FASS
Current Topics
2005

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TABLE OF CONTENTS

Investments

1. General overview of 2004
2. The year ahead
3. Current investment related topics
4. Charts

Life Assurance

1. Regulatory issues
2. Accounting Standards
3. Market / Pricing issues
4. New business statistics
5. References

General insurance

1. IFRS 4 – Impact on the General Insurance industry.
2. The Implications of the Policy Statement 04/16 on the Implementation of the ECR and ICA for General Insurers.

Pensions

1. Introduction
2. Pensions Statistics
3. Pensions Act 2004
4. Finance Act 2004
5. Guidance Note Changes
6. Pensions Regulations Changes
7. Accounting for Pension Expense
8. OPRA updates / guidance
9. Other issues

Other

1. The Morris Review
2. With profits bonds - Maybe the grass isn't greener…

PART ONE - INVESTMENTS

1. General overview of 2004

i. Global equities
ii. Bond markets
iii. UK equities
iv. Overseas equities
v. UK commercial property

2. The year ahead

i. Growth & inflation forecasts
ii. US twin deficits and the dollar
iii. Chinese growth & renminbi

3. Current investment related topics

a. Equities

i. CP176 and Commission Unbundling
ii. International Financial Reporting Standards (IFRS)
iii. Sarbanes-Oxley Act of 2002
iv. Split Capital Investment Trust (Splits) Crisis

b. Bonds

i. Possible introduction of ultra long conventional and index-linked gilts
ii. Longevity bonds
iii. Index-linked gilts
iv. Collateralised Debt Obligations (CDO's)

c. Property

i. Property Investment Funds (PIF's)
ii. Property Derivatives

4. Charts

i. UK equities, price, PE and dividend yield charts
ii. UK gilt yields, yield curves and overseas government bond yields charts
iii. Overseas equity market price charts
iv. Trade-weighted sterling and various exchange rate charts
v. Gold & oil price

Section 1 : General Overview of 2004

Global Equities

Global equities rose over 2004, with the total return FTSE World index climbing by 12.3% in local terms and 8.2% in sterling terms during this period. Most of these gains came during the beginning and the tail-end of 2004, with stock markets trading sideways in between.

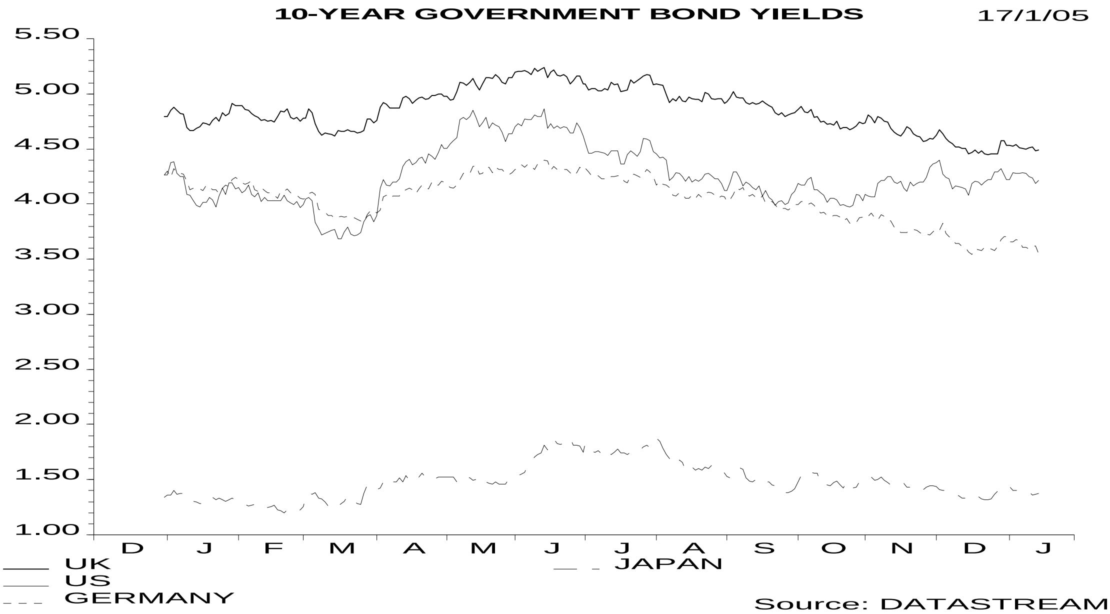
The low interest rate, low inflation, global economic environment has been generally supportive for equities. Also, investor sentiment also took an upturn following the US general election.

However, an increase in terrorist activity and renewed unrest in the Middle East continued to cause some uncertainty over the last year. Unprecedented demand for oil from China, combined with fears about supply, caused a sharp jump in oil prices, with the price of crude oil surpassing $50 per barrel. However, the price has since fallen back somewhat.

In currency markets, a weak US dollar staged something of a recovery at the start of 2004, aided by strong US economic data. However, concerns over the US current account deficit have led to the dollar falling significantly further against the euro and sterling towards the end of the year.

	2004 Local Total Returns (%)	**2004 £ Total Returns (%)**
FT All-Share	12.8	12.8
S&P 500	10.9	3.4
FTSE World Europe (ex UK)	13.0	13.8
Topix	11.3	8.6
MSCI Pacific (ex Japan)	25.4	20.8
MSCI Emerging Markets	16.5	17.4

Bond Markets



Bond markets came under heavy selling pressure in March and April as strong US economic data led to fears that US interest rates would soon rise. Indeed, this turned out to be the case. The Federal Reserve voted for a 0.25% increase on 30 June 2004 and then lifted the borrowing rate to 2.25% with further increases in August, September, November and December.

Although there have been concerns that interest rates will rise rapidly, the Fed reassured investors somewhat by stating that any further rate rises would be conducted at a “measured” pace. Furthermore, some mixed economic data and a lack of inflationary pressures then proved positive for bond markets and, as a result, they have generally performed well over the second half of 2004.

Meanwhile, the European Central Bank (ECB) has maintained interest rates at 2% over the last year - the lowest rate since the euro’s introduction. In the UK, an upturn in economic data and the spendthrift attitude of British consumers led to 0.25% rate rises in February, May, June and August. The UK borrowing rate now stands at 4.75%.

	2004 £ Total Returns (%)
FTA British Government Fixed Interest All Stocks	6.6
FTA British Government Index Linked All Stocks	8.5
JPM Global Government Bonds (ex UK)	2.5
Cash	4.4

Equities – UK

The FTSE 100 index has risen by 8% over the last year. Strong economic data and encouraging trading updates from several British companies have helped drive the market forward. In recent months, Reuters, Yell and Tesco are among those to announce outstanding results.

Takeover activity – both actual and rumoured – has been a positive factor. For example, the takeover of Abbey by Spain's Santander Central Hispano is the largest European cross-border banking deal. Oil stocks have also been particularly beneficial in helping lift the FTSE 100 index, as the high oil price has benefited BP and Shell.

Source: DATASTREAM

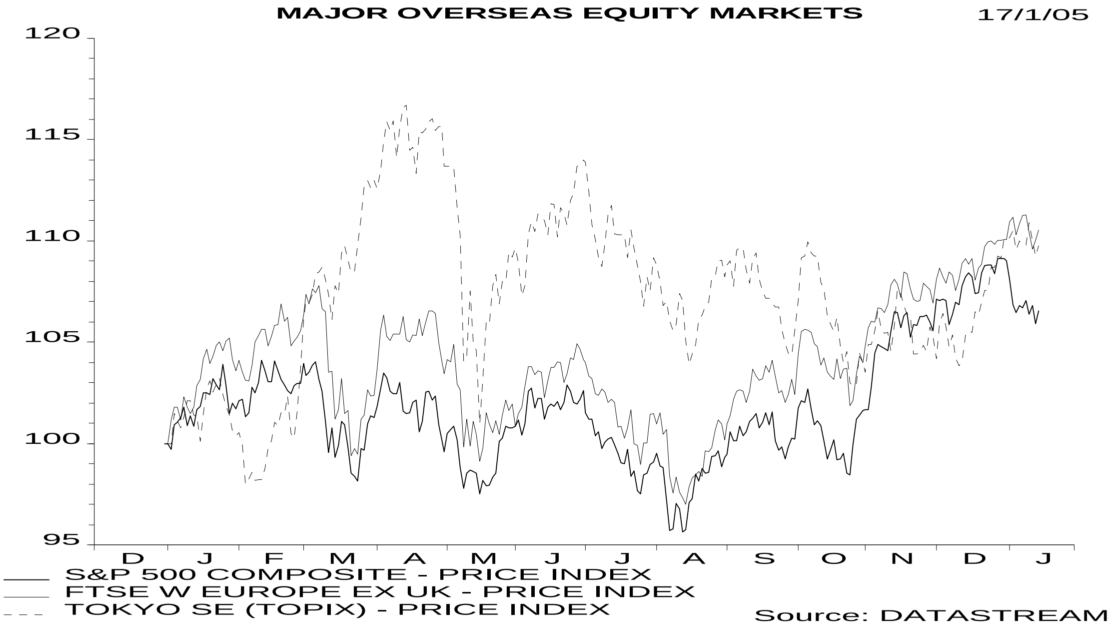
Equities – Overseas

The period under review has been generally positive for US equities. The stock market has gained ground, largely on the back of strong company results and optimism that economic growth is recovering.

Recent corporate results have provided evidence that companies are managing to increase profits at a healthy rate. However, the rate of profits growth does appear to be slowing slightly.

As a result, some analysts suspect current levels of profitability could be approaching a peak. President Bush's recent re-election provided the thrust for a small market rally, with the release of some upbeat economic data also driving the market forward.

Overall, the Standard and Poor's Composite price index advanced by 9% over the last year.

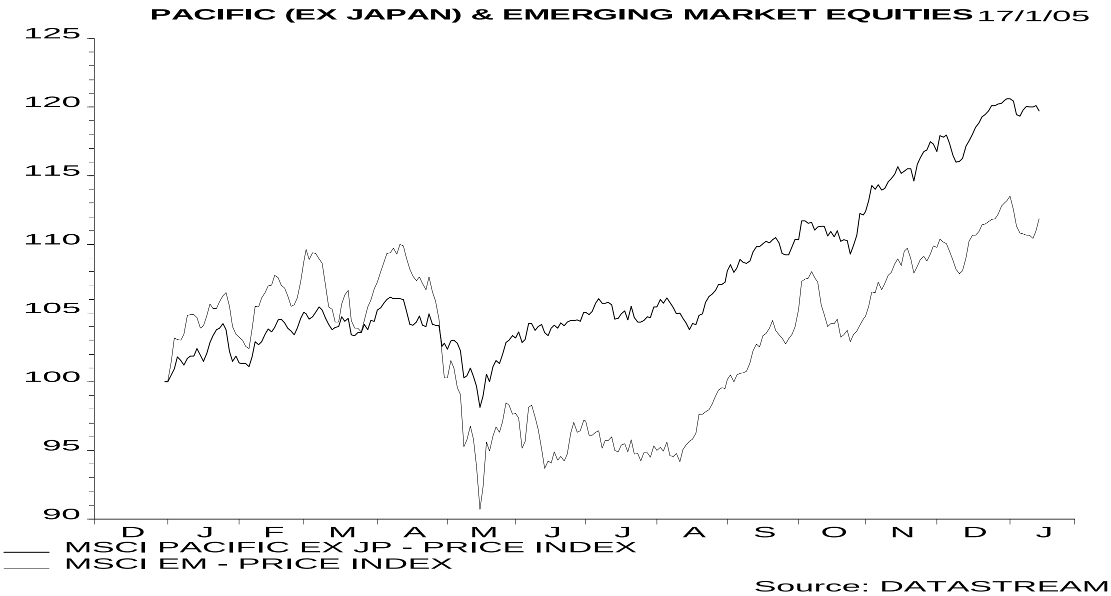


European equities fared reasonably well over the last twelve months after rebounding from long-term lows in 2003. Markets in the region enjoyed a positive start to 2004, with an improvement in the fortunes of Europe's economy feeding through to corporate profits.

European companies are managing to grow profits at an impressive rate and, with the region still in the early stages of economic recovery, European equities have been attracting the attentions of foreign investors. However, the Madrid bombings in March caused a sharp sell-off and recent data showing that the economy may be struggling to gain momentum is of some concern. Nevertheless, European equities have risen by 10% over the last twelve months.

Overall, Japan's Topix index has risen by 10% during the period under review. The improving global economic outlook and signs that Japan is finally ridding itself of deflation have been the main stimuli for the stock market, with foreign investors buying back particularly heavily into Japanese equities. However, domestic demand for equities has been generally weak throughout and there have been some recent concerns about the sustainability of the country's economic recovery. A major focus for Japanese investors has been the battle between Sumitomo Mitsui Financial and Mitsubishi Tokyo Financial for control of UFJ, which would create the world's largest bank, with about US$1,700bn of assets.

In Asia-Pacific, markets have moved ahead over the last twelve months. Improving global economic conditions have been beneficial for exporters, while China's phenomenal growth rate has helped buoy economies throughout the region. The economic impact of the recent tsunami, which ravaged shorelines in countries around the Indian Ocean, is likely to be acute on a local basis but national economies, such as those of Indonesia and Thailand, are not expected to be severely affected in the long term.



UK Commercial Property

Commercial property delivered another year of strong performance over 2004. Despite weak, though improving, fundamentals, total returns were 19% for the last year, the strongest for a number of years. Overall, property has benefited from a favourable supply and demand backdrop.

Given the more stable economy, with less 'boom and bust', demand for property has been more resilient. Also, this time around supply and demand are more in equilibrium as over supply of new speculative property is not so much of a problem.

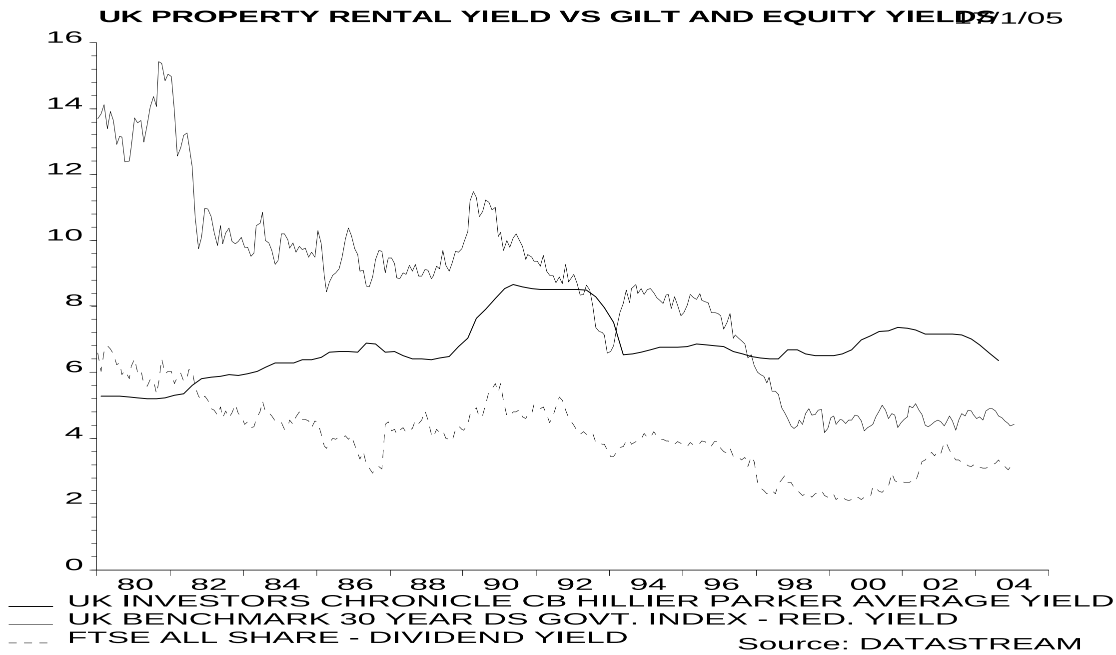
	2004 Total Local Return (%)
UK Investment Property Databank (IPD)	19.0

Although there are distinct signs of a recovery in some areas of the market, which is pushing up rents, recent performance has primarily been yield driven on the back of the weight of money flowing into the asset class. This has had the effect of pushing up capital values.

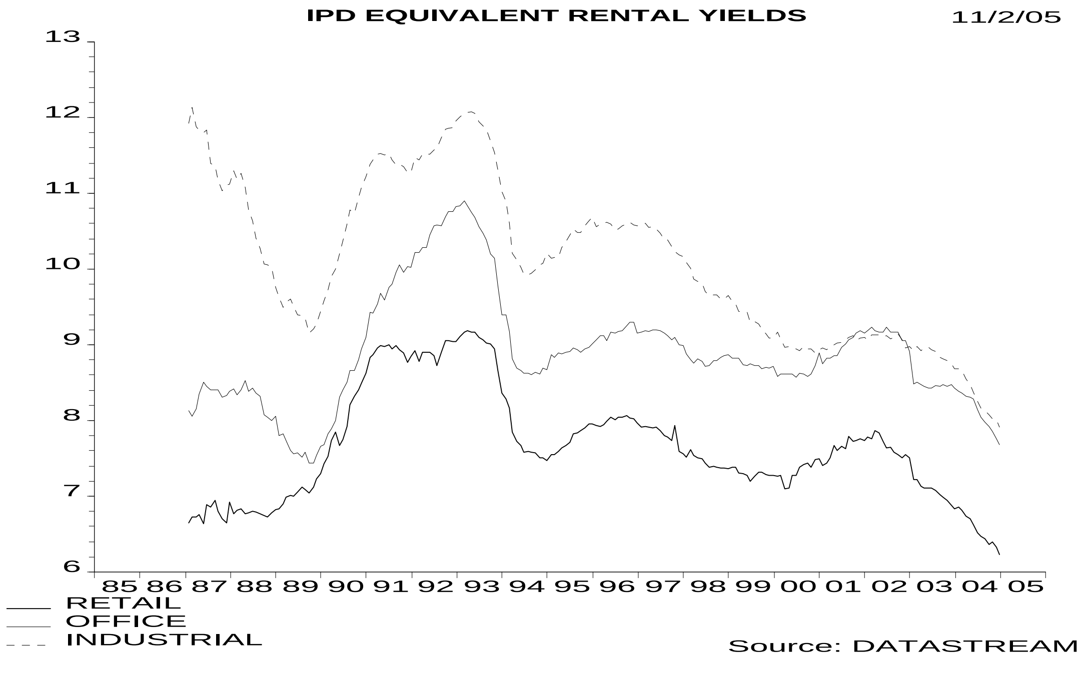
There is still interest from private investors but at lower levels than previously as a result of the lower arbitrage possibilities now present in the property market. Institutional interest, though, is increasing as the prospect of rental recovery improves.

Investment interest is unlikely to dissipate over the near term. Property will likely remain less volatile than most other asset classes. Its defensive attributes, relatively high yield plus security of income, are highly valued by investors. However, a question mark hangs over whether the 5-yearly upward only rent reviews will be scrapped by the government, who are concerned UK companies are suffering as a result.

On a medium-term view, commercial property might be expected to perform somewhere between the equity and gilt markets. Future levels of returns from commercial property, however, are unlikely to be as high as in the recent past.



Retail has been the best performing property sector over the last three years, but the improving financial services outlook is likely to benefit the office sector in the coming months and, after a couple of years of significant underperformance, offices should start to deliver improved returns from 2005.



Section 2 : The Year Ahead

Consensus Growth & Inflation Forecasts

GDP growth is forecast to decelerate in the major developed countries/regions in 2005. For example, in the US growth is expected to slow from 4.4% last year, to 3.5% this year as personal consumption and business investment moderate. Growth is also expected to slow a little further in 2006 in the UK and US, but to pick-up in Euroland and Japan - helped by stronger personal consumption.

Consensus GDP Growth Forecasts (%)			
	2004 est	**2005 est**	**2006 est**
UK	3.1	2.5	2.4
US	4.4	3.5	3.4
Euroland	2.0	1.7	2.0
Japan	2.9	1.1	1.8

Source : Consensus Economics, February 2005

Meanwhile, consumer price inflation in the US and Euroland is also expected to slow in 2005 and again in 2006 - helped by an expected downward correction in the oil price from recent peaks and the slowing economic growth backdrop. Meanwhile the new measure of UK consumer price inflation is expected to rise in 2005 and 2006. For Japan, it is expected that Japanese inflation will at last turn slightly positive in 2006.

Consensus Inflation Forecasts (%)			
	2004 est	**2005 est**	**2006 est**
UK	1.4	1.7	1.8
US	2.7	2.4	2.2
Euroland	2.1	1.8	1.7
Japan	0.0	0.0	0.3

Source : Consensus Economics, February 2005

Overall, several structural factors, such as the IT revolution, deregulation and competition from cheaper Chinese goods have generally been responsible for the benign inflation backdrop. Furthermore, the increased credibility of central banks also means inflation expectations have been lower than otherwise.

US Twin Deficits and the Dollar

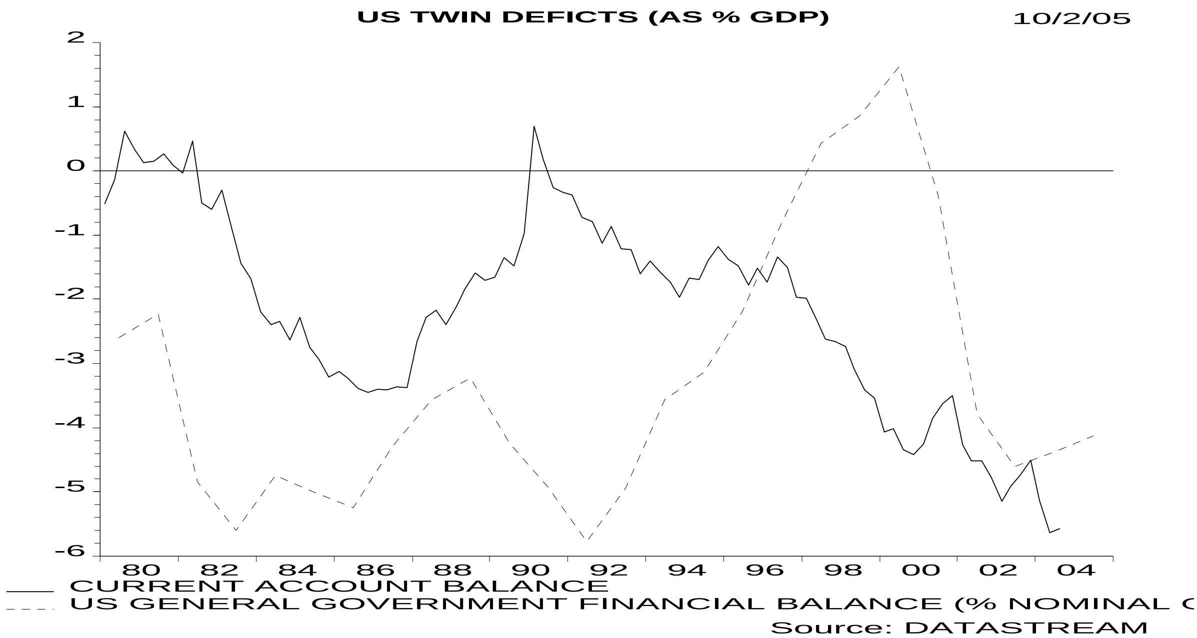
A question mark continues to hang over the sustainability of the large US current account deficit – now currently close to 6% GDP (approx. $600Bn). As the US trade-weighted dollar has fallen by approximately 25% since end-2001, with little improvement in the current account deficit position, the focus has now turned to the government budget deficit.

