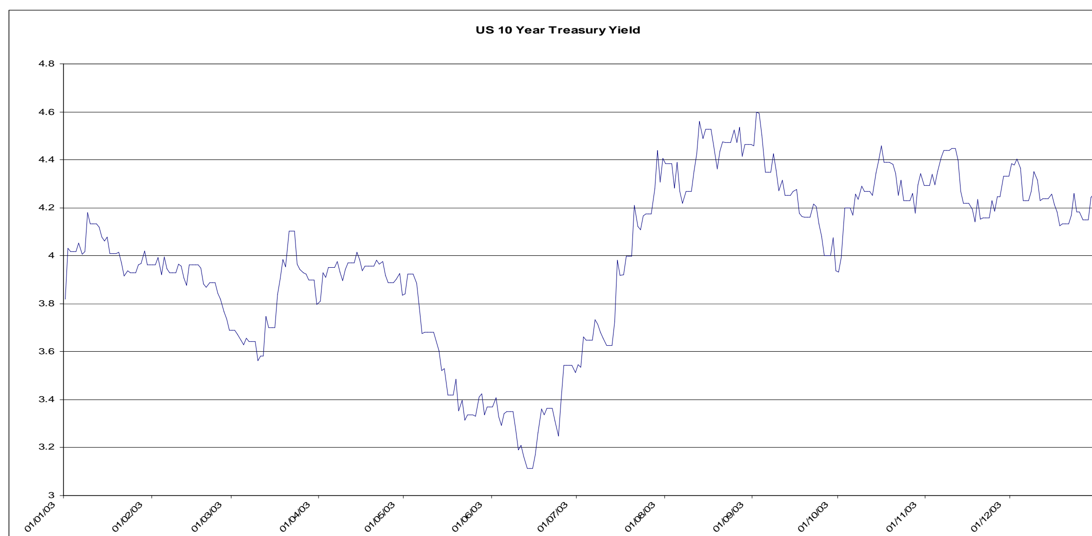

4) Employee Benefits

4.1) Catastrophe Risk

Post September 11th the insurance industry is looking increasingly at the risks presented by Catastrophic Events and is identifying ways to protect against the potential risk of insolvency. This is impacting terms offered by insurers and reinsurers for Group Life products in particular, especially where there is an obvious accumulation of risk e.g. large companies working in Canary Wharf.

The exact definition of what constitutes a Catastrophe will vary between insurers but will often involve reference to a specified number of deaths resulting from the same cause (or related cause) over a specified time period.

Many companies are now imposing maximum payouts in the event of a Catastrophe (Event Limits). Event Limits are determined by the postal location of the employees and the risk exposure of the insurer and reinsurer at that location. These Event Limits are often about £100M and mean that insurers will restrict the pay out to the Event Limit if the aggregate amount of the individual member benefits on death as a result of a Catastrophe exceeds the limit. If the Event Limit is breached then either individuals will receive reduced benefits on death as a result of a Catastrophe or employers will have to find the extra amounts required to bring individual benefits up to the level they would have been had the member died as a result of a non-catastrophic event.

In practice, these Event Limits are extremely large and the likelihood of them being breached is exceptionally small. There would never have been an event in the UK to date that would have given rise to a £100M Group Life liability. However, for the largest schemes the imposition of these Event Limits could theoretically severely reduce the amounts that employers receive in the event of multiple deaths from a Catastrophe. This potential exposure, no matter how remote, is one that concerns the Trustees of the Group Life schemes. In order to make sure that these limits could not significantly reduce their ability to pay benefits to those involved in a Catastrophe, the largest risks are being split between different insurers to maximise cover.

This means that the company will be more adequately covered in the event of a Catastrophe than had they insured all benefits with one insurance company.

It should be noted that often these limits are being imposed by insurers as their reinsurers are implementing Event Limits. If larger schemes do start to split their risk however between companies it will mean that reinsurers will have to be even more aware of the source of their risk since it may be the case that they reinsure more than one of the companies sharing the risk.

4.2) Tax Simplification

Following on from the publication of "Simplifying the taxation of pensions: increasing choice and flexibility for all" in December 2002, the government produced its proposals for simplifying the taxation of pensions in December 2003.

The aim of the new tax regime is to remove the obstacles to saving that exist as a result of the existing tax regime. They are seeking to improve individuals' understanding of the tax system and to make the system more transparent and flexible. The main impact out-with the pensions market itself is in the Group Life market.