This was prompted by Alan Greenspan's speech at the end of last year and subsequent comments by Treasury Secretary Snow and President Bush in January 2005.

The current account balance can be defined as the difference between national (private and public) savings and national investment. Given the relationship, a tighter fiscal policy could potentially be an important factor in reducing the current account deficit also.

However, what is the chance of a meaningful reduction in the budget deficit going forward? The 2004 budget deficit of around 3.5% will be the highest since 1992. The US administration have already announced it's FY 2005 estimate amounts to only a marginally smaller share of GDP. Beyond 2005, the outlook is more uncertain. The FY 2006 budget published in early 2005 suggests a deficit above $400Bn (compared to estimates of $412Bn in 2004 and $427Bn in 2005).

Therefore, with little sign of the budget deficit being reduced significantly over the next couple of years, the pressure on the downside to the dollar could remain a feature. With China unlikely to revalue the renminbi to any great extent (see next section), this implies the overvalued euro and sterling may continue to take the strain against the dollar.



Chinese Growth & Renminbi

Consensus forecasts suggest China's growth rate will slow from an estimated 9.5% in 2004, to 8.4% in 2005 and 7.8% in 2006. [1]Last year, high demand for power caused some local governments to ask companies to shift production from daytime to overnight, as power grids were overloaded.

These energy bottlenecks contributed to restrictions being placed on lending on some forms of investment, thereby causing a slowdown in money supply growth, investment intentions and consumption. As China is a major source of demand for

[1] See "Market Cycles – A little trouble in big China" – Bijal Shah, Dhaval Joshi, Chris Mellor (SG) 14 January 2005.

raw materials, there is a risk that recent buoyant industrial commodity prices may fall if China keeps policy tight, as witnessed by the recent fall in money supply (see chart below). Since the middle of last year, China's visible trade balance has moved sharply into surplus, due to a slowdown in imports – which some are pointing to as a further indication that China's domestic demand may be cooling.

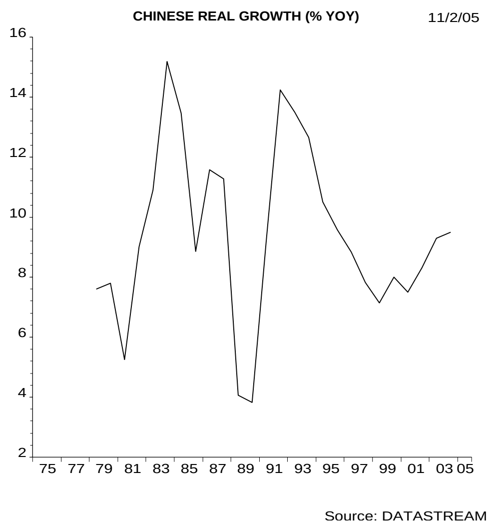
	2004 Total $Return (%)
Reuters CRB Commodity Futures Index	11.2

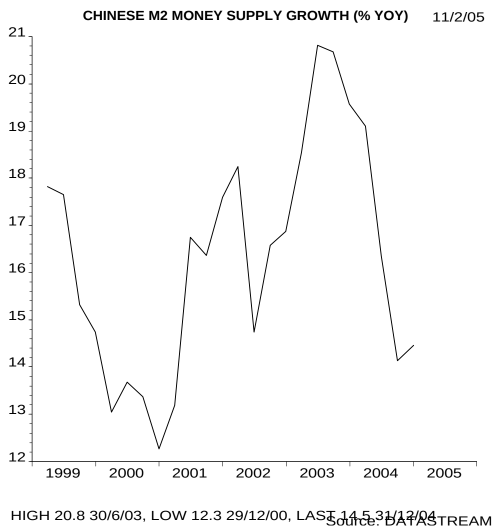
It looks unlikely we will see any major revaluation this year, if any, of the renminbi which has been pegged for a decade against the US dollar (Rmb 8.276 - Rmb 8.28). Any small revaluation could further encourage more speculative capital on heightened expectations of further renminbi appreciation, giving rise to higher foreign exchange reserves.

This in turn could boost the money supply, causing higher inflation and excessive bank lending. The US would clearly like to see the renminbi appreciate against the dollar in order to help its burgeoning trade and current account deficit position and stem unrest that China is stealing US jobs. However, as stated last year by Li Ruogu (deputy governor of the People's Bank of China), America's current account deficit problem lies with its lack of saving, not the renminbi.

[2]Some observers have also claimed it is a myth that China's large and growing trade surplus proves the renminbi is undervalued, pointing out that China's overall trade surplus was a modest $32Bn - very small compared to America's trade deficit of $600Bn. They also point out that China's surplus with the US (approx. $80Bn) is offset by a deficit (approx. 100Bn) with other Asian countries from which it imports capital and equipment components.

They claim further that a 10% revaluation in the renminbi and all other Asian currencies would only result a fall in the dollar's trade weighted index of about 4% - nowhere near enough to reduce the US deficit substantially, all other things equal.





[2] See article "Economics focus – Yuan step at a time" – The Economist, 22 January 2005. See also "To Be a Rock and Not to Roll" – Stephen King (HSBC) January 2005.

Section 3 : Current Investment Related Topics

Equities

CP176 and Commission Unbundling

In May 2004, the FSA set out its findings on soft and bundled brokerage commissions in policy statement PS 04/13. This concluded that fund managers' use of commission should be limited to the purchase of 'execution' and 'research', and the FSA committed to clarifying the scope of these terms.

In November 2004, the Financial Services Authority (FSA) published a supplementary policy statement (PS 04/23) which sets out its views on 'non-permitted services', 'execution' and 'research'. They hope this will assist the industry to continue its progress towards a market-based solution to the transparency and accountability issues raised by soft and bundled brokerage commissions.

'Non-permitted services' were expanded to include valuation and performance measurement services; dedicated telephone lines; subscriptions for publications; most custody services; and travel, accommodation or entertainment costs.

'Execution' is deemed to include execution services such as the booking and processing of orders; related costs arising from trading activities which would constitute active order management, i.e. advice on order handling, program trades etc.

'Research' is deemed to embody the concept of rigorous, 'value-added' analysis, with clear intellectual content that assist fund managers to make investment decisions in relation to their clients' portfolios. Research will include original written research, discussions between fund managers and research providers and possibly 'artificial intelligence'. This will not include raw data feeds.

The 'industry' (Investment Management Association (IMA), National Association of Pension Funds (NAPF) and the London Investment Banking Association (LIBA)) has taken up the challenge to develop improved disclosure on the costs to clients of 'execution' and 'research'. The industry promised to provide proposals on disclosure to the FSA by the end of 2004. The FSA plans to consult on the issue in spring 2005.

International Financial Reporting Standards (IFRS)

[3]What is IFRS 2005? From 1 January 2005 over 7,000 listed companies in the EU must report using the standards issued by the International Accounting Standards Board (IASB). These are either called International Accounting Standards (IAS) or more recently International Financial Reporting Standards (IFRS). The move to IFRS actually goes beyond the EU since several other countries are also mandating an equivalent move, and outside Europe there is increasing adoption of IFRS. For example, Australia will also adopt IFRS in 2005. In all, post 2005 there will be over 90 countries that either mandate IFRS, permit domestic companies to use IFRS or base local accounting standards on the IFRS rules and over 1 million individual companies using IFRS. In March 2004 the IASB published what it termed the 'stable platform' of standards to be used in 2005. However, the standards that must be applied by EU

[3] Source: UBS's "IFRS 2005: A guide for Portfolio Managers" dated 14 January 2005

companies have to be endorsed by the European Commission; a process that has not been a formality. Will all European companies face changes?

Some European companies already report under IFRS – about 10% of the Eurotop 300 companies, but less than 5% of all EU listed companies. Although for these the impact of IFRS will be more limited, their financial statements will still change in 2005 as a result of recent amendments to IFRS accounting. **For example, from 2005 stock options must be expensed and goodwill is no longer amortised.**

The adoption of IFRS in Europe is perhaps the most significant and dramatic change in accounting ever seen. For some companies the impact on their financial statements will be modest, but for others almost all line items in the income statement and balance sheet, and also many of the subtotals within cash flow statements, are liable to change and this could have a material impact on key performance metrics.

Sarbanes-Oxley Act of 2002

Sarbanes and Oxley are US senators who introduced a bill to tighten the internal controls of US listed firms. In effect companies are required to report on their internal controls against fraud. The bill was introduced in reaction to scandals such as Enron.

President Bush called the Act's provisions "the most far reaching reforms of American business practices since the time of Franklin Delano Roosevelt". The Act will have a significant impact on the reporting practices of public companies, or their senior management and boards, on the accounting and legal professions, and on stock analysts.

Section 404 of the Sarbanes-Oxley Act (US) applies to all companies listed in the US. Under this section of the Act, Management must assess the effectiveness of the internal control structure and procedures which impact financial reporting.
This reporting methodology came into effect from April 2004 for US domestic Registrants, and, is scheduled to come into effect from July 2005 for foreign companies with US listings.

At the time of writing however (February 2005), the Securities and Exchange Commission(SEC) is examining a delay that would mean foreign companies with US listings would not have to comply with section 404 until 2006.

Among other things, the Act:

- Requires that a company's audit committee be comprised of independent directors and enhances the powers and responsibilities of the audit committee;
- Obliges CEOs and CFOs to certify their company's financial statements and provides criminal sanctions for false certifications;
- Requires attorneys who represent public companies to report evidence of securities law violations to a company's chief legal counsel or CEO and, if those officers do not take appropriate action, to the company's audit committee, its independent directors or the board of directors as a whole;
- Requires public companies to make rapid disclosure of material changes in their financial condition and to report all material off-balance sheet transactions,

arrangements, obligations and other relationships that might have a material current or future effect on the financial health of the company;

- Requires corporate directors, principal stockholders and officers to disclose transactions in their company's securities within two business days;
- Creates a "Public Accounting Oversight Board" to regulate the accounting profession;
- Prohibits an accounting firm that audits a public company from contemporaneously providing certain non-audit services to the same company, and requires that non-audit services not specifically prescribed by statute be approved by a company's board of directors;
- Increases SEC funding by over $300 million, and authorises the SEC to censure any person appearing or practising before the Commission; and lengthens the statute of limitations for securities fraud suits.

Split Capital Investment Trust (Splits) Crisis

On 24 December 2004 the Financial Services Authority (FSA) announced that eighteen firms had agreed to contribute to a package of approximately £194M for investors. The FSA has made no determination of regulatory breaches or imposed any penalties on the firms.

Andy Adams of Edinburgh University has kindly provided the following description of how the 'splits' crisis came about[4].

The aggressive pursuit of fees by certain fund management companies and broker/advisers drove them to launch new split capital investment trusts[5] ("splits") that exploited the retail demand for high yield in the environment of falling interest rates of the late 1990s.

This led in many cases to substantial bank debt financing and investment in the ordinary income shares of other splits. Thus, the need for ever-more demanding starting yields for income-bearing shares and gross redemption yields for zero dividend preference shares ("zeros") caused the promoters of splits to devise increasingly aggressively structured funds that did not fully take account of possible stock market conditions.

The impact of falling markets from 2000 accompanied by equity dividend cuts led to collapsing market prices and dividend cuts for the income-bearing shares of many splits. The substantial cross-holdings then caused dividend cuts to compound themselves across a section of the splits sector, and share prices fell yet further.

Even the market prices of a number of zeros fell sharply, a type of share that had generally been sold as low risk. By the end of 2001, desperate measures were being taken to save many of the new splits and the FSA started to take a much keener interest. Confidence in splits then collapsed and many private investors incurred significant financial losses.

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[4] Andy Adams has recently edited a book on the subject: "The Split Capital Investment Trust Crisis" available on Amazon.

[5] A split capital investment trust is one with more than one main class of share capital. However, in everyday usage, the term is often taken to include investment trusts with substantial levels of bank debt.

Bonds

Possible Introduction of Ultra-Long Conventional & Index-Linked Gilts

Informal dialogue between the UK's Debt Management Office (DMO) and several pension industry participants last summer suggested that demand for high-quality bonds from the UK pension industry and other investors is likely to increase in the future.

Various reasons include; demographic trends; closer matching of assets and liabilities reflected in a shift from equities to bonds in pension portfolios; the likely shift from Defined Benefit to Defined Contribution schemes will increase demand for annuities.

In December's Pre-Budget Report 2004, the Chancellor asked the DMO to consult market participants (by 21 January 2005) on the possible introduction of additional gilt instruments, specifically:

- Ultra-long (circa 50-year) conventional and index-linked gilts; and
- Ultra-long (circa 50-year) conventional and index-linked annuity type gilts.

Rather than paying semi-annual interest followed by a 'bullet' repayment on the maturity date, a conventional annuity type gilt would make a regular fixed payment that would include both interest and some repayment of the principal.

The DMO's "Issuance of ultra-long gilt instruments Consultation Document" dated 2 December 2005 also shows that initial consultation proposed that the issuing of index-linked bonds with limited price indexation properties (LPI bonds). However, this was rejected on the grounds they are likely to appeal to only a limited group of investors and may lead to fragmentation of the gilts market with a resulting loss of liquidity.

Longevity Bonds

In December, the Governor of the Bank of England called on the Treasury to consider issuing "longevity bonds" as a way to tackle Britain's pension crisis. It was proposed that private annuity providers could use them to hedge aggregate longevity risk. The return from longevity bonds would be contingent on a reference population's longevity. This proposal was formalised in the UK Debt Management Office's (DMO's) "Issuance of ultra-long gilt instruments Consultation Document" dated 2 December 2005.

The proposal was welcomed by the actuarial profession but warned they could represent a risk to future generations of taxpayers, as it would involve the government in underwriting longevity risk.

Index-Linked Gilts

The DMO also announced that new index-linked gilts issued from 2005-06 will use 3 as opposed to the current 8-month indexation lag to the RPI. This reflects the adoption of a 3-month lag as current international best practice. The indexation methodology and relevant formulae are shown in the UK Debt Management Office's (DMO's) "Issuance of ultra-long gilt instruments Consultation Document" dated 2 December 2005.

Collateralised Debt Obligations (CDO’s)

During the last several years, Collateralised Debt Obligations (CDO’s) have gained popularity as an asset class. CDO’s were a natural development in securitisation, first introduced in 1988. In broad terms, in all these structures a portfolio of securities is transferred to a special-purpose vehicle (SPV) which in turn issues tranches of securities of different seniority to investors in the capital market, to fund the purchase of the portfolio.

The term CDO has evolved in recent years into a generic name for securitisations of assets such as collateralised mortgage obligations (CMO’s), collateralised loan obligations (CLOS’s) and collateralised bond obligations (CBO’s)). Originally CDOs were developed as repackaging structures for high-yield bonds and illiquid instruments such as certain convertible bonds, but they have developed into sophisticated investment management vehicles in their own right.

Through the 1990s CDOs were the fastest growing asset class in the asset-backed securities market, due to a number of features that made them attractive to issuers and investors alike. A subsequent development dating back to 1997 was the synthetic CDO.

The main difference between a cash and synthetic CDO is that in the latter, no transfer of securities takes place, with the underlying reference pool of assets remaining on the balance sheet of the originator. Instead, the CDO’s collateral pool consists of credit derivatives, usually in the form of credit default swaps, although these can also be total return swaps.

Property

Property Investment Funds (PIF's)

In May of last year, the Royal Institute of Chartered Surveyors (RICS) reported that the property industry was jubilant at the prospect of the government introducing Property Investment Funds, or PIF's for short. The March 2004 Budget at last gives the UK property industry what it has wanted for so many years: the prospect of a tax-transparent property investment vehicle.

The current consultation paper, Promoting More Flexible Investment in Property: a Consultation (HM Treasury), issued by the government at the last Budget, calls the putative new vehicle a Property Investment Fund, or PIF. The UK is the only G7 country without them and some readers may be more familiar with the principle via its well-established US counterpart, the Real Estate Investment Trust, or REIT.

So, why do we need a PIF, REIT or whatever we decide to call it? The answer is that the tax regime in Britain has made it virtually impossible to extend the benefits of investing in commercial property to a wide range of individuals and smaller pension funds. Not only has this deprived investors of access to a stable and generally well-performing type of asset, but it has also limited the flow of investment funds into the buildings that British industry and commerce need to operate efficiently.

The investment market has been largely limited to institutional investors or property companies that are large enough to buy and manage whole properties that may individually have a value of many millions of pounds.

Individuals and institutions can, of course, invest via listed property investment companies. But for companies, rental income that comes through as profit is subject to corporation tax at 30 per cent. Thus investors receive only £7 for every £10 of rents that the companies pull in. The missing £3 cannot be reclaimed by the investors even if - like a pension fund - they are not liable for tax.

Property Derivatives

In late 2002, the Financial Services Authority (FSA) agreed that life insurance companies can include property derivatives based on the Investment Property Databank (IPD) index when they calculate their solvency ratios. Until the decision in December 2002, property derivatives were not "admissible assets" for solvency purposes, which inhibited their development.

Currently, only one such instrument exists, Barclay's Property Index Certificates (PIC's), the first of which was issued in 1994. At present, the FSA decision covers only simple forward contracts and swaps, rather than more exotic contracts such as options, which could potentially be developed later.

In a simple derivative product such as a PIC, the issuer (in this case Barclays) offers, say, £100M of PIC's which will pay a return equivalent to the IPD Annual Index total return over the life of the PIC (typically 3, 5 or 7 years). In this instance, the certificates would be backed by £100M of property from the seller of the risk, which receives interest (less a margin) for the life of the PIC.

The seller is able to free up capital for short-term investment elsewhere, while retaining its property exposure. The PIC buyers get exposure to the property market and Barclays take a margin. The beauty is that no physical buying and selling of property takes place, saving on transaction costs. Also, no stamp duty is payable.

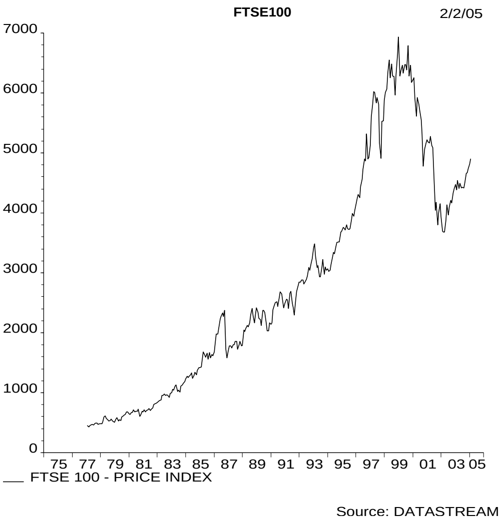
More recently however[6], two unnamed UK companies have recently set in motion what some are referring to as the first true derivatives market for property exposure. The derivatives contract between a life assurance firm and a property company works on a similar principle to those in which investors buy/sell equity and currency derivatives.

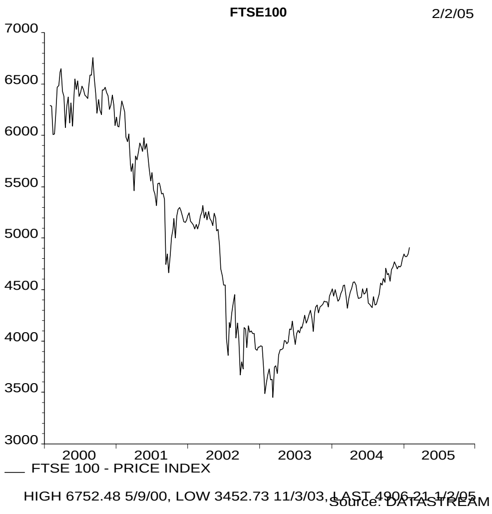
In this particular instance, the property company wanted to increase exposure whereas the life assurer wanted to reduce exposure for the same amount. The property derivatives allow the market participants to take a view on physical property without the expensive fees of property transactions.

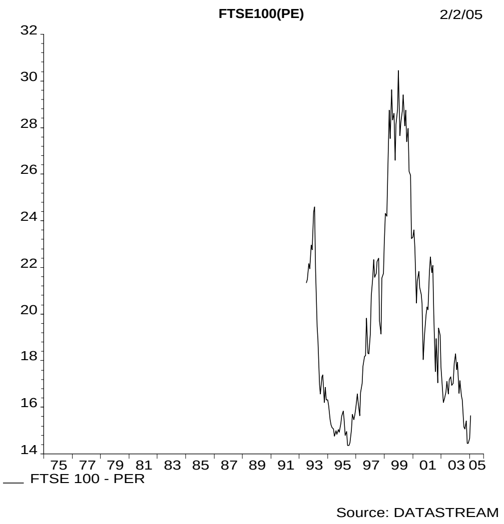
No money will initially change hands, but the firms will settle up at the end of each year. Any future property derivatives market is most likely to be used by big companies and investment funds, although some observers question whether it will be possible to find enough buyers and sellers at the same time.

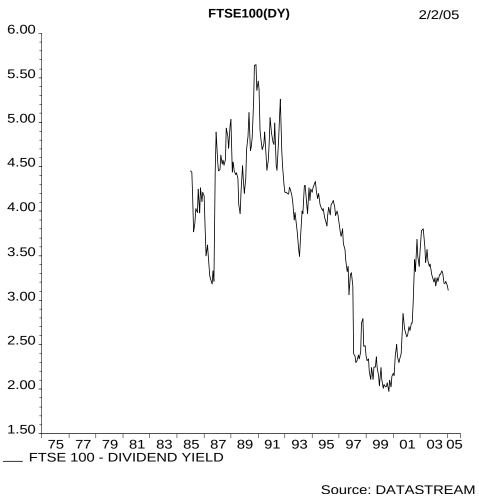
[6] See BBC internet news article "Firms 'lay wager' on UK property" article of 14 January 2005. http://news.bbc.co.uk/1/hi/business/4175159.stm

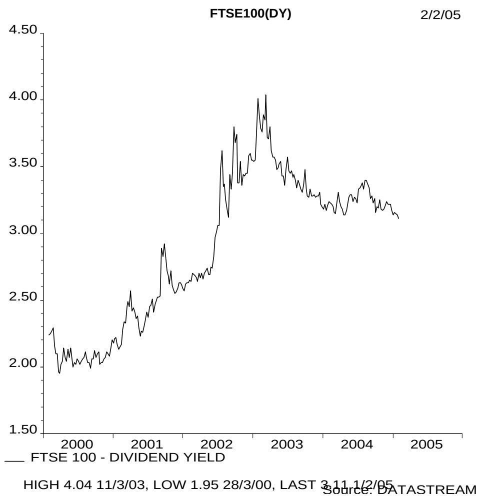
Section 4 : Charts

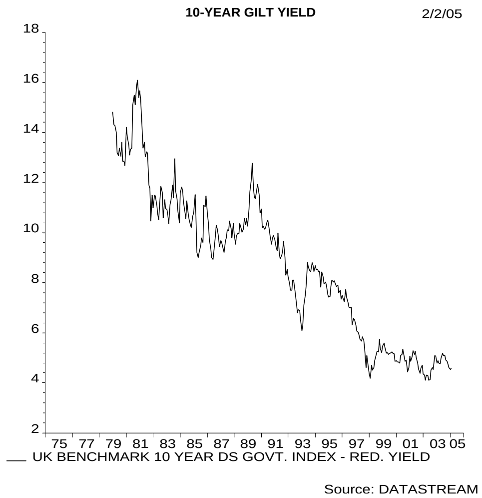











10-YEAR GILT YIELD
2/2/05
18
16
14
12
10
8
6
4
2
75 77 79 81 83 85 87 89 91 93 95 97 99 01 03 05
UK BENCHMARK 10 YEAR DS GOVT. INDEX - RED. YIELD
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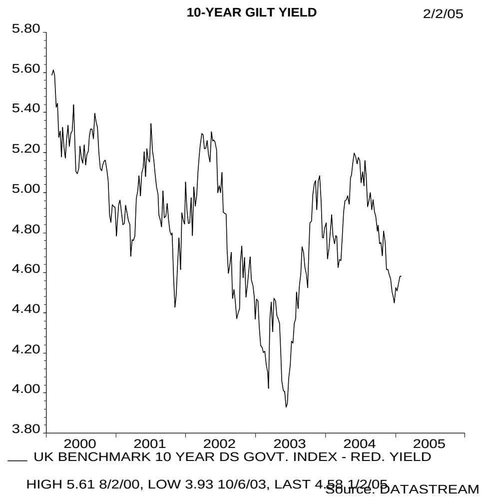
10-YEAR GILT YIELD
2/2/05
5.80
5.60
5.40
5.20
5.00
4.80
4.60
4.40
4.20
4.00
3.80
2000 2001 2002 2003 2004 2005
UK BENCHMARK 10 YEAR DS GOVT. INDEX - RED. YIELD
HIGH 5.61 8/2/00, LOW 3.93 10/6/03, LAST 4.58 1/2/05
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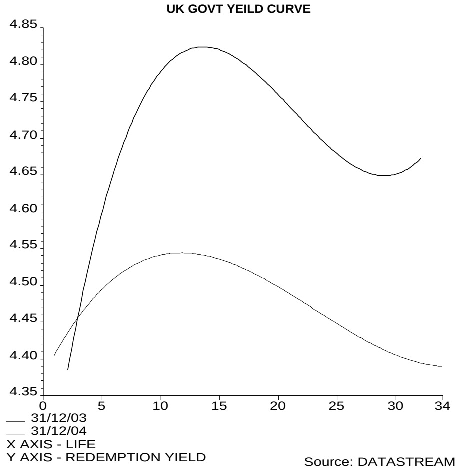
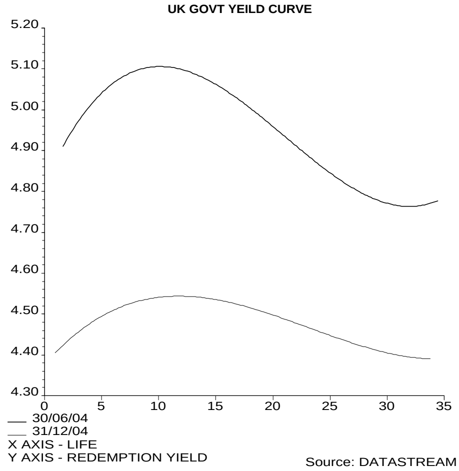

UK GOVT YEILD CURVE
4.85
4.80
4.75
4.70
4.65
4.60
4.55
4.50
4.45
4.40
4.35
0 5 10 15 20 25 30 34
31/12/03
31/12/04
X AXIS - LIFE
Y AXIS - REDEMPTION YIELD
Source: DATASTREAM


UK GOVT YEILD CURVE
5.20
5.10
5.00
4.90
4.80
4.70
4.60
4.50
4.40
4.30
0 5 10 15 20 25 30 35
30/06/04
31/12/04
X AXIS - LIFE
Y AXIS - REDEMPTION YIELD
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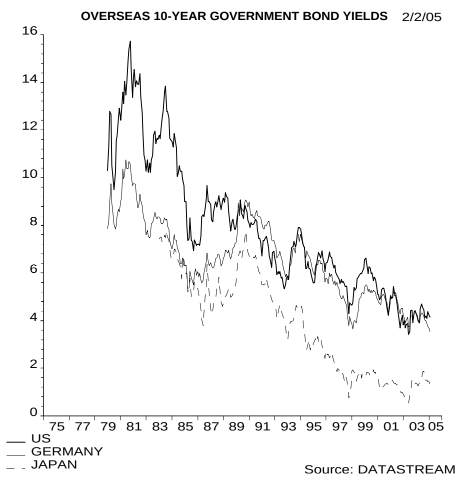
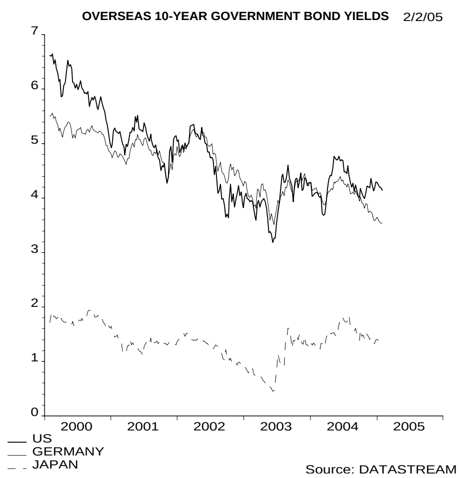
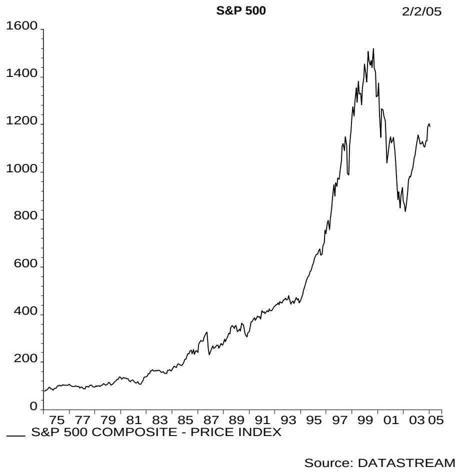

OVERSEAS 10-YEAR GOVERNMENT BOND YIELDS
2/2/05
16
14
12
10
8
6
4
2
0
75 77 79 81 83 85 87 89 91 93 95 97 99 01 03 05
US
GERMANY
JAPAN
Source: DATASTREAM


OVERSEAS 10-YEAR GOVERNMENT BOND YIELDS
2/2/05
7
6
5
4
3
2
1
0
2000 2001 2002 2003 2004 2005
US
GERMANY
JAPAN
Source: DATASTREAM


S&P 500
2/2/05
1600
1400
1200
1000
800
600
400
200
0
75 77 79 81 83 85 87 89 91 93 95 97 99 01 03 05
S&P 500 COMPOSITE - PRICE INDEX
Source: DATASTREAM


S&P 500
2/2/05
1600
1500
1400
1300
1200
1100
1000
900
800
700
2000 2001 2002 2003 2004 2005
S&P 500 COMPOSITE - PRICE INDEX
HIGH 1509.84 29/8/00, LOW 797.70 23/7/02, LAST 1189.41 1/2/05
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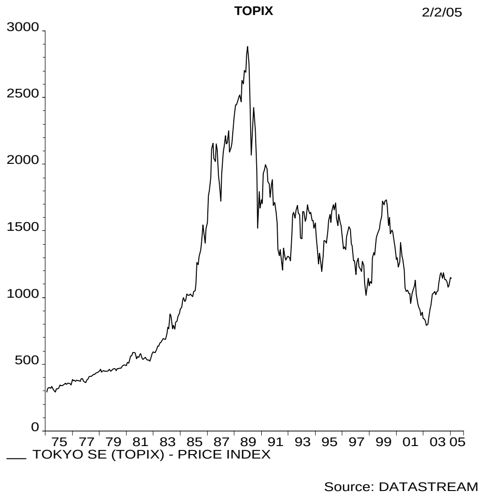
TOPIX
2/2/05
3000
2500
2000
1500
1000
500
0
75 77 79 81 83 85 87 89 91 93 95 97 99 01 03 05
TOKYO SE (TOPIX) - PRICE INDEX
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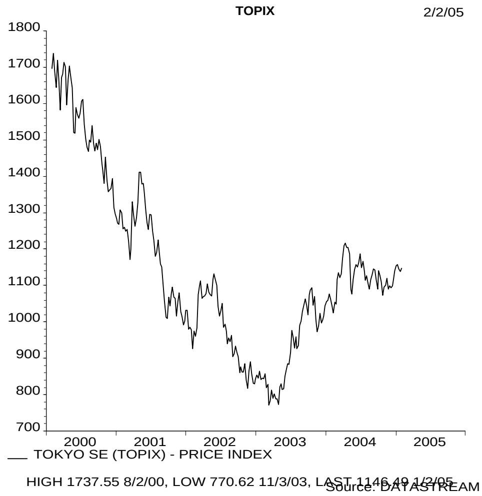
TOPIX
2/2/05
1800
1700
1600
1500
1400
1300
1200
1100
1000
900
800
700
2000 2001 2002 2003 2004 2005
TOKYO SE (TOPIX) - PRICE INDEX
HIGH 1737.55 8/2/00, LOW 770.62 11/3/03, LAST 1146.49 1/2/05
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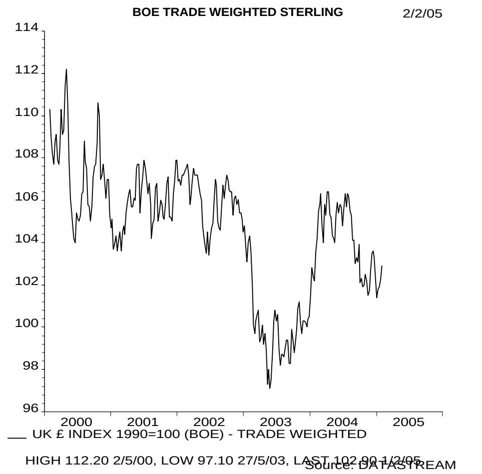
FT/S&P EUROPE (EX UK)
2/2/05
500
450
400
350
300
250
200
150
100
50
75 77 79 81 83 85 87 89 91 93 95 97 99 01 03 05
FTSE W EUROPE EX UK - PRICE INDEX
Source: DATASTREAM


FT/S&P EUROPE (EX UK)
2/2/05
500
450
400
350
300
250
200
150
2000 2001 2002 2003 2004 2005
FTSE W EUROPE EX UK - PRICE INDEX
HIGH 449.20 5/9/00, LOW 179.52 11/3/03, LAST 289.78 1/2/05
Source: DATASTREAM


BOE TRADE WEIGHTED STERLING
2/2/05
140 130 120 110 100 90 80
75 77 79 81 83 85 87 89 91 93 95 97 99 01 03 05
UK £ INDEX 1990=100 (BOE) - TRADE WEIGHTED
Source: DATASTREAM


BOE TRADE WEIGHTED STERLING
2/2/05
114 112 110 108 106 104 102 100 98 96
2000 2001 2002 2003 2004 2005
UK £ INDEX 1990=100 (BOE) - TRADE WEIGHTED
HIGH 112.20 2/5/00, LOW 97.10 27/5/03, LAST 102.90 1/2/05
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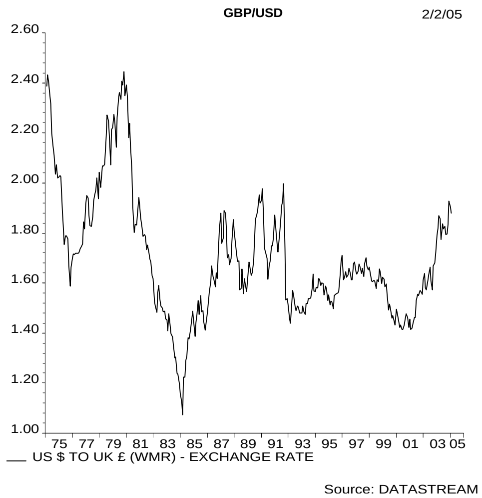
GBP/USD
2/2/05
2.60 2.40 2.20 2.00 1.80 1.60 1.40 1.20 1.00
75 77 79 81 83 85 87 89 91 93 95 97 99 01 03 05
US $ TO UK £ (WMR) - EXCHANGE RATE
Source: DATASTREAM


GBP/USD
2/2/05
2.00 1.90 1.80 1.70 1.60 1.50 1.40 1.30
2000 2001 2002 2003 2004 2005
US $ TO UK £ (WMR) - EXCHANGE RATE
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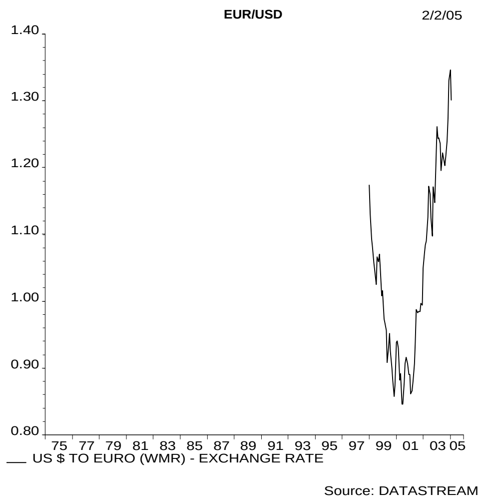
Source: DATASTREAM


EUR/USD
2/2/05
1.40 1.30 1.20 1.10 1.00 0.90 0.80
75 77 79 81 83 85 87 89 91 93 95 97 99 01 03 05
US $ TO EURO (WMR) - EXCHANGE RATE
Source: DATASTREAM


EUR/USD
2/2/05
1.40 1.30 1.20 1.10 1.00 0.90 0.80
2000 2001 2002 2003 2004 2005
US $ TO EURO (WMR) - EXCHANGE RATE
HIGH 1.36 28/12/04, LOW 0.84 24/10/00, LAST 1.30 1/2/05
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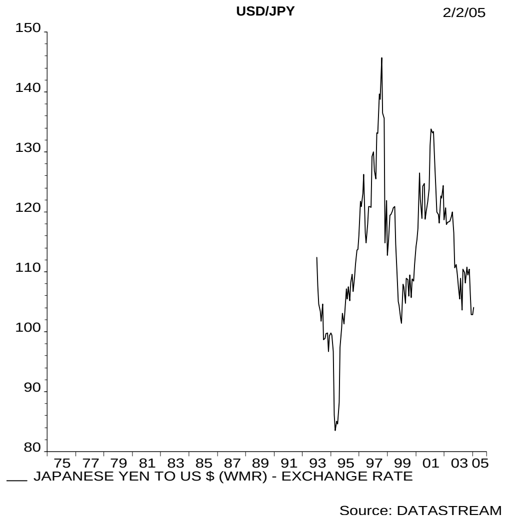
USD/JPY
2/2/05
JAPANESE YEN TO US $ (WMR) - EXCHANGE RATE
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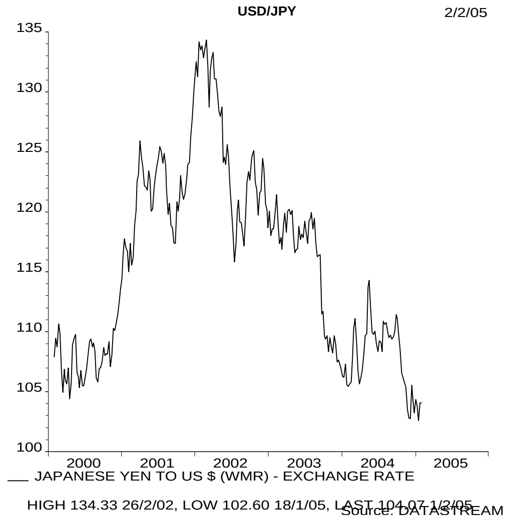
USD/JPY
2/2/05
JAPANESE YEN TO US $ (WMR) - EXCHANGE RATE
HIGH 134.33 26/2/02, LOW 102.60 18/1/05, LAST 104.07 1/2/05
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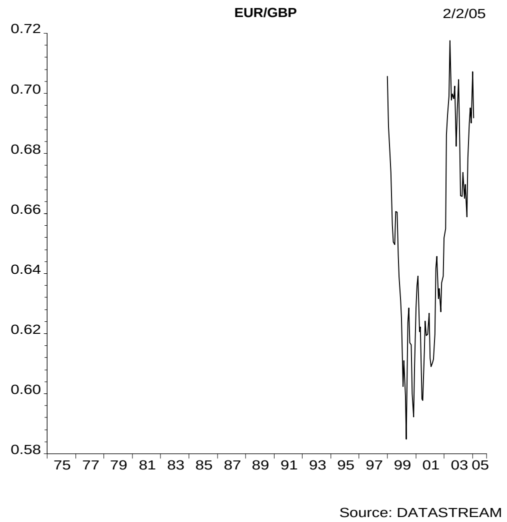
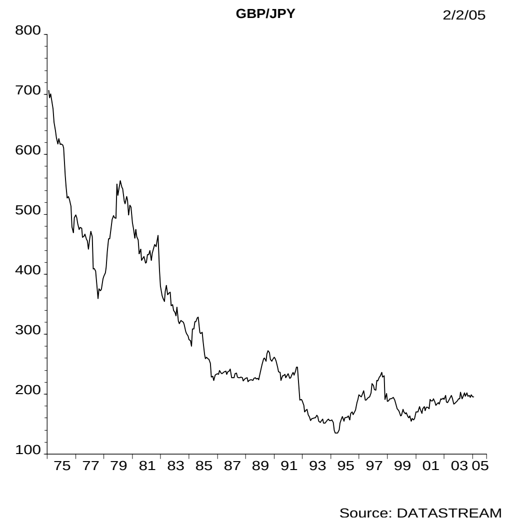
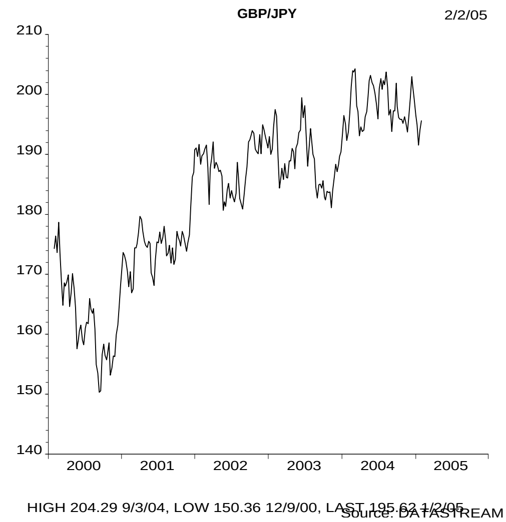

EUR/GBP
2/2/05
Source: DATASTREAM


EUR/GBP
2/2/05
HIGH 0.72 27/5/03, LOW 0.58 24/10/00, LAST 0.69 1/2/05
Source: DATASTREAM


GBP/JPY
2/2/05
Source: DATASTREAM


GBP/JPY
2/2/05
HIGH 204.29 9/3/04, LOW 150.36 12/9/00, LAST 195.62 1/2/05
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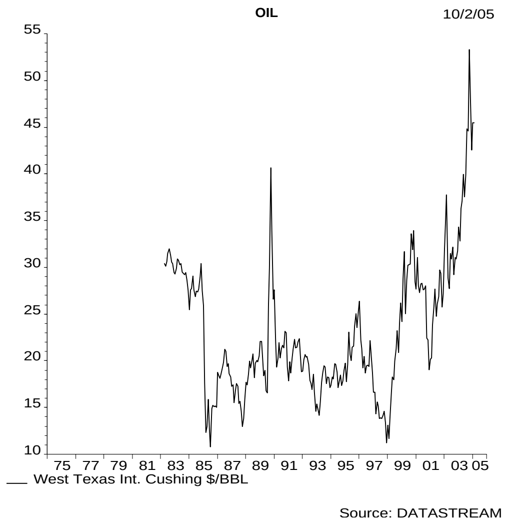
OIL
10/2/05
55
50
45
40
35
30
25
20
15
10
75 77 79 81 83 85 87 89 91 93 95 97 99 01 03 05
West Texas Int. Cushing $/BBL
Source: DATASTREAM


OIL
10/2/05
60
55
50
45
40
35
30
25
20
15
2000 2001 2002 2003 2004 2005
West Texas Int. Cushing $/BBL
HIGH 54.92 20/10/04, LOW 18.38 12/12/01, LAST 45.46 9/2/05
Source: DATASTREAM


GOLD
10/2/05
800
700
600
500
400
300
200
100
75 77 79 81 83 85 87 89 91 93 95 97 99 01 03 05
Gold Bullion $/Troy Ounce
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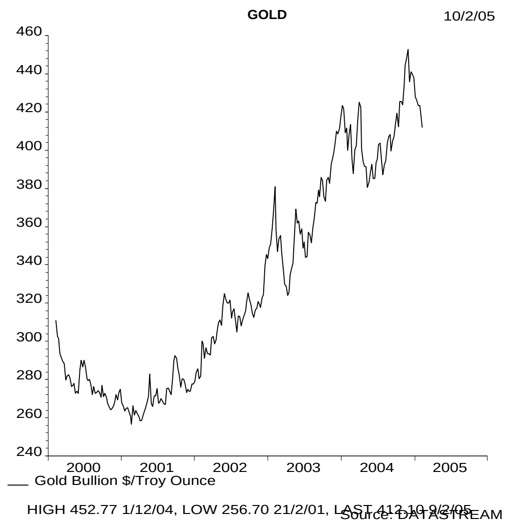

GOLD
10/2/05
460
440
420
400
380
360
340
320
300
280
260
240
2000 2001 2002 2003 2004 2005
Gold Bullion $/Troy Ounce
HIGH 452.77 1/12/04, LOW 256.70 21/2/01, LAST 412.10 9/2/05
Source: DATASTREAM

PART TWO - LIFE ASSURANCE

2.1 REGULATORY ISSUES

The FSA continued with their deforestation programme with the issue of a number of consultation papers and policy statements (in particular PS04/16 with its 362 pages making CP195 look like light reading!). The highlight for the last 12 months was the implementation of the Prudential Sourcebook. Other notable events were the issue of final rules and guidance on the role of actuaries in life assurance, the re-consultation on treating With-profits policyholders fairly and depolarisation & the menu.