The main proposal impacting life benefits is that members can now have tax-free lump sum benefits of up to £1.5m (known as the "Lifetime Allowance" (LTA)) in aggregate from registered schemes. Any lump sum in excess of the LTA will be heavily taxed at 55%.

This proposal would mean that there is no longer a maximum lump sum death benefit of four times salary (where the salary is restricted to the Earnings Cap) that can be taken tax-free. Also, since the earnings cap restriction will no longer apply the need for an Unapproved Group Life product to provide benefits above this cap will no longer exist.

It should be noted that Dependant's Death in Service Pensions (DISP) will not count towards the LTA. However, since these pensions are taxed as income in payment, a shift towards higher lump sum provision and lower pension provision may result with DISP only tax efficient for those high earners requiring benefits in excess of the LTA.

Although a shift from pension provision to lump sum provision may be desirable from a tax perspective for individuals, it will be interesting to see the reactions of employers to this. Employers may feel that they have a moral responsibility to ensure that dependants are adequately provided for life. The provision of a pension is an obvious way in which this can be done – a lump sum amount if invested inappropriately will not meet this need. As a result employers may still prefer some DISP provision.

A shift from pension provision to more lump sum provision by employers may cause some capacity issues within the insurance market. Employers who traditionally felt they could meet regular pension liabilities as part of their annual budget may not be so comfortable meeting the more significant and variable outflows associated with lump sum benefit payouts. As a result they may seek to insure these benefits. Are there a sufficient number of insurance companies with adequate capital to meet an increased demand for lump sum benefit provision?

The proposal also presents an issue over who should be checking aggregate benefit levels for individuals. The legal personal representative of an individual's estate is liable for the tax on any excess benefits above the £1.5 limit even although they do not necessarily receive any of the benefits (as these would normally be distributed by the trustees of the

Group Life schemes) – should this individual therefore be involved in the benefit provision stage?

Although benefits will in theory be unlimited, in practice insurers and reinsurers can be expected to continue to impose sensible limits on benefits in aggregate across a workplace and in relation to an individual's income. It is likely however, that individuals who were previously subject to an earnings cap would receive increased benefits as a result of the tax simplifications.

4.3) Critical Illness

The Critical Illness industry has seen significant market growth in recent years mostly on the back of the mortgage market as individuals and companies, to a lesser extent, become more aware of the need for benefits to help provide financial support for individuals and the families of these individuals on detection of a Critical Illness such as Heart disease or Cancer.

Recently however, there have been issues for insurance companies as to their ability to continue to provide Critical Illness cover on the same terms or rates. Medical advances have increased the detection of illnesses often only previously diagnosed after a person died. This has resulted in benefit payments where previously there would have been none. The success of NHS screening programs has meant that many more people are being diagnosed with these illnesses before they become fatal and hence benefit payouts have increased.

Medical advances have also led to an increase in the detection of conditions such as minor heart attacks. Such conditions may not lead to a significant change in lifestyle for an individual and in the past would have gone un-noticed but now if detected will merit a payout under a "Critical Illness" policy. Furthermore, some treatments covered under a Critical Illness policy, such as balloon angioplasty, are becoming more routine and accessible to patients. As a result the industry may have to consider changing Critical Illness definitions if the cost of cover is to be kept under control.

In response there has been a significant move away from Guaranteed rates in the individual market. Insurers and reinsurers are much more nervous about the risk of providing long term guarantees when incidence rates are linked in part to advances in medical science, the effects of which are exceptionally hard to predict. Such concerns do not exist to the same extent in the Group Risk market, as premium rates have been traditionally reviewable bi-annually.

4.4) Income Protection

From the 1st January 2004 the FSA have introduced new rules regarding the Solvency Margins that needs to be held for Income Protection business.

Previously insurers were required to hold a Solvency Margin equal to 4% of reserves. Under the new rules, this margin will now reflect a companies claims liabilities. Insurers will have to hold the higher of a margin based on premiums and one based on claims.

This increased provision will impact on the amount of capital required to support income protection business and in turn its profitability. Not all companies may be able to absorb this change within their existing margins and as a result we may see a hardening of income protection rates. In particular, if reinsurers react to this change by changing the terms that they offer, companies may be forced to review rates in line with reinsurer changes.

4.5) FSA Regulation of Non Investment insurance contracts

Currently non-regulated IFAs are permitted to sell Group Risk Business. From January 2005 only regulated IFAs will be able to conduct this business and non-regulated advisers will have to apply for authorisation before then to allow them to continue selling and advising on this type of business. Advisers currently authorised to give advice on investment business will need to apply to have their authorisation extended to cover non-investment business before January 2005.