2.1.1 Prudential Sourcebook

The rules and text for PS04/16 was finalised in November 2004 and came into force on 31st December 2004 meaning that the annual returns for 2004 will be based on the new rules. The Prudential Sourcebook includes details on:

- The ICAS framework
- The “twin peaks” approach
- Prudential systems and control requirements
- New capital adequacy rules

The “twin peaks” approach was covered in depth in 2004’s current topics paper and we have chosen not to repeat this topic this year. However, it is worth noting that the Faculty and Institute have introduced a number of new guidance notes to help actuaries working in this area.

This new “twin peaks” approach will be used for the 2004 annual returns and will for the first time be in the public domain. Interestingly, this first public disclosure coincides with equity volatility being at a particularly low level as at year end and this may have a significant impact on the results of the realistic valuation of liabilities.

2.1.2 Individual Capital Assessments

There are three key acronyms within this new framework. They are:

- Individual Capital Adequacy Standard (ICAS). This is the framework which sets out the key rules and principles for calculating……
- …..Individual Capital Assessments (ICA). These are internal, company specific calculations, determined in accordance with the ICAS framework. The result is the amount of capital the firm has determined that it needs to cover the specific risks within its business. This ICA has to be submitted to the FSA for review and potential discussion / debate.
- Individual Capital Guidance (ICG). The FSA will give each firm individual capital guidance reflecting their own view of what adequate capital should be for the firm’s particular business.

With effect from 1st January 2005, firms needed to be in a position to explain to the FSA how they have carried out their Individual Capital Assessments (ICAs). However, in this initial period of implementation, the FSA plan to give firms three months' notice of a requirement to send them the ICA (with documentation) for review. This process of review has now commenced, but it is expected that the review process may well take 2 ½ years to complete. Indeed, a recent letter from the FSA to the ABI has re-iterated the 2 ½ year target to complete the review and highlighted that there is a scheduled timetable for reviewing ICAs. The letter has asked for companies not to send in their ICAs before a request for submission is made by the FSA!

The FSA have clarified a number of key items within the framework since the early consultation paper. In particular, they have clarified that although firms must set their own risk of ruin, the ICG will be based on a 99.5% confidence level over a one year period. The FSA have also noted that instantaneous shocks are OK for now and therefore a one year value-at-risk approach can be used.

The FSA have also clarified what the implications of falling below the level of capital indicated by the ICG might be. The FSA expect to be notified when capital falls below the level implied by the ICG along with details on what has caused the situation to occur and how it will be rectified (or details on why the original ICG is no longer appropriate).

ICA and ICG will be a private matter between the insurer and the FSA, at least for the initial submissions, although some firms may choose to publish their capital position if they feel this will give them a competitive advantage. The initial calculations are likely to show quite significant variation in approaches / levels of sophistication and shocks used and hence comparability between companies will be difficult in the early years.

Indeed surveys conducted by the consultancies have clearly illustrated the different approaches being taken (e.g. for individual property market shocks, the range of market falls being considered is from –14% to –34%, although there does appear to be a narrower consensus of opinion around equity market falls).

It will be interesting to see how the industry and the regulators deal with the lack of comparability when pressure starts to mount for these figures to be disclosed. In particular, it is likely that sufficient historical data to calibrate shocks to a 0.5% one year event are only available for market risk and probably only equity risk within market risk. Therefore judgement / expert opinion will be necessary in calibrating all other risks.

In a presentation to the Association of British Insurers (ABI), the FSA confirmed that their review would check:

- That all significant risks have been considered in the company's calculation.
- The level of consistency with capital planning
- The justification of the stress tests / scenario analysis that the company has considered within their ICA calculations
- What management actions have been allowed for in the calculations
- The correlation approach taken (which determines the level of diversification benefit between risks taken credit for).
- How the Board has managed to satisfy itself with the ICA.

The risks to be considered within the ICAS framework should be assigned to one of six categories. The six categories are:

- *Market Risk,* which refers to the risk that arises from exposure to an adverse variation in costs or returns, resulting from a change in market price or rate which is not matched by a corresponding movement in liabilities.
- *Insurance Risk*, which refers to the inherent uncertainties as to the occurrence, amount and timing of insurance liabilities.
- *Credit Risk*, which refers to the risk of loss if another party fails to perform its obligations, or fails to perform them in a timely fashion.
- *Operational Risk*, which refers to the risk of direct or indirect loss resulting from inadequate or failed internal processes, people and systems or from external events.
- *Liquidity Risk*, which refers to the risk that a firm – although solvent on a balance sheet basis – either does not have sufficient financial resources available to meet its obligations as they fall due or can only secure them at excessive cost.
- *Group Risk*, which refers to the risk arising from belonging to a group of companies.

Particularly difficult areas within the framework include operational risk and staff defined benefit pension schemes. For operational risk, firms are only starting the journey of collecting all the relevant internal data about loss incidence and loss value to allow sophisticated modelling of operational risk. Therefore, the operational risk figures within the ICA can be considered to be early estimates (or placeholders) which will be refined by the industry in the years ahead. Certainly the FSA will be looking for more development in this area going forwards.

The other main controversial area has been around staff defined benefit pensions schemes and how to allow for these within the ICAS framework. Possible (early) approaches revolved around the FRS17 deficit or treating the assets as being part of the company and then stressing the liabilities in a similar manner to other (policyholder) liabilities within the company.

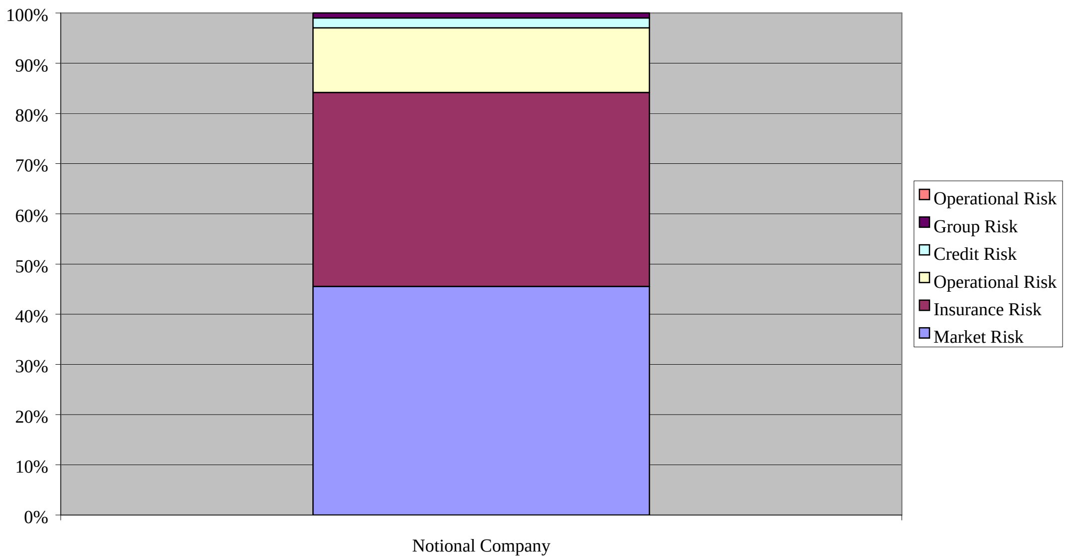
However, very serious concerns were raised by the industry as regards defined benefit pensions schemes as in effect the ICAS would be forcing the life industry to capitalise their pension schemes whereas other firms in other sectors do not have to. This could have led to consequences for those pension funds and also for the general competitiveness of the UK insurance sector.

Recently further guidance has been issued for this, although it is still rather vague at this stage. The latest guidance has stated that they do not expect insurers to bring the pension scheme assets and liabilities onto their own balance sheet and apply the same modelling or valuation techniques to those assets and liabilities as are applied to their own assets and liabilities. Instead, the basis to determine the impact of the stress test will revolve around capitalising 5 years worth of additional contributions.

Initial surveys by consultancies have generally indicated that market risk and insurance risk compete for the position as the largest source of risk (across all business), followed by operational risk then credit risk.

However, the relative importance of each risk type depends on the business (so for example with profits will show a very different profile to say term assurance). The chart below illustrates how an ICA may be composed by the various risk types.

Example of how an ICA may be composed



It is important to note that the generation of an ICA (and subsequent review by the FSA) is really only the first step taken in the overall journey. ICA will become embedded within the management of a company and significant amounts of work by the industry is still required to make this happen. Future developments could include:

- Determining management actions that could be taken to reduce or control the ICA.
- Projecting future ICA levels to enable appropriate strategic decisions to be made
- Introducing ICA into product design / pricing.
- Using ICA for capital allocation and performance measurement.

It seems certain that minds will be focussed on any actions that could be used to reduce the ICA/risk profile of the business. Companies will no doubt review their PPFMs and investment strategies to limit market risk in their portfolios. Also longevity risk is another key risk for pension schemes and annuity companies and further matching opportunities may well be explored, such as longevity linked bonds where interest payments are tied to the national cumulative survival rate calculated by the Office of National Statistics. BNP Paribas are the first to launch such a bond.

Reinsurance agreements are likely to be reviewed to see if additional value can be created for the company by reducing the “on balance sheet” capital it requires.

The Actuarial Profession have introduced a number of new guidance notes for actuaries, but of particular note are GN46 which provides guidance on carrying out an Individual Capital Assessment and GN47 which provides guidance on the use of stochastic modelling. The guidance notes are held on the profession’s web-site along with a list of all the guidance notes which have either been amended or newly introduced.

2.1.3 The role of actuaries in life assurance

With Policy Statement 04/16 the FSA ended the current Appointed Actuary regime. A firm must now appoint one or more actuaries to perform:

- Actuarial Function, in respect of all classes of its long term business; and
- The With-Profits Actuary, in respect of all classes of its with-profits business (if any).

Chapter 4.3 of the Supervision Manual (SUP) outlines the responsibilities of each of these roles. The main requirements of the Actuarial Function relate to the ability of the firm to meet its long term liabilities, with the With-Profits Actuary responsible for the management of the with-profits business.

2.1.4 Treating Customers Fairly

During 2004 companies responded to the Consultation Paper 04/14, which was an update to original FSA Consultations through CP207. These papers required the introduction of Consumer Friendly Principles and Practices of Financial Management (CFPPFM), target ranges (each policy's payouts must fall within a target range of that policy's asset share), and other ways of ensuring that with-profits policyholders are treated fairly, such as, what to tell policyholders if a fund closes to new business.

Whilst the principles of CP207 were welcome, much of the detail was going to be impossible to effect. CP04/14 proposed some compromises and the general feedback on the paper was that a great deal of the changes were very welcome, including the intended removal of the requirement to consider individual policy asset shares and the recognition that existing Court sanctioned arrangements take precedence over these FSA rules where necessary.

The new rules detailed in CP04/14 did however leave a number of concerns for companies, including the practical problems relating to the target range proposals. There were also concerns that the closure to new business was the wrong trigger point for writing to policyholders, and that the cost of producing a Consumer Friendly PPFM (CFPPFM) will outweigh the benefits for existing customers – which will be limited to a small minority who will actually read it and get something from it.

As a result of feedback from CP04/14 the FSA have introduced Policy Statement 05/1. The rules and guidance cover:

- Amounts payable under with-profits policies;
- The approach to surrender values;
- The charges to with-profits funds;
- How new business is written; and
- The provision of information to policyholders.

The main changes from CP04/14 include:

- Payouts - the new rules allow companies to continue to supplement maturity values from profits on surrendering policies provided it is an established practice that surrendering policyholders have been treated fairly and consistently.

The FSA has also relaxed its requirement so that only 90% of maturity payments need to fall within the target range for situations where individual policy asset shares calculations are used, as well as those where specimen policy asset share calculations are used. The FSA has also included some guidance on how companies can demonstrate that their surrender values meet the new standards where companies do not use asset share techniques to specify surrender values.

- Timescales – the rules will come into force on 30 June 2005, with some exceptions – including target ranges, surrender values and CFPPFM – which are not required until 31 December 2005. As a result of the deferral of CFPPFM there will be a requirement to produce one final edition of the With-Profits Guide.
- New Business Terms – the FSA has included additional guidance for companies on whether a new with-profits fund should be set up for new business. This includes areas to consider in order to establish whether the chosen option is fair to existing and new policyholders.

There are also a number of areas where the FSA are going to consult further, through a forthcoming Quarterly Consultation paper, including:

- There are a number of tax proposals – relating to the amount charged to the with-profits fund – that have been removed from PS05/1 on which there will be further consultation.
- The treatment of Market Value Reductions (MVRs) with regard to shareholder transfers. There are arguments that suggest these are negative terminal bonus and should reduce shareholders' transfers for cases where they apply.
- Whether private Rights of Action for damages should be disapplied for some Treating Customers Fairly rules.

2.1.5 Consumer Friendly PPFMs

Companies are required to provide Consumer Friendly PPFM (CFPPFM) on/and after 1 January 2006:

- To existing with-profits policyholders with their next annual benefit statements (ABS). The CFPPFM is not required to be issued annually thereafter although future statements must clearly refer to it;
- To potential with-profits policyholders at the point of sale where a with-profits policy is an option (deemed as such where a with-profits policy key feature document is provided);
- To all with-profits policyholders where notification is required due to a change in the Principles within the PPFM.
- On the website; and
- On request.

One change in PS05/1 is that companies are no longer required to do a one-off mailing to with-profits policyholders. Also, companies that do not issue any post-sale information do not need to issue the CFPPFM but must have it available on request and on website.

This seems a strange requirement in that companies who do not give their policyholders any information are not required to actively provide this information which seems to defeat the purpose of greater transparency and trying to provide more information to policyholders.

<u>Comment on PS05/1</u>

The changes in the timetable are welcomed as they give extra time before the implementation of changes, e.g. in the production of the CFPPFM. However, there is still a considerable amount of effort needed over 2005 to make the required amendments to the PPFM document and the other necessary changes in the calculation of bonus rates to comply with the requirements of the new regulations.

There is also some confusion over when the target ranges come into effect, e.g. COB 6.10.29 and COB 6.12.17 both say target ranges must be specified but one stated 30 June 2005 with the other 31 December 2005. The relaxing of the regulations on what can be paid out on surrender will make compliance much easier for many companies. However, the restriction on surrender payments being fair will force companies to take a closer look at what benefits they are actually providing on surrender and assessing how fair they are being.

The removal of the requirement to provide a CFPPFM to every policyholder is welcomed, however, there is still scepticism that there will be enough benefit provided to the policyholder to justify the cost and effort that will be required to produce the documents.

On the subject of reducing shareholders' transfers when an MVR applies seems interesting. We await the upcoming consultation, including how consistency will be reached between conventional and unitised with-profits polices. In particular, with conventional with-profits policies, there is not a clear definition as to what parts of payouts relate to guaranteed benefits and terminal bonus.

The new rules on MVRs seem slightly arbitrary, particularly as there are already rules on surrender values and these therefore only apply to UWP (the question being why treat differently from differently from CWP). They state that they cannot be applied unless:

- The market value of assets is <u>significantly</u> less than the face value of units; or
- There is a high volume of surrenders relative to the <u>liquidity</u> of the fund.

There is no guidance on what is considered significant - should it be 5%, 6% or some other arbitrarily chosen number. If the rate is set at 5% is does not seem fair that one policy with a theoretical MVR of 4% should receive no reduction and a contract taken out a couple of months earlier or later should have its full MVR of 6% applied (plus any addition needed to compensate for the MVR not charged to the other policy).

Although liquidity may be an issue in extremis, another rule might be more helpful for when the cost to the rest of the fund (and hence policyholders) is significant (even if the fund has no liquidity issues).

2.1.6 Depolarisation and the menu.

After numerous consultation papers, the FSA finally published the policy statement "Reforming polarisation: Implementation – feedback to CP04/3", with the new rules becoming mandatory on 1st June 2005.

As a result of this deregulatory measure, firms will be able to:

- Sell products from the whole of the market, or
- Sell products from a limited number of providers, or
- Only sell products from a single provider.

To improve customer disclosure, two new documents have been developed which aim to increase transparency and assist customers to better understand the choices available to them. The initial disclosure document sets out the scope of advice a firm can offer (e.g. it could deal in the whole of the market, or just deal with a single product provider). This document also informs the customer of what level of advice they will receive from the company.

The second disclosure document is a fees and commission statement and is referred to as “the menu”. This “menu” outlines the payment options open to the customer for paying for the cost of advice received. It also outlines the commission payable across products and compares this against market average commission.

The theory behind this development has been that improved initial disclosure will increase the awareness of customers of the cost of advice and empower them to get better value for money from the sales process. This should exert general downward pressure on commission levels and help to reduce commission bias.

2.2 ACCOUNTING STANDARDS

2.2.1 Financial Reporting Standard 27

After a short period of consultation, the UK Accounting Standards Board ("ASB") issued Financial Reporting Standard 27 ("FRS27") in December 2004, which sets out changes to life insurance accounting. The final standard incorporated some significant changes from the initial exposure draft and, in particular, mandatory adoption was deferred by a year to December 2005.

In addition to issuing the reporting standard, a Memorandum of Understanding (MoU) was also published and has been signed by the ASB, the ABI and leading members of the life assurance and bancassurance sectors. This MoU contains an agreement by the insurers/bancassurers involved to publish certain information in the operating and financial review section of their annual accounts for the 2004 year end in exchange for the one year deferral of FRS27 implementation.

The FRS was born as a result of the Penrose report. The ASB received a request from the Financial Secretary to the Treasury to initiate an urgent study into accounting for With-Profits business. The Penrose report criticised a number of aspects of existing accounting practices, including:

- The current practice of recognising a liability for bonuses declared to date but not recognising a specific liability for accrued terminal bonus, *and*
- That there was insufficient information provided about the amount of reserves available to meet expected future bonuses, *and*
- The fact that insurers could make important changes affecting policyholders without those changes being apparent from financial statements, *and*
- The complexity of insurers' regulatory returns and financial statements.

As well as addressing the key With-Profits issues, the ASB has been keen to improve the clarity of disclosures on the capital available to a life assurer including detailing the restrictions as to its availability and use. The key requirements of FRS27 are outlined below.

<u>"Realistic" valuation of With-Profits liabilities</u>

The ASB has sought to integrate the new regulatory regime into financial statements. In particular, for large With-Profits funds (>£500m), the liabilities of the With-Profits fund must be measured in accordance with the FSA's realistic capital regime although these liabilities need to be adjusted by the amount that can be attributed to shareholders (e.g. shareholders' share of future payment of bonuses), with this adjustment being recognised within the FFA instead.

<u>Value In-Force / Embedded Value</u>

The standard allows companies (such as bancassurers) who currently include an embedded value (EV) of in-force business in their accounts to continue with this practice, although it restricts other companies from introducing this method.

However, the reporting standard explicitly prevents the value of in-force business from including future investment margins thereby making the EV independent of the assets backing the liabilities (save for some second order effects such as taxation). The standard defines future investment margins as the amounts by which assumed investment returns exceed the risk-free return on assets.

Options and Guarantees

FRS27 requires that for With-Profits funds falling within the scope of the FSA's realistic capital regime, the options & guarantees within those funds must be measured at fair value or estimated by a market consistent stochastic model.

The ASB has tried to encourage all options & guarantees, whether within a With Profit fund or not, to be valued at fair value or using a market consistent stochastic model, but have not compelled this development for practical reasons. For those offices choosing not to stochastically / fair value options and guarantees in funds not captured by the FSA's realistic capital regime, then FRS27 contains some significant additional disclosure requirements.

For all options and guarantees, FRS27 requires disclosures of:-

- Details of the process used to determine assumptions that have the greatest effect on the measurement of liabilities and practical disclosure of assumptions
- Terms and conditions of options and guarantees
- Information on exposure to interest rate risk or market risk. This requires, amongst other things, disclosure of the main variables determining the amount payable under the option or guarantee and information on the potential effects of adverse changes in market conditions.

The additional disclosures for options and guarantees not valued on a market consistent basis includes:

- Details of the nature and extent of the options and guarantees, and
- The basis of measurement for the amount at which they are stated, *and*
- The main variables that determine the amount payable, *and*
- Details on the effects of adverse changes in the key market variables affecting the amounts payable. There are slightly different requirements depending on whether the option / guarantee is in or out of the money.

Disclosure – the Capital Statement

The ASB sought to provide increased clarity, for investors and policyholders, over the financial strength of the insurer and provide an insight into the composition of, and constraints over, the availability of capital to meet risks across the businesses.

To achieve this, the ASB has come up with the concept of the Capital Position Statement which shows;

- shareholders' funds, *and*
- adjustments to restate these amounts on to their regulatory equivalent, *and*
- Total available regulatory capital.

The Capital Position Statement must be supported by narrative explaining any constraints over capital and its potential availability to meet risks in different parts of the business.

The Capital Position Statement will be supported by a table showing movements in capital over the year for each UK life fund which is shown separately in the main Capital Position Statement. This table aims to explain the reasons for the change in capital from year to year and will show the impact on capital resulting from changes in assumptions, changes in management policy, changes in regulatory requirements and also the impact of new business. This tabular disclosure does not need to be provided until Dec 2006 (1 year after mandatory adoption of the rest of the standard).

Memorandum of Understanding

Despite only being published in June 2004, the original consultation paper (Financial Reporting Exposure Draft 34) proposed implementation from December 2004. The industry had concerns over the short consultation period given and practical issues of implementing within the timeframe given that a final standard would not be issued until December of that year.

The outcome of negotiations between the ASB and the ABI resulted in the final standard deferring mandatory implementation by one year until December 2005. In addition, a “Memorandum of Understanding” has been published and agreed by the ASB, the ABI and eight major UK insurers / bancassurers.

By signing up to this “Memorandum of Understanding”, the eight leading insurers / bancassurers have agreed to provide limited sections of the FRS27 in the Operating Financial Review (or similar sections) of their accounts as at December 2004. The key requirements of this MoU revolve around the provision of a (limited) Capital Position Statement with its various disclosures.

2.2.2 European Embedded Values

Embedded values are intended to reflect a realistic, risk adjusted valuation of shareholder cashflows arising from in-force business and net assets. However, there are a number of problems with the traditional embedded value methodology, including:

- The process of determining the risk discount rate (the rate used to calculate the present value of future shareholder cashflows) is very subjective and it is not always clear that sufficient allowance for risk has been made.
- Credit is taken for higher expected returns from riskier assets such as equities without it being transparent that the risk discount rate charges appropriately for the risks involved with investing in these assets.
- The final embedded value can potentially be changed by changing the investment mix.
- It is not transparent whether an appropriate value (or even any value!) is recognised for financial options and guarantees within the embedded value framework.

To deal with the problems inherent in traditional embedded values, the European Embedded Value (EEV) principles have been developed[7]. The 12 EEV principles have been developed by the CFO Forum. (The CFO Forum is a group which represents the Chief Financial Officers of major European insurers.) These principles were published in May 04 and provide a framework for the derivation of valuation assumptions, calculations and reporting of embedded values. The intention of these principles is to improve comparability and transparency of embedded values.

Whilst the value of financial options and guarantees is recognised (captured through principles six and seven) there is no definitive statement on how to set the risk discount rate. There is, however, a requirement to give details on how the risk discount rate (as well as other assumptions) is determined.

The CFO Forum's intention is that member companies reporting supplementary embedded value information will adopt the principles from the 2005 financial year. However, AVIVA have become the first European life insurer to fully implement EEV principles (1 year ahead of the CFO Forum's target), and recently stated that they are using this basis for reporting their 2004 preliminary results. They have already announced restatement of their full year 2003, and 6 month 2004 results on an EEV basis. The restatement on the EEV basis has not significantly changed the operating profits for the group.

For those readers wanting a detailed discussion on this topic, a paper by O'Keeffe et al. titled "Current Developments In Embedded Value Reporting" is available on the profession's website.

2.2.3 International Financial Reporting Standards

International Financial Reporting Standards (IFRS) are a framework of accounting rules developed by the International Accounting Standards Board (IASB). The purpose of developing these standards is to improve transparency and comparability of accounts across different sectors and companies. So the accounting for something depends on what it is and not into what it is written. Thus if a unit trust savings plan is essentially the same as a unit linked savings plan, then they would have the same accounting treatment. These criteria are particularly desirable properties with the increasing globalisation of business.

IFRS has particularly hit the headlines over the last few years because the EU has mandated that listed companies in the member states should change from local accounting standards to IFRS from January 2005.

However, given the complexity involved in accounting for life insurance, the development of these standards has split into two phases. Phase I (an interim step to full implementation of IFRS) has just been implemented (January 2005) and we will see the first full set of financial statements on IFRS from 31st December 2005.

There has been little in the way of public restatements of accounts on an IFRS basis, but we will see interim statements during 2005 which will start to shine a torch on the likely impact for companies. However, it is fair to say that bancassurers who put the embedded value in their primary accounts will experience a bigger impact than pure insurers.

[7] It should be noted that this is not the only framework being developed to deal with the problems of traditional embedded values. The main other framework is market consistent embedded values.

The IASB published IFRS4 in March 2004, which along with IAS18 (*Revenue*), IAS32 (*Financial Instruments: Disclosure and Presentation*) and IAS39 (*Financial Instruments: Recognition and Measurement*), make up the body of Phase I of IFRS. A few points arising are:

Product Classification

IFRS4 exempted considerably more contracts than Exposure Draft 5 initially led many to believe. The impact of IFRS on many insurers has therefore been less than expected. Under IFRS, each product has to be classified into one of three categories:

1. Insurance.
2. Investment with Discretionary Participation Feature (ICwDPF).
3. Investment without Discretionary Participation Feature (ICwoDPF).

For contracts to be classified as insurance, they must include significant insurance risk transfer – term assurance, whole of life assurance and annuities are examples of contracts that meet this definition. Lapse and expense risk are not sufficient and neither are contracts that contain financial risk only.

For a contract to be classified as ICwDPF, it has to have a contractual right to receive, as a supplement to guaranteed benefits, additional benefits:

(a) that are likely to be a significant portion of the total contractual benefits;

(b) whose amount or timing is contractually at the discretion of the issuer; and

(c) that are contractually based on: (i) the performance of a specified pool of contracts or a specified type of contract; (ii) realised and/or unrealised investment returns on a specified pool of assets held by the issuer; or (iii) the profit or loss of the company, fund or other entity that issues the contract.

Products that do not fall into the Insurance or ICwDPF categories are classified as ICwoDPF.

Impact of product classification

Products classified as Insurance fall under IFRS 4. IFRS 4 largely allows companies to continue to use their existing accounting policies. Products classified as ICwDPF should fall under IAS 39 and IAS 18, however, these are exempted in Phase I and can continue to be valued in a similar manner to insurance contracts. Products classified as ICwoDPF will be accounted for under IAS 39, IAS 18 and IAS 38. IAS 39 relates to the part of the contract that is a financial instrument, IAS 18 deals with the part of the contract that provides future investment management services and IAS 38 relates to any intangible assets that have to be recognised.

Embedded Derivatives

Embedded derivatives must be accounted for at fair value although Phase I does have an exemption (from fair value measurement) for derivatives if it is regarded as an insurance contract.

Disclosure

The other main requirement of IFRS is that expanded disclosures will be required to improve comparability between companies. These will include risk management objectives, reconciliation of reserves and intangible assets, sensitivities of liabilities to key assumptions and concentrations of risk.

Although the move to more transparent and consistent accounting is viewed as a good thing, insurers are likely to face greater volatility in their earnings, which may well have a knock-on effect on markets as companies take action to reduce this volatility.

The IASB has commenced Phase II, which is expected to introduce some form of full fair-value methodology for measuring liabilities for all contracts, but the implementation timetable is still uncertain. Initial feedback from the IASB suggests that it is likely that similar principles to Phase I will be applied to Phase II.

2.3 MARKET / PRICING ISSUES

2.3.1 Stakeholder / Individual Pensions

The Stakeholder individual pensions market has had a tough time since its introduction during 2001. The only charge that can be taken from a Stakeholder pension is an annual management charge (AMC) and this charge cannot exceed 1% of the fund value per year. As described in the FASS Current Topics 2004 paper, there are two key problems with this charging structure. They are (a) the shape of the charges compared to the shape of expenses incurred, and (b) the level of charges.

Insurers are having difficulty covering the cost of advice incurred when selling the product (together with other expenses) with the maximum level of charges imposed under Stakeholder. Therefore, there has been a recent trend to cut back commission over the last few months of 2004. In particular, Norwich Union has made the most significant initial move in the individual pensions market.

They have cut commission down to 10% of the LAUTRO scale (down from 45%) for their Stakeholder style products prompting other insurers to review their commission levels. In addition, Norwich Union have also recently launched a new (non-Stakeholder) individual pension which has a reduced allocation percentage (amount of the premium invested) for an initial period.

The Government announced during 2004 that the price cap for Stakeholder pensions will be increased to 1.5% of the fund value each year for the first 10 years and 1% thereafter. Although not ideal, it will give the products a fighting chance of being more profitable, although profitability will still be heavily driven by persistency and expense efficiency. There will no doubt be a battle ahead for the income generated by this extra charge between commission-based advisers who will want to see an increase to commission levels, whilst providers will want the income to increase the likelihood of the product making profits.

For large Stakeholder schemes (and Group personal pensions), current charges are often well below the 1% a year cap and charges are often driven by competitive forces rather than price restrictions. Therefore, the change in price cap is unlikely to have too significant an impact on this market.

2.3.2 Child Trust Funds

This is a new Government initiative to encourage the savings habit for the next generation. The Government will pay £250 into a Child Trust Fund for all those born on or after 1st September 2002, with a further £250 for poorer families. Family and friends will be able to contribute an extra £1200 a year between them. When the child reaches age 7, the Government will make a further contribution, although the level of this extra contribution is as yet undisclosed. All income and capital growth within the fund will be tax exempt, although the proceeds of the fund will not be accessible until the child turns 18.

Providers of Child Trust Funds must offer a “Stakeholder fund”. The “Stakeholder fund” must have exposure to shares, have a minimum contribution level of £10 and have a maximum charge of 1.5% per year. It must also provide a life-styling facility through which it will be possible to gradually move from shares into lower risk assets such as cash and Government bonds. It must be possible to start this process no later than the child’s 13th birthday.

The provider of Child Trust Funds may also offer other (non Stakeholder) funds which do not have the restrictions that “Stakeholder funds” have.

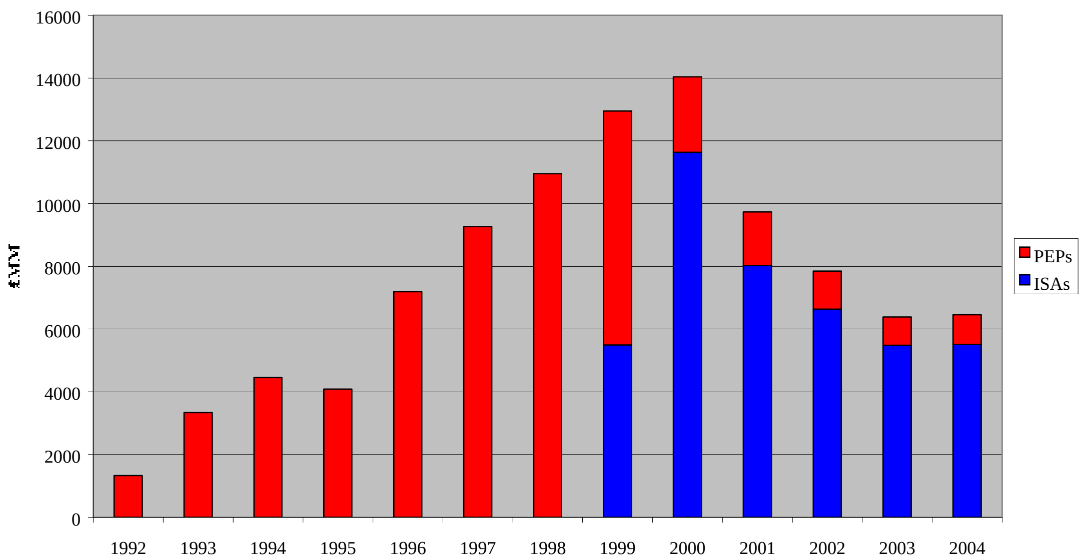
Although there is a general consensus of the need to encourage the habit of savings, it will be interesting to see what the various political manifestos for the impending election make of the Child Trust Fund initiative (and also of ISAs which are discussed below).

2.3.3. Individual Savings Accounts (ISA)

ISAs have had a bit of a rough ride during the last few years. Consecutive years of stockmarket falls have dented the confidence of investors and consequently seen ISA sales fall from previous highs. Recent statistics from the IMA have shown that gross sales have not made any ground over the lows of 2003, despite improved stock market performance, showing that confidence has not yet been restored.

The recent high interest rate account offerings may also have diverted investors monies from equity ISAs.

PEP / ISA (Gross) Sales



There is general uncertainty around the Government's commitment to ISAs despite the Government's surprise recent intervention. The ISA allowance was due to fall to £5,000 from April 2006, but Gordon Brown has postponed this planned reduction to the annual allowance and has proposed maintaining the allowance at £7,000 until 2009/2010. Although this has been welcomed by the savings industry, there have been many calls for a longer period of commitment to the annual allowance and even more calls for the annual savings allowance to be increased.

2.3.4 Pensions Simplification

The last 12 months have seen a pretty static market for the post-retirement sector. This could possibly be a result of the market and annuity rate falls of recent years meaning people are holding off retirement to try and build up bigger pension funds in order to try and provide for a more acceptable level of retirement income.

The Finance Act 2004 has potentially provided some impetus for this market, although it may be currently leading to a planning blight (and hence contributing to static / slight falls in this market). Final regulations and guidance are expected in 2005 with implementation scheduled for 6th April 2006.

Under the new regime, there will be three separate options for those retiring with individual pots. They are:

- Lifetime annuity
- Unsecured pension
- Alternatively secured pension

Lifetime annuities will be level, increasing or linked (RPI or unit-linked) and it is understood that with-profits will also be allowed although as legislation currently stands this would be excluded. There is also the potential for “Capital Protected” annuities, where the payment on death before age 75 is the balance between what has been paid out as annuity income and the purchase price of the annuity.

Unsecured pension is the new name for income drawdown. The key issue here is the removal of the requirement to take minimum levels of income up to age 75. This allows the customer to take tax free cash, say to pay-off a mortgage or make a significant purchase, but not be physically retiring and hence defer pension income until a later date. However, unsecured income must stop by age 75. The legislation also allows for limited period annuities with a maximum term of 5 years. Therefore, part of the fund can secure this temporary annuity whilst leaving the balance of the fund fully invested.

Alternatively secured pension has been developed to cater for those who had religious objections to annuities. The maximum income level for these products are very low, so it is almost inevitable that a substantial fund will be left on death which will appeal to those concerned about inheritability. When the customer receiving the alternatively secured pension dies without any surviving dependants, then there are three main options:

- Customer can nominate someone else in the scheme to receive their pension fund.
- Customer can nominate a charity to receive the fund.
- Customer can leave the choice of beneficiary to the scheme administrator.

If a surviving dependant exists, then the fund must be used to provide a pension for him / her.

2.3.5 Regulation of Protection Products

The FSA took control of the regulation of non-investment insurance business on 14th January 2005. This has introduced the Statement of Demands and Needs (SoDN). The SoDN must set out the customer's demands and needs. Since the regulations were published, there has been a good deal of industry discussion as to what the client's "demands" and "needs" means, although the FSA has given relatively little guidance.

However, it will be interesting to see what impact this has on the protection market. Some commentators are suggesting that this could actually give some impetus to Income Protection sales at the expense of Critical Illness sales as Income Protection may better meet the customer's needs although it is more difficult (and hence time-consuming) to sell due to its complexity.

2.3.6 Looking ahead

2005 is looking like being a very busy year, especially since a number of Government initiatives take effect. A few brief highlights include:

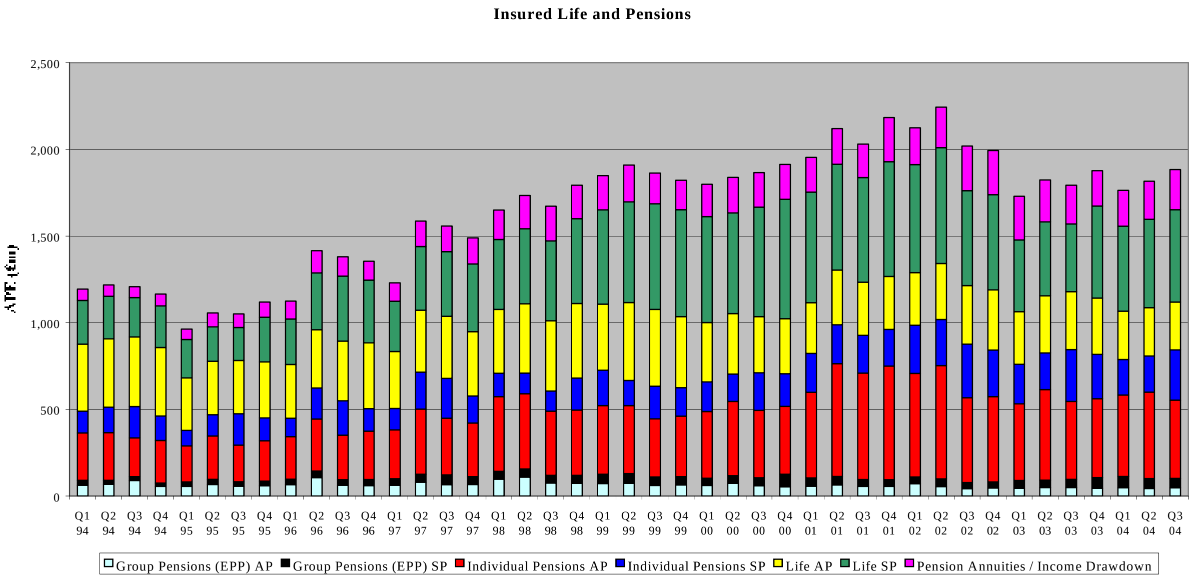
- The Inland Revenue will announce what amendments it intends to make to the Finance Act 2004. The industry has a long wish list of things that need changed, so it will be interesting to see which of these actually happen. The final changes will be in the Finance Bill which may be published in March.
- In the first quarter of 2005, a few more rainforests will be destroyed as a result of final regulations and extensive guidance being provided by both the Inland Revenue (Finance Act) and the DWP (Pensions Act).
- In April 2005, there will be the implementation of the first stage of the Pensions Act, which includes the replacement of OPRA (Occupational Pensions Regulatory Authority) with The Pensions Regulator and start of the Pension Protection Fund.
- The Pensions Commission will publish its second report, probably in October, which will follow on from its initial investigation. This second report will outline recommendations of the way forward for pension provision in this country. One major issue to be wrestled with is whether they will recommend compulsory contributions for employers and / or employees. This could have a major impact on the industry.

2.4 NEW BUSINESS STATISTICS

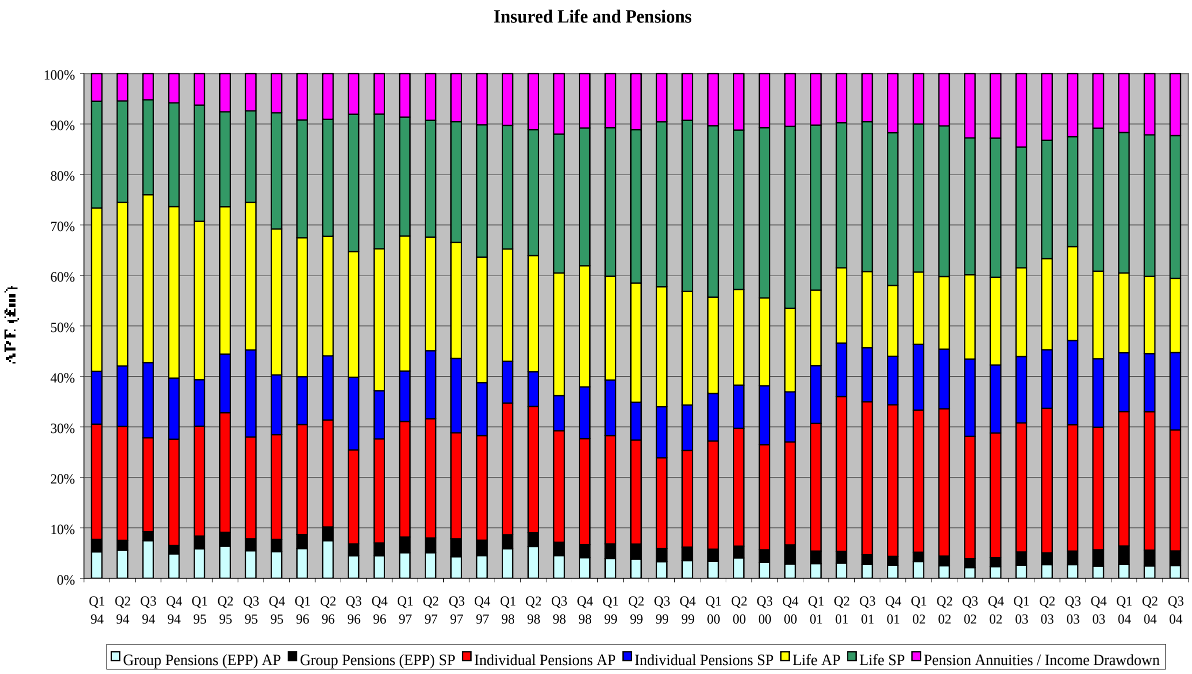
Current Sales Volumes and Past Trends

The charts below show new business volumes based on data from the Association of British Insurers (ABI). As at the date of writing, data for Q4 2004 was not available. The figures for collective investment schemes have been excluded from this analysis. Single premium figures are divided by 10 to give the annual premium equivalent (APE).