The final FSA rules for non-investment business have now been published and present a better picture for group risk business than previously anticipated. A new definition of group policy has been created enabling for the first time group income protection products to be differentiated from individual protection.

There is however, still some uncertainty around the treatment of group polices taken out by employers where the employees pay or contribute towards the cost. There is a possibility that the FSA may require members of such schemes to be treated as retail customers. As a result insurers would have to issue Key Features type documents pre-sale and cancellation notices post-sale to scheme members who contribute to the cost of their benefits. Discussions are still ongoing, however, whatever the outcome, the sales process for group protection is likely to change and as a result so too may the distribution profile of this type of business.

4.6) Age Discrimination

The government consulted for the first time last year on age discrimination. In order to comply with the EU Directive, Age Discrimination legislation must be implemented in the UK by the end of October 2006. As a result, draft regulations are expected early 2004.

The regulations are expected to apply to, amongst other groups, Employers and Trade Unions. Since Insurers provide benefits to these groups they could be seen to be actively encouraging discrimination if the benefits provided to these groups apply age restrictions.

The main change for the insurance industry will be the potential removal of a normal retirement age. This has different effects on the various Group Risk products.

The repercussions for Group Life are minimal when compared with those for products such as Income Protection and Critical Illness.

The consultation paper recognised that for defined benefit pension schemes an age for funding purposes would still be necessary and under the proposed rules, it will still be permissible to fund for a particular level of pension at a certain age. However, to date no such agreement has been reached on a similar practicable stance for Group Income Protection. The presence of a maximum age up to which benefits will be paid is a vital part of income protection. With no such maximum age, and increasing longevity, the cost of providing income protection could become prohibitively expensive.

Providing critical illness benefits to working individuals at older ages will present a similar problem. What will companies' attitudes be to the price discrimination between old and young employees? Will the market for Group Critical Illness drop?

To make matters worse from a direct insurer's point of view these restrictions will not apply to reinsurers. The "distance" in relationship between scheme members and reinsurers means that the restrictions do not apply to them and hence direct insurers could be left with an unwanted non-reinsurable risk.

The insurance industry is currently lobbying so that proposed rules adequately reflect industry requirements without leaving employers exposed to claims of discrimination.

4.7) Disability Discrimination Bill

This bill removes insurance companies exemption from the existing disability discrimination legislation. Insurers will however only be held liable for any discrimination resulting from their direct actions.

This could cause a narrowing of disability definitions within income protection products. For example, conditions incorporating subjective symptom exclusions could effectively be prohibited by the new bill.

4.8) Employment Equality – Sexual Orientation

Regulations have been introduced to outlaw direct and indirect discrimination on account of sexual orientation. Currently this does not prevent employers from providing benefits based on marital status only (e.g. Spouse Death in Service Pensions). However if an employer chooses to provide a dependant's death in service pension benefit then they are no longer permitted to restrict this to opposite sex dependants only.

4.9) Civil Partnership Proposals

There are proposals to give live-in partners the same legal status as married ones. The result of this will be that providers may need to introduce an additional category of Group Life pensions benefits covering both Spouses & Civil Partners. Alternatively, they may need to widen the existing Spouses category to include Civil Partners. As a result, as more pensions would now be due on death than before, rates changes may be required.

4.10) New Pensions Bill

The main change affecting employee benefits business is the change to the LPI basis. This will increase the number of benefit tranches and may lead to system changes and more detailed explanation being demanded by clients.

4.11) EU Directives

There are a number of potential EU directives that could have a direct or indirect impact on group risk products.

The proposed EU Gender directive would prevent insurers from differentiating between males and females in pricing decisions. This could have wide ranging consequences for the insurance industry. The impact on individual risk products could be significant as there are currently sizeable differences in rates between males and females. For group risk the impact may be more manageable for larger schemes where there is a stable mix

of genders. However margins may still need to be increased to guard against selection. The ABI and other industry bodies are currently lobbying against this proposal on the basis that there is a significant body of evidence to suggest that gender is a valid risk factor.

The EU Directive on Agency Working would bring in similar employment rights for agency workers as currently exist for fixed term employees. It is uncertain whether it would be the obligation of the agency to provide these benefits or whether this would fall on the employer. This may depend on where the contractual obligation lies. In either case there would be an increase in the number of employees qualifying for group risk products, with the additional complication of the administration of another class of members and a potential impact on rates/terms available for contracts such as group income protection.

Additional directives that would have a lesser impact include: The Pension Directive, the Distance Marketing Directive and the Unfair Commercial Practice Directive.