New business APE by product grouping



Proportion of new business APE by product grouping



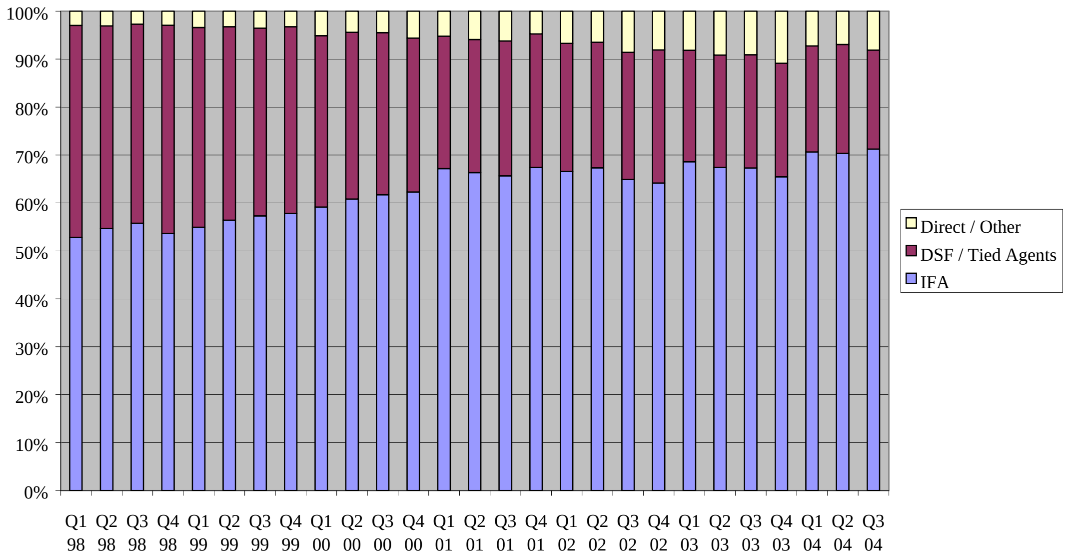
Some of the key highlights are:

- The market has significantly increased since 1994, rising from just under £1.2Bn per quarter in 1994 to just under £1.9Bn in the third quarter in 2004. This represents growth of 4.8% per year.
- However, the market is some way off the highs reached during 2002. 2003 was a difficult year for sales and saw a 15% fall in total market volumes compared to 2002. Investor confidence appears to still be missing as the first three quarters of 2004 has shown only a slight recovery in APE (up 2%) from the comparable period during 2003.
- Life SP's recovered some of the ground lost during 2003 with a relatively strong performance in 2004. Part of the reason for this was that property was the investment of choice during 2004 and life bonds have been seen as a relatively cheap way of getting exposure to the property market.
- Guaranteed Bonds showed strong growth as investors continued to look for downside protection against future stock market falls and providers pushed these guaranteed bonds strongly. There was also a lot of marketing activity in this sector as a number of key providers either restructured their product offering or offered special terms.
- The ABI data showed that pension annuities / income drawdown plans saw another year of substantial falls in new business volumes. It is not clear why this is the case, but it may partly be because pension funds have not recovered to the levels seen before the stock market falls in 2000 – 2002 and therefore potential retirees are holding off retirement until a better level of income is secured.
- Another possible reason may be the uncertainty caused by the impending A-day for pensions and hence it may be causing a planning blight in the interim.
- Group SP's volumes have continued to show significant increases during 2004 with group transfer business again helping to drive this increase.

Distribution Channels

The following chart shows the relevant significance of the different distribution channels over the same period as above.

Distribution of insured life and pensions by channel



The chart above, based on ABI data, clearly illustrates that IFAs are the dominant provider of new business and have increased in relative importance since 1998. This increase has been at the cost of DSF / Tied agents who have shown a steady decline in the proportion of new business that they generate.

From starting at a very low level, direct / other (which includes direct marketing and telesales) now grabs around 10% of new business, although this has fallen back again slightly during 2004.

2.5 REFERENCES

- 2004 current topics paper
- Actuarial professions website
- O'Keeffe et. al paper on "Current Developments in Embedded Value Reporting".
- Aviva Website
- Swiss Re's sigma No 7/2004.
- Various presentations given by major consultancies on hot topics such as ICAS
- FSA website.
- IMA website.

PART THREE – GENERAL INSURANCE

IFRS 4 – IMPACT ON THE GENERAL INSURANCE INDUSTRY

Introduction

Following the publication of the International Financial Reporting Standards (IFRS 4) on 31 March 2004 by the International Accounting Standards Board (IASB), this document briefs what has happened so far. It also sets out what possible actions are required from the industry in order to ensure the industry is in the position to adopt the new changes with adequate resources and minimal cost and risks to their business.

It outlines the reasons from the IASB for issuing the IFRS 4, the possible risks to the industry, the current position, what the industry might need do and the next stage of the IFRS 4 project.

Reasons for issuing the IFRS 4

This is the first IFRS to deal with insurance contracts.

Accounting practices for insurance contracts have been diverse, and have often differed from practices in other sectors.

Because many entities (i.e. non-insurance entities) will adopt IFRSs in 2005, the IASB has issued this IFRS:

1. To make limited improvements to accounting for insurance contracts until the Board completes the second phase of its project on insurance contracts.
2. To require any entity issuing insurance contracts (an insurer) to disclose information about those contracts.

This IFRS 4 is a stepping stone to phase 2 of this project. The Board is committed to completing phase 2 without delay once it has investigated all relevant conceptual and practical questions and completed its full due process.

Key Dates

Below are the important dates in the IFRS calendar:

March 2004	New and revised IFRS issued by IASB have been completed
March 2004	IFRS will apply to 2004 accounts (for reports submitted after January 2005)
January 2005	All European Union publicly quoted companies must adopt IFRS in parallel with standard reporting schedules
January 2006	Dual reporting ends, IFRS become the standard

Possible Threats to the Industry

The main threats that IFRS could pose to the industry are listed below:

- Share price value reduced
- Corporate value reduced
- Business disruption
- Ignorance of non-financial staff
- IFRS constantly changing
- Expertise shortage as deadlines approach
- Cost of poor planning
- Penalties for failure to comply.

Impact on the General Insurance industry

Significant new disclosure requirements will heighten the spotlight of transparency on risk management. The industry therefore needs to manage the possible balance sheet risks arising from IFRS, including the potential for earnings volatility and mismatches between assets and liabilities.

From 2005, companies will need to provide 'information that helps users understand the estimated amount, timing and uncertainty of future cash flows from insurance contracts'.

This will require far more quantitative and qualitative disclosure in the following areas:

- Factors affecting year-on-year movements in liabilities
- Exposure to insurance and financial risks, in particular concentrations of risk
- Sensitivity analysis to show the impact of different risk scenarios and market variables on cash flows
- Asset, liability and risk management procedures

What the existing practices are

Companies produce regular reports such as quarterly reserving reports and month end accounting on the performance of businesses underwritten. The methods, assumptions and risk policies are all defined and disclosed in these reports or papers written specifically for these purposes.

What companies may not have in place

Companies might lack the infrastructure of risk monitoring, stress testing, control and disclosure needed to comply with IFRS 4.

The answers to all the following questions will therefore be crucial in forming a view of how prepared the companies are at this stage to the imminent changes:

- Are the assumptions used so far all verifiable?
- Does all the documentation in place stand up to very prominent disclosure and scrutiny?
- Are data used all reliable and timely?
- Have companies got any cash flow forecasts in place that will enable management to anticipate the impact of what could be very different profit profiles under the new IFRS criteria, including any potential volatility or earnings surprises?
- What strategies the companies have already in place on financial and market risks?

Actual changes in accounts (numbers)

Elimination of equalisation and catastrophe provisions is the only change for GI companies under Phase I as changes in accounting measures for assets and liabilities for general insurance business are going to be minimal.

Actual changes in accounts (disclosure)

Extra disclosures will be required which include:

1. Explanation of recognised amounts

    - accounting policies;
    - assets, liabilities, income and expense arising from insurance contracts.
    - the process used to determine material assumptions and, where practicable, the actual assumptions.
    - the sensitivity of results to changes in assumptions.
    - material changes in insurance liabilities, reinsurance assets and deferred acquisition costs.

2. Amount, timing and uncertainty of cashflows

    - risk management policies and processes.
    - terms and conditions of insurance contracts which have a material effect on future cashflows.
    - information on insurance risk including claims development data for general insurance.
    - information on interest rate risk and credit risk component with the disclosure requirements of IAS 32.

Next steps for IFRS 4

Work continues at the IASB on insurance accounting, and changes in Phase 2 of the project are expected to be far more extensive. It appears that accounting will be on the basis of fair values when it is implemented.

This will require all an insurer's assets and liabilities to be held at 'fair value' in its accounts. Any changes in fair value during an accounting period will give rise to a profit or loss, whether or not the changes arise from any differences in the expected income or outgo. Fair value is defined as being 'the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction'.

For further reading, please refer to the references set out below.

References

International Financial Reporting Standard - IFRS 4 Insurance Contracts	International Accounting Standards Board - March 2004
Guidance on Implementing IFRS 4 Insurance Contract	International Accounting Standards Board - March 2004
Financial Accounting International Standards	International Accounting Standards Board - March 2004
Basis for Conclusions -IASB Publishes IFRS 4 "Insurance Contracts"	Towers Perrin Tillinghast April 2004 Update
International Financial Reporting Standards And Fair Value Accounting	Towers Perrin Tillinghast May 2004 Update
IFRS 4 – The future of insurance reporting – for now	IFRS – Global Reporting Revolution PWC LLP April 2004 Update
IFRS and risk management	IFRS – Global Reporting Revolution PWC LLP April 2004 Update
Bridging the information gap – Insurance analysts' perspectives on the move to IFRS	IFRS – Global Reporting Revolution PWC LLP May 2004 Update
The Impact of IFRS on the insurance industry	Swiss Re sigma report No 7/2004 @ http://www.swissre.com

Definitions

Insurance Contract	IFRS – A contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder).

THE IMPLICATIONS OF THE POLICY STATEMENT 04/16 ON THE IMPLEMENTATION OF THE ECR AND ICA FOR GENERAL INSURERS.

Introduction

The FSA published Policy Statement (PS) 04/16 on 1 July 2004 which provides feedback on Consultation Paper (CP) 190 and CP 195 and is limited to insurance companies.

The background to PS 04/16 is the FSA's work in making insurance companies' solvency requirements more realistic and more transparent.

In CP 136 they set out plans for an internal capital assessment (ICA) and in CP 190 they proposed a new formal solvency test, the enhanced capital requirement (ECR), a formula-based minimum solvency level for general insurance companies.

PS 04/16 discusses the submissions received on CP 190 and sets out some modifications to the proposals.

Changes to the ECR

The proposed ECR calculations were set out in CP 190, and have been widely publicised which is the sum of a number of loadings on premiums written, technical reserves held and assets owned, the loadings varying by class of business and type of asset.

For most companies the ECR was significantly higher than the current legal minimum capital requirement (MCR) set out in EU directives.

PS 04/16 makes only one change to the calculation of the ECR: the loading for money-market funds which are holdings in collective investment schemes.

Collective investment schemes may hold any type of security as their underlying asset, and in CP 190 they had been treated as equities, and attracted a 16% loading.

The FSA has now accepted that where collective investment scheme is invested purely in money-market instruments it can be treated as a cash equivalent, and need bear no ECR loading.

Naturally, the effect of this on any company depends on how much it holds in investment of this type. For the market as a whole its effect will be limited by the fact that collective investment schemes accounted for less than 3% of companies' total assets in their FSA returns for the year ending 2003.

However, an equity-based risk charge on what is essentially a cash asset, carrying cash-type risks and returns, would have been a significant disincentive to hold assets of this type. It was to avoid a disincentive to invest in a conventional asset class that led the FSA to make this change to the proposals.

Implementing the ECR

More important than any actual changes to the formula are changes in the way the ECR is to be implemented.

The timetable is to be faster than anticipated in CP 190, which proposed a one-year notice period for the full implementation.

As the final Prudential Source Book (PSB) text was published in November 2004 to come into force on 31 December 2004, this means that firm with 31 December year-end dates will be required to implement the new regime – calculating and reporting their ECRs – as at 31 December 2004.

Firms with an earlier year-end date may get a short postponement (unlikely though if with a November year-end).

However, the nature of the ECR requirement has been changed, a change that had been trailed by the FSA in recent months.

The ECR will no longer be a "hard" capital requirement, at least in the next few years, although the FSA will consult again about this, in 2006.

This means that an insurer that does not hold capital at least equal to its ECR will not automatically be penalised or made subject to binding requirements to restore the position.

However, the ECR will still be used when the FSA considers the appropriateness of an insurer's ICA and when it issues individual capital guidance (ICG).

The ECR may not be a " hard" test, but a firm that fails to meet it will clearly still need firm evidence that its capital position is nevertheless satisfactory.

It will serve the FSA as a flag that a company may need closer scrutiny than others.

The postponement of the use of the ECR as a hard test is partly because of the work the EU is undertaking in its Solvency II project.

This is currently expected to lead to a draft directive being introduced in early 2006, which may impose new EU-wide capital requirements that supersede the ECR.

To make two major formal changes to capital requirements in three years would probably be seen as regulatory overload.

However PS 04/16 makes it clear that if the Solvency II timetable slips beyond the current early-2006 deadline then it will reconsider the introduction of the ECR as a hard requirement, although such a decision would be subject to further consultation at the time.

It has to be said that there appears to be a good deal of scepticism in the insurance industry as to whether the EU will be able to stick to its timetable for Solvency II.

As it will not be a hard requirement, the FSA has dropped its proposal to make the calculation of the ECR a public exercise, with a form in the returns setting out the result.

Instead, the result will be reported privately to the FSA.

However this does not give firms a high degree of privacy: the ECR was designed to be calculated from existing forms in the FSA returns, which are public documents, and anybody can calculate any insurance company's ECR from its return.

Some degree of approximation will be required – for example the change to the treatment of money-market funds means that line 43 of form 13 does not map straightforwardly to an ECR loading -–but the uncertainty is likely to be minor for most companies.

The precise level of ECR may be private but reasonably accurate calculations could be made by anybody.

There has been some criticism of the decision to allow firms to keep their ECRs private, and it does seem to run contrary to the FSA's normal approach. It will be interesting to see how many insurers choose to make their calculations public.

Another item that prevents outsiders from calculating companies' ECRs exactly is the treatment of derivatives.

Under the proposals in PS 04/16 firms will treat the value of a derivative and the value of the asset associated with it as a single asset, with a contribution to the ECR based on the risk and return of the two together.

This is an adjustment that can be made only by those who have a detailed knowledge of the company's holdings of derivatives.

Completing the ICA

PS 04/16 does not make any changes to the regime set out in CP 190 for the implementation of the internal capital assessment, but it does make some changes to the timetable and sets out some clarification.

With effect from 1 January 2005 firms will be required to explain to the FSA how they have assessed their ICAs.

In effect this means that all firms will need to have completed an ICA by the end of 2004. This is a year earlier than was previously anticipated, but the FSA does recognise that the internal processes needed to carry out this work will take time to implement and that they will be looking at work in progress for some time.

They intend to review firms' ICAs over a two-and-a-half-year period, starting with firms that have the highest impact (basically, the biggest firms) and where the business or the risk profile warrants early attention.

There is also clarification of a sort of the basis for preparation of the ICA.

PS 04/16 says that individual capital guidance (ICG) will be set to produce capital consistent with "a 99.5% confidence level over a one-year period or, if appropriate to the firm's business, a lower confidence level over a longer period", and that the ICA should be prepared on the same basis.

This has in the past been equated to a financial security rating of BBB, although a security rated BBB appears to have a slightly lower probability of default.

Clarification from the FSA has indicated that firms that intend to maintain a higher rating than BBB should not prepare their ICAs to the higher basis but should demonstrate their greater strength by holding capital that is higher than an amount consistent with BBB.

This means that different companies' ICAs should be at a similar level of security.

The time horizon over which an ICA should be performed has been much discussed over the last two years.

PS 04/16 says that it should be prepared on the basis of "a 99.5% confidence level over a one-year period or, if appropriate to the firm's business, a lower confidence level over a longer period".

As some of the risks already present in a firm's balance sheet are unlikely to be sources of actual loss within the one-year horizon, but could be significant thereafter, it is rather surprising that the possibility of a one-year horizon is still contemplated.

A crucial aspect of insurers' ability to absorb losses is whether they can withstand the challenge of writing business through an underwriting cycle; an analysis horizon of one year is surely too short to assess this. Doubts remain as to whether an ICA prepared on a one-year basis can really answer the questions it is intended to and, in practice, it is acceptable to the FSA.

Individual Capital Guidance

No changes are made to the nature of ICG in PS 04/16.

However, there is some clarification of how it will be used.

ICG will be the FSA's view of what is an adequate level of capital for an individual insurer, it will be a regulatory intervention point.

It is pointed out that therefore firms will probably want to maintain a buffer of capital in excess of their ICG.

A firm may disagree with its ICG, which will lead to discussions and negotiations with the FSA.

However, if this does not lead to agreement then the FSA will be prepared to use its powers to vary the firm's permissions.

Finally, the FSA recognises that holding capital is not always the most appropriate way to meet risks.

Sometimes the FSA may identify an element of risk that needs to be met in other ways, perhaps by changing processes or setting up internal checks.

For this reason the formal ICA process will often be carried out in conjunction with Arrow visits, after which ICG will be advised.

Conclusion

PS 04/16 does not change much of what was expected after CP 190, but the timetable has become rather more challenging.

The most important change is probably the formal recognition of the ECR as a soft test.

On the other hand, the FSA does recognise that companies will grow into the new regime, especially in relation to the quality of the research that needs to go into an ICA; accordingly its expectations will become progressively higher over time.

References

Policy Statement 04/16 – Implementation of the ECR and ICA – original paper	Towers Perrin Tillinghast August 2004 Update
Policy Statement 04/16	http://www.fsa.gov.uk/pubs/policy/ps04_16.pdf
Lloyd's: Integrated prudential requirements and changes to actuarial and auditing requirements - Including feedback on CP04/7	Policy Reports December 2004 http://www.fsa.gov.uk/pubs/index-chrono-2004.html
Consultation Paper 190	http://www.fsa.gov.uk/pubs/index-chrono-2004.html
Individual capital adequacy standards - Feedback on CP136	Policy Reports July 2003 http://www.fsa.gov.uk/pubs/index-chrono-2003.html
Integrated Prudential sourcebook for insurers	Policy Reports July 2004 http://www.fsa.gov.uk/pubs/index-chrono-2004.html

Definitions

Money-market funds	Money-market funds are holdings in collective investment schemes, shown in line 43 of Form 13 of the FSA returns.
Arrow	Arrow is the risk-based approach to supervision developed by the FSA to facilitate the identification of risks and the allocation of their resources. For more detailed information, please see "The Firm Risk Assessment Framework", published by the FSA in February 2003

PART FOUR - PENSIONS

1. Introduction

The public profile of pensions has increased sharply over recent years and this is likely to continue in 2005 with significant changes in the industry expected over the coming years. These changes include a new Regulator, with more powers than Opra, and the new 'insurance' schemes the Pensions Protection Fund and Financial Assistance Scheme. All of these changes are scheduled to take effect in April 2005 although the Financial Assistance Scheme will be delayed.

Also, the replacement of the unloved MFR with Scheme Specific Funding is expected to be implemented in September 2005. Alongside this, there will be further activity preparing for the Inland Revenue's radically revised pensions tax regime, which comes into effect in 2006. Details of these and other changes as a result of the Pensions Act 2004 and Finance Act 2004 are discussed in detail in section 3 and 4.

On top of these issues many schemes continue to struggle with FRS17 deficits despite improved equity returns. This is primarily due to falling bond yields and rising longevity. Accounting for pension schemes under IAS19 has also seen changes in 2004. These are covered in section 7.

There have been a number of changes to Guidance Notes over the last twelve months. The most significant of these is arguably GN48 covering peer review of Scheme Actuaries' work. These, and other significant changes are covered in section 5.

Section 6 covers the main changes to Government regulations affecting pension schemes, and section 8 covers notes and guidance from Opra over the year.

Finally, section 9 comments briefly on some other issues, such as investment strategy for pension schemes and mortality investigations.

The comments in this paper are based on information available at the time of writing and are the authors' only, and do not necessarily represent the authors' employer's views.

2. Pensions Statistics

2.1 Key Market Indicators

The following table sets a summary of key investment market indicators measured as at 31 December over the last four years:

	2001	2002	2003	2004
FT All-Share Index net dividend yield	2.63%	3.55%	3.10%	3.05%
Merrill Lynch over 10 year AA Corporate yield	5.99%	5.52%	5.42%	5.30%
FT Actuaries 15 year gilt index	5.04%	4.50%	4.84%	4.57%
FT Actuaries over 5 year index-linked gilt index (2.5% inflation)	2.41%	2.14%	1.95%	1.66%
Implied Inflation	2.57%	2.31%	2.83%	2.86%

The main points to draw from this table are:

- Yields on fixed-interest gilts have fallen over the period by around 0.5%, however, yields on index-linked gilts have fallen even more, by around 0.75%. These changes are significant and will have increased many defined benefit schemes' liabilities as often the Scheme Actuary's funding basis is linked to levels of gilt markets.
- Corporate bond yields have fallen steadily over the four-year period, whereas implied price inflation has increased. This is expected to have increased funding costs and FRS17 accounting costs and Balance Sheet liabilities.
- The net dividend yield has been volatile reflecting the fluctuating levels of the UK equity market over recent years.
- Implied inflation (calculated by ratioing the yields on fixed interest gilts and index linked gilts) has fluctuated over the period, but remained within 0.5% of the Government's target of 2.5%.

2.2 Government Statistics

The following table summarises some key Government statistics relevant to the pensions industry:

	2002/2003	2003/2004	2004/2005	2005/2006
Basic State Pension (£ per annum)	3,926	4,027	4,139	4,267
Lower Earnings Limit (£ per annum)	3,900	4,004	4,108	4,264
Upper Earning Limit (£ per annum)	30,420	30,940	31,720	32,760
Average Earnings (£ per annum)	24,544	25,376	26,255	-

As expected the above figures have increased broadly in line with inflation each year.

3. Pensions Act 2004

The Pensions Act 2004 received royal assent on 18 November 2004. Its provisions will be implemented over a two-year period, with the first major changes effective from 6 April 2005.

The main provisions of this Act are summarised below.

3.1 Pension Protection Fund (PPF)

The PPF is a new compensation scheme that will apply to defined benefit and hybrid schemes where the sponsoring employer becomes insolvent and the scheme has insufficient assets to meet its liabilities. It is expected to commence in April 2005 and will be funded by a levy on defined benefit pension schemes. Certain schemes (such as unfunded Government schemes) will be exempt.

Details of how schemes will qualify for entry to the PPF are expected in April 2005. Levies will be set by the PPF Board and will eventually comprise of a fixed levy and risk-based levy.

Exactly what the risk-based levy will look like is unknown, although it is likely to depend on issues such as funding position, investment strategy and strength of employer. The initial levy is payable on 6 April 2005 but is not risk based (due to time required to set it up), but purely flat rate and has been set at £15 per active member and pensioner, and £5 per deferred pensioner as at 31 March 2005.

Schemes must also pay an administration levy based on membership numbers. An additional levy towards the PPF Ombudsman will apply, although not for the year commencing 6 April 2005.

The levy will be payable by the Trustees of defined benefit pension schemes. It is possible that Trustee decisions such as investment strategy will influence the level of the future risk-based levy payable, although it is currently too early to say. It would, however, also be concerning if conversely Trustee decisions were being influenced in this way by the PPF.

As more becomes known about the risk-based levy, Companies may want to consider their overall funding strategy, and whether it is better to pay additional contributions and bring the levy down. Other options may be buyout of members if the market is offering annuity rates which look attractive. However such decisions are long term planning ones once the PPF is in place.

3.2 Scheme Funding

The much maligned Minimum Funding Requirement (MFR) will be replaced with a new set of rules and there will be a requirement to satisfy a **Statutory Funding Objective** (SFO). The expected date is September 2005.

The SFO is expected to be less prescriptive than the MFR and will require the assets to match the 'technical provisions' (the EU term for 'liabilities') and if the SFO is not met, the Trustees must prepare a Recovery Plan which sets out the steps that they will take to meet the SFO and the period over which it will be achieved. At present the Government is not planning to impose a specific period for the recovery plan (although this may change). Regulations in this area specifying how the SFO will be calculated are expected in June 2005.

Trustees will also need to put in place a **Statement of Funding Principles** setting out their policy, timing and method of ensuring that the SFO is met. The Government intends that members should be advised of the funding position of the scheme and this could perhaps be done through the Trustees' Annual Report and Accounts or members' annual benefit statements.

The Statement of Funding Principles will, for many schemes, be the first time that the overall funding strategy has been clearly documented and made available for scrutiny by others. As with the Statement of Investment Principles, it is expected to involve considerable work initially.

The Statutory Funding Objective raises some interesting issues in relation to the balance of power between the Trustee and Employer, with any disputes being referred to the new Regulator.

Finally, the Act requires actuarial valuations to be carried out annually, or as an alternative, a full valuation every three years, providing the Trustees obtain an update actuarial report for the intervening years. This will increase schemes' running costs, but it could be argued that the introduction of more regular actuarial advice is in line with current best practice.

3.3 Pension Increases

The requirement for pension increases in line with RPI with a cap of 5% per annum (LPI) will still apply for pensions accrued from 6 April 1997 to the 5 April 2005. Pensions accrued after that date need only be increased at the lesser of 2.5% per annum and RPI.

Pensions arising from money purchase schemes (or money purchase benefits in other schemes) will no longer need to be increased with LPI.

Employers may wish to assess any long term cost savings expected to arise as a result of reducing the cap to 2.5% per annum, but any expected savings should be weighed up against the added complexity of administering a pension scheme with another tranche of benefit with different attaching pension increases.

3.4 Contracting Out

The Act introduces the ability to commute GMPs for cash (subject to possible additional restrictions). Spouse's GMP payable on the death of the member would be calculated ignoring any cash taken by the member in respect of their GMP. This proposal will remove the current restriction on the amount of tax-free cash that can be taken by some members.

Protected rights benefits will be allowed to commence payment earlier than at age 60 (but not later than age 65 on most schemes unless the member agrees otherwise). The Government intends that this change will help encourage flexible retirement.

Finally, the definition of 'working life', which is used to calculate GMPs, is being amended. Working life is currently defined to extend from age 16 to State Pension Age. This is currently age 65 for men and age 60 for women, but will be equalised at 65 between 2010 and 2020. For the purpose of GMP calculations the ages will remain as 65 for men and 60 for women so the definition of working life has been amended to reflect this.

Companies may wish to consider reviewing their contracting-out decision to establish whether it remains viable. Some companies may also wish to reduce risk in their pension scheme by contracting-in and reducing the level of benefits their schemes provide.

3.5 Financial Assistance Scheme

The Financial Assistance Scheme will be available to make payments to individuals who are or were members of certain underfunded pension schemes which **commence** wind-up before the PPF takes effect. The Regulations will prescribe several conditions which must be met by a scheme before payments from the Financial Assistance Scheme are made available to members or former members.

As with the PPF, the Regulations may enable the assets (and liabilities) of the scheme in wind up to be transferred to the financial assistance scheme.

There are currently no details on the Regulations for implementation of these proposals, although the implementation date is expected to be between April 2005 and June 2005. When they are available, the Regulations will set out further details of how the amount of the payments will be determined and the circumstances in which they will be paid. It has recently been announced that those within 3 years of retirement age will receive a top up to 80% of scheme benefits, but that assistance will be capped at £12,000.

3.6 New Regulator

The Pensions Regulator will "operate a targeted and proportional regulatory regime, applying greater regulatory scrutiny where it deems members' benefits are most at risk. This approach will be supported by increased powers to gather, retain and share information".

In practice, the Pensions Regulator will inherit all of OPRA's powers and functions. However, it has a much more complex structure and a range of additional powers and functions, including the ability to issue Codes of Practice, provide notices where a breach of legislation has arisen and additional powers in relation to winding up of schemes.

For most schemes in most situations, the existence of the Pensions Regulator will be of little relevance. Where schemes do interact with the Pensions Regulator, it expected to be a more constructive relationship than was previously possible with OPRA.

3.7 Member Nominated Trustees

The Government's intention remains that 1/3 of Trustees will be member nominated - although in the longer term this may rise to 50%. As a result, the employer 'opt-out' which permitted schemes to have less than $^{1}/_{3}$ member nominated trustees in certain circumstances and was part of the original Pensions Act 1995 legislation is being removed and this will simplify arrangements.

In practical terms, given the increased responsibilities on Trustees and the requirement for knowledge beyond that currently required, it may be difficult to find members wishing to be Trustees, particularly when the scope of their duties and responsibilities is explained to them. However, even where vacancies are not filled, they will need to be kept open.

3.8 Trustee Knowledge

The Act requires that Trustees must have an appropriate degree of knowledge and understanding of the law relating to pensions, principles of funding and investment of assets. They will also need to be conversant with their Trust Deed and Rules and associated scheme documents. Codes of Practice are expected to confirm what this means, but these are not yet available.

The requirements on Trustees will clearly be greater than the current requirements. Trustees will need to be able to demonstrate that they are suitably trained for the job, and this will inevitably lead to increased need for training and development. In some cases professional assistance such as an Independent Trustee may be advisable.

3.9 Consultation by Employers

Employers will be required to consult with employees when making certain changes to future provisions of the pension scheme. Trustees will also be impacted as they may be required to undertake similar consultation through the Employer if they propose to make changes.

Regulations are not yet available but are likely to refer to timescales, information requirements and other aspects of the consultation process.

It should be borne in mind that these are consultation requirements and not consent requirements.

3.10 Scheme Modification

The Act provides that where a modification is being made to a scheme which might result in a member's accrued rights being reduced, there will be considerably more communication to members. The Trustees must:

- give the affected member a written explanation of the proposed modification (and its effect on him),
- tell him he is entitled to make representations and give him a reasonable opportunity to do so,
- obtain his written consent to the modification, and
- meet certain reporting and approval requirements

In a similar way to the current provisions under Section 67 of the Pensions Act 1995 in some cases it will be possible to make changes without consent, provided that actuarial equivalence can be certified, although it will still be necessary to notify members and allow them to make representations.

3.11 Early Leavers

Currently, many schemes provide only for a refund of employee contributions if a member leaves within two years. However, the Act provides that members who leave after 3 months' pensionable service, but before becoming entitled to secured (or vested) preserved benefits in the employer's pension scheme, will have the option to chose between a refund of their own contributions and a transfer payment to another arrangement. This will potentially increase administration costs.

The Act also includes a proposal to increase the latest age from which pensions must become payable to early leavers, in line with the Government's policy of extending working life and encouraging flexible retirement. The latest age at which early leaver benefits must become payable will be increased from Normal Pension Age or 60 if later, to the later of age 65 and the individual's Normal Pension Age.

Schemes could reduce the impact of these proposals on their costs by having longer waiting periods before joining although they would need to bear in mind the stakeholder requirements. However, this may deter employees from joining the occupational pension scheme when they become eligible to do so.

3.12 Debts on Employer

Regulations over the year have introduced the requirement for full buyout funding of benefits on wind where the employer is solvent or insolvent.

At present when an employer leaves a multi-employer scheme its debt is calculated as its share of any shortfall in the scheme on the MFR basis.

To date the government has not yet revised this calculation to be on the buy out basis. The new legislation will make this change but also allow some flexibility in calculating the debt when an employer leaves a multi-employer scheme.

The Government has said that this debt would be based on buyout unless financial support arrangements that the Regulator considers adequate are put in place. Regulations will provide greater details on how these provisions will work.

The provisions in relation to multi-employer schemes are expected to reduce the claims on the PPF where group companies are available to share the cost of pension liabilities when an employer withdraws from the group. These provisions may become an issue for multi-employer schemes in a corporate transaction or reorganisation.

3.13 Pension Disputes

The requirement for an Independent Dispute Resolution Procedure (IDRP) will remain and the Trustees will need to make decisions in relation to a dispute but the procedure will not need to involve two stages as it does currently, so complaints from members may be resolved sooner, and more efficiently.

A further simplification relates to the requirement for decisions to be taken and notified to the applicant which will change from being required in set time limits to ‘within a reasonable period’.

The expected implementation date is September 2005. A Code of Practice setting out further details is expected but is not yet issued.

3.14 State Pensions

The rate at which deferred State Pensions are increased between State Pension Age and payment date is increasing from 1/7% per week to 1/5% per week from 6 April 2005.

In addition, the Government plans to allow anyone who defers their State Pension for at least 12 months to chose to take their missed pension instalments plus interest as a lump sum (subject to tax).

The Act will also enable disclosure of State Pension information to scheme advisors and administrators. This will assist third parties providing services to Trustees to prepare combined pension forecasts allowing for retirement benefits from different sources.

These proposals may encourage employees to request working on after retirement age, although it seems unlikely that there will be a significant change in working patterns resulting from these proposals alone.

3.15 Deferred Revaluation

Deferred pension benefits must be revalued from a member leaving a scheme to the time the benefits come into payment. The Pensions Act will provide that from April 2006 (expected date) a scheme can satisfy revaluation requirements by revaluing a deferred member’s total benefits in line with RPI.

3.16 Financial Planning

The Secretary of State is given powers to obtain individual member information from the scheme in order to promote financial planning for retirement. The provisions on how this information may be used are detailed. Commencement orders have not yet been issued.

The Government has been promoting combined pension forecasting for some time, and whilst these are currently voluntary this may be made compulsory if insufficient numbers of schemes provide them. Commencement orders have not been and may not be issued.

Employers may also be required to take action to enable their employees to obtain information and advice about pensions. Regulations are not currently planned in this area.

The expected implementation dates for these changes are June 2006 and April 2007 (if they do in fact go ahead).

3.17 Refunds of Surplus

Current regulations refer to a refund of surplus only being permitted if there is an excessive surplus on the statutory basis described in the Income and Corporation Taxes Act 1988. The requirement to dispose of excessive surpluses is being removed and therefore existing legislation will need to be amended. In future, the Trustees may agree to a refund of surplus to the Employer if certain conditions are met. It is the intention that a scheme should be fully funded on a buy-out basis before a refund can be made so very few schemes would currently be expected to meet this requirement.

3.18 Transfer of Employment

Pension protection on the transfer of employment is to be introduced. Following the transfer of a business to a new employer, some form of pension protection will apply to employees who were active members or were eligible to join the former employer's pension scheme. Pension arrangements with the new employer do not necessarily have to be identical to those provided by the former employer. The new pension arrangements must either be a final salary scheme which satisfies the Reference Scheme Test or provides equivalent benefits or a money purchase scheme with a minimum level of employer contributions at least matching employee contributions (up to a maximum of 6% of salary).

3.19 Paternity and Adoption Leave

Paid adoption and paternity leave are to be treated in the same way as maternity leave in that members will accrue benefits as if they are earning full pay and employer contributions are paid on the full notional salary, but the member will pay contributions on actual salary received.

3.20 Inalienability of Pensions

Schemes will now be permitted to recover overpayments of benefits to members.

3.21 Pensions Ombudsman

A Deputy Ombudsmen will now be permitted to be appointed who will carry out the duties of the Ombudsman when the position is vacant or at any other time as the Secretary of State agrees. In addition, the definition of administration is to be clarified with reference to the role of the Ombudsman largely relating to the administration of a pension scheme.

3.22 Additional Voluntary Contribution Schemes

The requirement for occupational pension schemes to offer an AVC scheme is to be abolished, although schemes may still do so if they wish.

4. Finance Act 2004

The Finance Act 2004 received royal assent on 22 July 2004. Its provisions will be implemented from 6 April 2006. The main provisions of this Act are summarised below.

4.1 Lifetime Allowance and Recovery Charge

The Act introduces a Lifetime Allowance (LTA) - the maximum value of pension benefits that can benefit from tax relief. The Standard Lifetime Allowance (SLA) is set at £1.5m for 2006/7, with increases in subsequent years being set by the Treasury. The SLA between 2006 and 2010 were fixed in the 2004 Budget as follows:

- £1.6m from 2007,
- £1.65m from 2008,
- £1.75m from 2009 and
- £1.8m from 2010.

The value of benefits will be calculated as Cash + Pension × 20 for defined benefit schemes, and the fund value for defined contribution schemes.

Where the value of benefits payable exceeds the LTA, a 'Lifetime Allowance Charge' (previously referred to as a Recovery Charge) will be payable. The charge will be 55% where the "excess" benefit is a lump sum or 25% where the "excess" benefit is a pension. Its payment is the responsibility of the scheme administrator and the individual.

4.2 Annual Allowance

The Act introduces an annual limit to the amount of any increases in the value of defined benefits which is known as the Annual Allowance. Money purchase contributions will also be limited to the Annual Allowance. This is intended to be a restriction which affects far fewer members than the Lifetime Allowance.

The Annual Allowance is set at £215,000 for 2006/7, with increases in subsequent years being set by the Treasury. Increases to 2010 were fixed in the 2004 Budget as follows:

- £225,000 from 2007;
- £235,000 from 2008;
- £245,000 from 2009; and
- £255,000 from 2010.

Individuals are liable for an Annual Allowance Charge where the limit is breached. This is at the rate of 40% on the excess over the Annual Allowance.

Contributions and benefits growth in the final year of service will be exempt from the Annual Allowance provided that all benefits vest in full in that final year.

For most members the limits will never apply, and the new contribution limits (see above) give considerably more scope than previously.

4.3 Member Contributions

With effect from 6 April 2006, up to 100% of taxable earnings (or £3,600 pa if greater) may be paid as tax-relievable employee contributions to registered pension schemes. Contributions above this amount are permitted, but will receive no tax relief.

Employers and Trustees need to decide whether to retain the existing limits in their own schemes on contributions/AVCs, abolish such limits or replace them with some other limit (perhaps designed to ensure that the Annual Allowance (see below) threshold is not breached).

It is possible that some members will want to make a large contribution at some time in their life (e.g. on receipt of a legacy). Where larger contributions are involved, the National Insurance savings afforded by the salary/bonus sacrifice alternative is likely to be an important consideration for members unless the Government clamps down on these arrangements.

4.4 Flexible, Early and Late Retirement

The Finance Act changes the minimum retirement age (except in cases of ill-health) to age 55 with effect from April 2010. Pension schemes will have the choice of whether to phase this increase or to introduce it in 2010. Transitional protection is given where, as at December 2003, members had the right to retire before age 55.

There will be no requirement to leave service in order to draw benefits from a pension scheme. Nor will there be a requirement to draw all benefits at the same time. Occupational schemes - both defined benefit and money purchase, will be able to allow partial retirement.

The Act also introduces changes to the provisions for income drawdown. Under income drawdown before the member has reached age 75, the maximum income each year will be 120% of the relevant FSA pension annuity tables, but there will be no minimum. This will apply to all types of money purchase scheme. The limits will be different after age 75.

4.5 Death Before Retirement Benefits

Under the Act, on death before benefits commence, an unlimited lump sum can be paid. Provided this does not exceed the unused Lifetime Allowance (see Section 4.1), this will normally be tax-free. Any excess will be taxable at 55%, and the recipient will be responsible for this charge.

In addition to the lump sum, unlimited (taxed) dependants' pensions can be paid.

Employers will need to consider whether or not to retain existing benefits on death in service, in particular to the possibility of paying more of the death benefits in the form of a tax-free lump sum, and less in the form of a taxed pension.

Some high earners not subject to the Earnings Cap will have a current tax-free lump sum death in service entitlement which is greater than that available under the new regime. Decisions will be needed on how to deal with such members.

4.6 Tax-Free Cash

Under the new regime, the maximum tax-free cash sum which an individual will be able to draw from the scheme will be 25% of the value of the pension benefits or fund, subject to a maximum of £375,000 (25% of the Lifetime Allowance). For money purchase benefits this is normally a straightforward concept.

However, for defined benefit schemes this simple principle will still need a more complicated calculation to establish the actual maximum amount which can be taken. The calculation is $\frac{P \times 20 \times CF}{3 \times CF + 20}$ where *P* is the member's pre-commutation pension, and *CF* is the Scheme commutation factor.

In most cases the change will represent a substantial improvement to the tax-free cash available. However there will be some cases where the change will reduce the amount available. In these cases members can obtain protection of their existing entitlements.

Members will also be allowed to take 25% of AVCs as cash, even where AVCs commenced after 6 April 1987. Previously this was not allowed.

The new rules represent changes to the limits, and do not immediately change Scheme benefits. It will therefore be up to individual Employers and Trustees to determine to what extent they would like to allow members to benefit from the changes (or what limits they need to impose to ensure that payments remain authorised). This will apply to both main scheme benefits and AVCs.

4.7 Trivial Commutation

The new limit for trivial commutation will be a value of all pensions of 1% of the SLA. Based on the initial SLA of £1.5m the limit will be £15,000 - this is equivalent to a pension of perhaps 2-3 times higher than the old limit.

Changes in the law will mean greater restrictions on when such trivial commutation can take place, with all such commutations (for example if you have multiple schemes) taking place within a 12-month period, and only available if the total value of pensions is trivial. However such commutation will be available at the option of the member - unlike the previous arrangement where it was at the discretion of the Trustees.

4.8 Earnings Cap

With effect from 6 April 2006, the Earnings Cap will cease to exist, as there will no longer be any service or salary related limits imposed by legislation or the Inland Revenue.

However, the Act does make provision for individual schemes to modify their rules where they refer to current Inland Revenue limits, and therefore schemes may decide to continue with such limits.

For defined benefit schemes Employers and Trustees will need to decide whether they want to retain the existing Earnings Cap (or similar) as a limit, or whether these should be abandoned. If the latter option is chosen, decisions will need to be made regarding future retirement provision for those members who are earning in excess of what was the Earnings Cap, as well as how to treat historic benefits which may no longer be capped. Supplementary retirement provision outside of the main pension scheme will also need to be considered.

Under the new regime, a large salary increase or retrospective benefit improvement could generate a significant increase in value of benefits and therefore an unexpected annual allowance charge. Hence the Annual Allowance will need to be monitored for high earners. A decision therefore needs to be made on how this will be done.

4.9 Unapproved and Unfunded Pension Schemes

The legislation surrounding funded unapproved schemes (FURBS) and unfunded unapproved schemes (UURBS) is complex - both in the historic rules, the new rules and therefore the transition. While both types of scheme will continue to be available, details of tax relief applying to contributions and benefits are very complex.

Certain transitional arrangements will apply. For example, an UURBS may be converted into a registered scheme within 3 months of April 2006, and certain benefits from existing FURBS can be protected.

Whether FURBS and/or UURBS should be provided after April 2006 or be replaced by registered scheme benefits or a salary supplement will be an important consideration, but will in practice require specialist advice.

4.10 Transitional Arrangements

Benefits built up prior to 6 April 2006 may be protected from the Lifetime Allowance and the associated charge on excess benefits. The transitional protection can take one of two forms:

1. **Primary Protection** - This will apply where benefits are valued at more than £1.5 million at 6 April 2006, and will operate by an individual registering a higher, Individual Lifetime Allowance. Benefit accrual can continue after 2006. The Lifetime Allowance Charge would apply to any benefits in excess of the Individual Lifetime Allowance.

2. **Enhanced Protection** - This will apply where the member opts out of future benefit accrual. This option can be chosen even where the value of benefits at 6 April 2006 is less than £1.5 million. In this case, there will be no liability to the Lifetime Allowance Charge or the Annual Allowance Charge.

Registration of protection must be given to the Inland Revenue within 3 years of 6 April 2006, although for Enhanced Protection contributions and accrual must cease before April 2006.

As well as the overall benefit protection, lump sum rights exceeding £375,000 (i.e. 25% of the Standard Lifetime Allowance) at 6 April 2006 may also be registered and protected, and lump sums in excess of 25% of benefits at 6 April 2006 can be protected for those not requiring enhanced or primary protection.

5. Guidance Note Changes

GN11: Retirement Benefit Schemes - Transfer Values

Version 9.1 *GN11: Retirement Benefit Schemes - Transfer Values* came into effect on 1 March 2004. The changes made to version 9.0 were minor clarifications, with the exception of the change made to paragraph 5.3.1 which stated that when preparing a GN11 report, to enable trustees to reduce cash-equivalent transfer values in underfunded schemes, the actuary may take assets into account at a higher amount than their market value, if he or she considers that to be appropriate. (This may be the case for certain insurance policies.)

Other clarifications were:

- Paragraph 5.2 required actuaries to advise the Trustees of the appropriate reduced transfer value or advise the Trustees of the implications where no reduction is applied. This has been moved after 5.3.5 (now 5.2.6), to make it clear that it imposes a duty which is not discharged merely by the provision of a 'GN11 report'.

- Paragraph 1.5 covers calculations for the purposes of both the Listing Rules and the Directors' Remuneration Report (DRR) Regulations. While the Listing Rules state that reductions to cash-equivalent transfer values in underfunded schemes should be ignored, Parliament did not include such a statement in the DRR Regulations. It is therefore a matter of legal interpretation whether reductions should be ignored or not. The Pensions Board did not consider that it was the responsibility of the Profession to make that decision. GN11 is therefore silent on the matter. It should be noted that, the Directors’ Remuneration Regulations refer to GN11 Version 8.1 which makes clear that no reduction is applied.

GN9: Funding Defined Benefits - Actuarial Reports

Version 7.0 came into force on 20 March 2004. (Version 6.0 can continue to be used for valuations with earlier effective dates, provided that this is indicated in the report.) The main changes proposed by the exposure draft EXD51 were discussed in last year’s Current Topics paper and are not repeated in this year’s paper. However, an explanation of the changes made to the exposure draft EXD 51 is given below.

- Paragraph 1.4 covers the position of updated funding advice between formal valuations. Despite some comments during the consultation that the scope of this paragraph was too wide of the Pensions Board has decided not to amend it. This is because the Pensions Board interprets the opening phrase “the actuary *may* need” as excluding immaterial augmentations or changes, and so no explicit materiality exemption was needed.

- Paragraph 1.7 has been added and states that any limitations on which third parties may rely on the advice must be set out in the report. The Pensions Board expresses no view about the desirability of such limitations. The Pensions Board also noted that the actuary might have separately agreed restrictions on the use of the report with the trustees.

- A new requirement on the actuary has been introduced in paragraph 2.2.5. This is to state in the report that the primary responsibility for the accuracy of the data lies with the trustees. The sections previously labelled “Funding Objectives”, “Valuation Assumptions and Methods”, and “Contributions” have been merged into a single section called “Funding” to emphasise the distinction between funding and solvency. The requirement to state the ‘ongoing’ funding level has also been re-introduced in paragraph 2.4.8. However, this is conditional: “Where the funding objectives set out in 2.4.1 include a target funding level”. The Pensions Board believes that the projected unit funding method is used in the great majority of cases and hence that a statement of the ongoing funding level will generally be required. The conditional clause also covers the reconciliation requirement. The Pensions Board expects that actuaries using objectives that do not include a target funding level would generally complete some reconciliation, but have not included a specific requirement to cover these rare cases.

- The Pension Board plans to require reconciliation on the solvency basis for all schemes in the next revision of GN9.

- An allowance for the buy-out cost to be estimated with reference to the “parameters provided by an insurance company” has been introduced in paragraph 2.6.4.

- A requirement to include in the report a note about the approximate nature of the gilts - 0.5% calculation used as an alternative to a detailed analysis of risk reserves has been added to 2.6.4.5.

- The Pension Board deleted “assuming the actual future experience reflects market levels and financial conditions at the valuation date” from (what is now) paragraph 2.6.6. This sentence refers to whether the contribution rate is expected to maintain members accrued rights and has been amended to address concerns about how this phrase should be interpreted. The new requirement “The actuary must state the assumptions used” is much less prescriptive. The Pensions Board decided to revise this paragraph so that it left the assumptions to actuarial judgement.

GN13: Actuarial Statements Required in Connection with the US Statements of Financial Accounting Standards No 87, No 88 and No 132 (FAS 87, 88 and 132)

In December 2003, the Financial Accounting Standards Board (FASB) issued a revision to the Statement of Financial Accounting Standards No 132 - Employers’ Disclosures about

Pensions and Other Post-retirement Benefits an amendment to FASB Statements No 87, 88, and 106 (FAS132).

GN13: Actuarial Statements Required in Connection with the US Statements of Financial Accounting Standards No. 87, No. 88 and No. 132 (FAS 87, 88 and 132) Version 3.3 came into effect on 1 June 2004 as a Technical Amendment.

The Guidance Note has been amended to:

- Ensure that references to FAS 132 in the Guidance Note are to the revised version; and

- Clarify that GN9 Version 6.0 should be used for the calculation of the Accumulated Benefit Obligation (ABO) set out in paragraph 2.5 of GN13 as FASB has approved GN9 Version 6.0 for this purpose (GN9 Version 7.0 came into effect on 20 March 2004). This means the ABO can be calculated as the value of accrued benefits on an ongoing basis excluding allowance for future salary increases (but allowing for statutory revaluation if a member left the scheme), or if greater the value of the scheme's discontinuance liabilities measured on a closed fund basis

GN48: Compliance Review: Pensions

GN48 is being introduced to ensure that advice given by Scheme Actuaries under Practice Standard Guidance Notes is subject to a process of review. It is being issued as Recommended Practice with effect from 31 December 2004, the intention being that it becomes a Practice Standard on 1 January 2007 (although as renewal of scheme actuary certificate in 2007 is dependant on compliance within the last year, it must effectively be complied with from January 2006).

Because this is the first Guidance Note issued by the Actuarial Profession to cover compliance review, it has been the subject of lengthy consultation. There was initial consultation with a large number of organisations that employ Scheme Actuaries. An Exposure Draft (EXD52) was then issued under Due Process and many firms and individuals provided comments in writing or at the consultation meetings held in London and Edinburgh. Many of the suggestions made were reflected in the final Guidance Note.

Detail

The profession believes that having work reviewed can enhance the quality of advice.

GN48 is concerned with the work of the Scheme Actuary. The Pensions Board has indicated that over the longer-term the intention is to extend the scrutiny further, at least to all areas of pension work for which there is an actuarial standard in place and possibly to all pension advice.

Evidence of compliance with GN48 will be achieved through self-certification provided as part of the scheme actuary certification process.

Restrictions on scope

- GN48 is not a general description of how to conduct an effective review. The Guidance Note does, however, indicate aspects of a broader review that are not covered by compliance review, such as checking the underlying calculation routines or carrying out an inspection of all the supporting files.

- Compliance review, as described in the Guidance Note, is not intended to represent a complete or sufficient review process. Compliance review is concerned only with those matters covered by Practice Standard guidance.

- The Guidance Note does not impose detailed rules concerning the contractual relationship between Scheme Actuaries and Reviewers. For example, confidentiality and liability to each other and the client are matters that both parties may wish to consider. Legal advice has been obtained concerning certain aspects of GN48 and a summary of that advice will be made available on the profession's website.

- The Guidance Note does not expand on the requirements of the Professional Conduct Standards (PCS). For example, the PCS governs professional behaviour in the event that either the Scheme Actuary or Reviewer is concerned about the professional standards of the other party. The Guidance Note also does not mandate that the Reviewer is a Scheme Actuary and relies on the PCS requirements that the Reviewer considers him or herself competent for the role.

In summary, the Guidance Note ensures only that, in certain aspects of a Scheme Actuary's role, the Scheme Actuary is required to obtain input from another actuary. The Scheme Actuary remains accountable for the advice delivered to the client.

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

Introduction

This Guidance Note sets out the way in which the actuary should determine the assets available to each priority liability class when an occupational pension scheme subject to the MFR requirements winds-up, and how any debt due from an employer should be determined.

The Government has laid regulations whose main purpose is to require that more debt on the employer calculations are performed on a full buy-out basis. To coincide with these new requirements the Pensions Board has revised GN19: Retirement Benefit Schemes Winding-up and Scheme Asset Deficiency. Version 4.5 came into effect on 15th February 2005 as a technical amendment (note that other versions have appeared during the year, each to take account of regulation changes).

Detail

The Occupational Pension Schemes (Winding Up, Deficiency on Winding Up and Transfer Values) (Amendment) Regulations 2005 make a number of changes to the calculation of the debt on the employer and associated allocation of assets to priority liabilities on a schemes winding up. In detail the regulations require:

- Schemes that commence winding up from 15 February 2005 to have the debt on the employer calculation performed on the full buy-out basis, regardless of whether at that point the employer was solvent or insolvent.

- The associated allocation of assets to priority liabilities on a scheme's winding up with an insolvent employer at commencement to have assets apportioned through valuing the liabilities on the full buy-out basis.

- The use of the full buy-out basis if from 15 February 2005 a participating employer in an ongoing multi-employer scheme becomes insolvent.

Future changes to GN19

The Pensions Act 2004 makes significant changes to sections 73 and 75 of the Pensions Act 1995. Sets of regulations covering both sections are expected to be finalised in the near future. GN19 is accordingly being subject to a major review to address the new requirements.

6. Pensions Regulations Changes

A number of regulations were amended over the year. Those of arguably most significance are detailed below:

Deficiency on Winding-Up

1. The Occupational Pension Schemes (Winding-Up and Deficiency on Winding-Up etc) (Amendment) Regulations 2004, came into force on 15 March 2004. The amending Regulations introduce stricter conditions on the wind-up of pension schemes where the sponsoring employer is still solvent, and will apply to schemes commencing wind-up on or after 11 June 2003.

   The Regulations amend the calculation of the liabilities for the purposes of both the statutory priority order covering the apportionment of assets on wind-up and the debt on the employer. In such cases the liabilities will include:

   - the estimated costs of winding-up the scheme;

   - annuity costs for pensioner members (including the costs of increases to those pensions); and

   - buy-out costs for those yet to receive pensions (i.e. deferred pensioners, future contingent pensions and those entitled to pension credits).

   Importantly, the employer's debt is not affected where the debt arises on cessation of the participation of a participating employer.

   Although the revised provisions apply to schemes commencing wind up on or after 11 June 2003, they only apply to calculation dates from 15 March 2004. Therefore the buy-out basis will only apply to debts where the applicable time is on or after 15 March 2004.

The question of whether or not an employer is solvent is determined at the commencement of winding-up.

The revised method of calculating the liabilities applies even where the employer subsequently becomes insolvent. *This will have an impact on the apportionment of liabilities where, as a result of subsequent insolvency, the trustees are unable to recover the full amount of the debt. The value of liabilities will be higher, leaving a lower level of cover for lower priority liabilities.*

This restriction on the calculation date may also have posed a problem for trustees where wind-up was triggered after 11 June 2003 but the employer became insolvent before 15 March 2004 (as the applicable time may be no later than the insolvency date).

2. The Occupational Pension Schemes (Winding-Up, Deficiency on Winding-Up and Transfer Values) (Amendment) Regulations 2005 came into force on 15 February 2005.

The broad aim of the amendments is to bring the priority allocation and debt calculation for insolvent employers in line with that for solvent employers. *The changes may have been driven by Government concerns that employers may be taking action to avoid the full buy-out debt that would apply in a "solvent employer wind-up" situation. Although this is being sold as a provision to protect the scheme (and hence members) as creditor, it could also driven out of a feeling that action needed to be taken to protect the PPF.*

The Regulations amend both the debt calculation and the section 73 priority allocation to be based on a buy-out liability valuation in the following circumstances:

- Wind-up: where the employer is insolvent at the point of commencement.
- An employer insolvency under a multi-employer scheme.

For debt calculation in such cases, the liabilities will also include the trustees' estimate of the likely expenses of wind-up.

Importantly, the Regulations do not impose this higher level of debt where an employer ceases to participate in a multi-employer scheme. *This was possibly presumably because this is politically difficult and will be dealt with in any case under the Pensions Act which will specify a debt based on buy-out cost (unless the Regulator specifies a lower debt).*

Priority Order Regulations

New Regulations came into force which will apply to wind-ups commencing on or after 10 May 2004. The new priority order is broadly the post-2007 priority order, except that increases to pensions in payment will take priority over increases to accrued rights.

Schemes which have already started to wind-up, or do so before 10 May 2004, will continue to use the current priority order.

The statutory priority order for wind-ups that commence between 10 May 2004 and 5 April 2007 (after expenses and debts to third parties) is:

(a) pensions or benefits derived from Additional Voluntary Contributions;

(b) pensions secured by annuities bought before 6 April 1997 which cannot be surrendered (without indexation);

(c) other pensions/benefits in payment (without indexation);

(d) benefits for non-pensioners - without pension increases;

(e) indexation for pensions in payment (categories (b) and (c) above); and

(f) non-pensioner indexation - in relation to (d) above.

Amendments to the Minimum Funding Requirement (MFR)

The Occupational Pension Schemes (Minimum Funding Requirement and Actuarial Valuations) Amendment Regulations 2004 came into force on 21 December 2004. The regulations:

- Extend the end-date of the transitional period from 31 December 2004 to 5 April 2006. Therefore MFR valuations will not be triggered following significant events or serious shortfalls before the scheme specific funding rules - included in the Pensions Act 2004 - have been implemented. However, where self investment above 5% is allowable under the transitional arrangements, the requirement to ignore such excess investment for MFR valuations will apply from 31 December 2004.
- Clarify what winding-up priorities should be assumed in the MFR certificate for an ongoing scheme. The certificate must reflect the priority categories which would apply if the scheme were to commence wind-up at the effective date of the statement. This is an important clarification as it has been an area of uncertainty for Scheme Actuaries in the past.

7. Accounting for Pension Expense

On 16 December 2004, the International Accounting Standards Board (IASB) issued an amendment to IAS19: *Employee Benefits.* The IASB decided to allow the option of recognising actuarial gains and losses in full in the period in which they occur, outside profit or loss, in a Statement of Recognised Income and Expense (SORIE) with the balance sheet reflecting the full surplus or deficit in the Scheme. This option is similar to the requirements of the UK standard, FRS 17 *Retirement Benefits.*

UK listed companies will be required to adopt IAS19 for their consolidated accounts for years commencing from 1 January 2005. Other companies will have a choice as to whether to adopt IAS19 or continue with UK accounting standard (FRS17).

IAS19 and FRS17 are very similar. However, there was previously a significant difference between their treatment of actuarial gains and losses.

Previously, IAS19 required actuarial gains and losses (i.e. unexpected changes in value of the benefit plan from, for example, pay increases exceeding those assumed, more/less members leaving the scheme than assumed, etc) to be recognised in profit or loss, either in the period in which they occur or spread over the service lives of the employees. Many entities choose to spread the gains and losses and their balance sheet will not show the full surplus or deficit in the scheme (as there will be gains and losses yet to be recognised in profit and loss). FRS17 recognises them immediately in the Statement of Total Recognised Gains and Losses (STRGL) and the balance sheet reflects the full surplus or deficit in the scheme.

IAS19 also permits use of a ‘corridor’ so that only actuarial gains and losses outside the ‘corridor’ equal to 10% of the greater of the asset value and liability values need to be recognised in profit and loss, and on the balance sheet.

Under the amendment, entities that currently spread the gains and losses under IAS19 **are not required to change their approach, but are now free to choose to do so**. In particular, the amendment allows UK companies that are already showing the surplus or deficit in full under FRS 17 to continue with their present policy when they adopt IAS19.

The amendment also (a) specifies how group entities should account for defined benefit group plans in their separate or individual financial statements and (b) requires entities to give additional disclosures.

UK listed companies which previously disclosed their pension costs under FRS17 (or SSAP24) will need to consider:

- The approach the company wishes to take towards the recognition of gains and losses.
- Ensure that the balance sheet figures for the start of the prior year are being calculated.
- The approach the company wishes to take to the initial recognition of surplus or deficit.

Other Companies will need to consider whether they would adopt IAS19 or remain on UK accounting standards.

The approach to be taken towards adopting IAS19 for the first time is set out in another International Financial Reporting Standard, IFRS1 (First-time adoption of International Financial Reporting Standards). This covers issues such as what prior year figures are required and how the initial surplus or deficit should be recognised.

In terms of the impact on the company balance sheet, IFRS1 gives companies the choice of either:

- recognising the initial surplus or deficit immediately on the balance sheet (as under FRS17), or
- calculating the IAS19 figures back to the beginning of the scheme and recognising on the balance sheet the liability or asset that would have emerged had IAS19 always been followed.

In practice we expect most companies to recognise the initial surplus or deficit immediately on the balance sheet as the alternative option will involve onerous calculations if the scheme has been in existence for many years.
It should be noted that the initial change to the balance sheet is recognised against retained earnings (or some other category of equity) in the balance sheet, but does not affect the profit and loss account.

8. OPRA Updates/Guidance

The most important updates published during the year were:

Opra Bulletin 30

Opra published Bulletin 30, which included the chairman's letter looking at the Pensions Act and Opra's priorities in the new regime. It also looks at Opra's (forthcoming) revisions to ON6 - the reporting guidelines for non-statutory whistleblowers (see below).

Occupational Pensions Regulatory Authority (Opra)

Opra published Opra Update 10 *Avoiding pension liabilities - implications of the Pensions Act 2004 for employers and trustees*, which sets out the approach that Opra (and TPR) intend to take to reduce the risk to scheme members and the PPF of pension liabilities being avoided.

The Update is aimed at employers and trustees of defined benefit pension schemes as well as companies involved in corporate transactions, and explains that certain corporate transactions on the part of a sponsoring employer and other actions or inactions by employers or trustees can create risks for the pension scheme. In addition the powers of TPR from April 2005 are set out.

These include contribution notices, financial support arrangements, restoration orders and clearance statements. Although Opra does not have these powers, it has set up a team to examine cases where employer-related risks may be apparent and from April 2005 it will pass any information on such risks to TPR. The Update sets out guidance for those who wish to pass information on to Opra, so that employers or other companies can discuss the implications of any proposed action to gauge TPR's likely view (although Opra cannot bind TPR to a certain view).

Contributions - Guidance for Personal Pension Providers

Since April 2001, reports to Opra have been required where employers have failed to pay contributions to personal pension arrangements (including stakeholder arrangements) within the required time periods. Opra Note 8, *Direct payment arrangements by employers to personal pension and stakeholder pension schemes*, issued in February 2001, provided guidance to providers of personal pension schemes (including stakeholder schemes). Update 6 provides further guidance on the change to Opra's regulatory approach in this area.

The Right to Report Problems to Opra

Opra's new guidance for voluntary whistleblowers outlines the circumstances in which pension scheme trustees and their professional advisers, pension scheme administrators and other service providers have a legal power to report to Opra. It follows the traffic light approach adopted in the revised Opra Note 1, reflecting Opra's focus on breaches that may pose a significant risk to members' interests. The guidance does not apply to mandatory reporting applicable to scheme actuaries or auditors, or to scenarios where trustees are obliged by statute to report (e.g., late contributions).

Compromising an Employer's Debt - Actions that Opra Expects Trustees to Take

The new guidance outlines important steps trustees must take when considering whether to compromise an employer's debt (i.e. to receive less than the statutory debt) in an underfunded pension scheme.

Update 7 was published on 17 May 2004, and sets out Opra's understanding of the legal position together with action that Opra expects from both trustees and advisers.

Although the update recognises that as a matter of law (as set out in Bradstock) trustees do not have to enforce the statutory debt the note has been produced because Opra has concerns that some trustees are entering into agreements that do not achieve the best outcome for members.

Generally, trustees' fiduciary duty requires them to get all the money owed to the trust - so the general position is that they would only enter into a compromise agreement where this is likely to result in more money than pursuing the full debt. The update gives a brief outline of the action that Opra would expect trustees to take in considering such an agreement, in particular:

- If trustees are conflicted, they should consider appointing an independent trustee (or where possible, opting-out of involvement in decision making).

- Other alternatives should be considered - such as deferral of wind-up (where there is a reasonable expectation that the employer's position may improve), reducing or ceasing future accrual in an ongoing scheme, applying for an MFR extension, enforcing the entire debt or seeking guarantees from the scheme employer or another employer in the group. The Update comments that some schemes have successfully obtained contributions from other employers within a group, either as a result of legal action, informal pressure or media campaigns.

- Trustees should take all the specialist advice they need. This will include advice from the actuary, investment advisers and investigating accountants or insolvency specialists who will be able to assess the financial circumstances of the employer. Opra's experience is that the latter often results in an increased offer from the employer.

- Trustees must negotiate assertively and not simply accept what the employer tells them. *This together with the point regarding conflicts is particularly pertinent for trustees who are closely involved with the employer - for example FDs. The update includes a reminder that the new Regulator will have powers to undo compromise agreements entered into after 11 June 2003.*

- Trustees need to be able to produce records to show the actions they have taken (they already have a statutory obligation to do this.)

- The same level of diligence must be applied as would be the case were the scheme continuing. Also, trustees should not rely on the PPF.

Opra states that compromise agreements for schemes in wind up fall into their amber scenario. The update makes a request for statutory reporters to consider whether to whistle blow where they are aware that an agreement is being considered and they have concerns, and emphasises that Opra would rather know before it is too late to take action.

In an ongoing scheme, Opra would expect trustees to let them know in advance if the trustees are considering compromising future contributions, or if the trustees are unable to take the steps outlined above.

In either case Opra would not expect reporting of a compromise agreement to be necessary where a court has approved the agreement.

Opra Bulletin 33

This Opra Bulletin contains comment on the transition from the MFR to scheme-specific funding. A summary of the main points in this Bulletin are:

- Opra will take a dim view of any trustee who commissions an out of cycle MFR valuation to delay the first scheme specific valuation

- The first scheme specific valuation will apply on a normal three year cycle – i.e. to the first valuation with a post 22 September 2005 effective date.

- The new regime is less prescriptive than the MFR, but trustees will be required to choose the actuarial method and assumptions to be used in funding valuations prudently. In line with the partnership approach of the new provisions, trustees will, however, need to obtain the employer's agreement to the method and assumptions to be used. Where a funding deficit is revealed by an actuarial valuation, trustees will be required to put in place an appropriate and time-limited recovery plan to eliminate it. When doing so they will be able to take account of relevant scheme-specific factors, including the employer's financial circumstances.

- The new requirements also feature improved arrangements for keeping scheme members informed about the funding position of their scheme. Trustees will be required to issue an annual funding statement to all scheme members providing updated information about the scheme's funding level, and about its solvency position - in particular, the extent to which members' accrued benefits could be secured through the purchase of annuities and deferred annuities if the scheme were to start winding up on the effective date of the valuation.

9. Other Issues

9.1 Investment Matters

Myners Principles

After two years, the Government has now reviewed industry progress on the original Myners Principles. Government proposals (which are subject to consultation) imply a considerable raising of the bar in terms of Trustee governance, responsibility and education regarding investment matters.

The review also alludes (like the Morris review) that Trustees consider yet further unbundling of actuarial and investment services.

Liability-Driven Investment (LDI) Strategies

Historically, many pension scheme trustees have invested their scheme's assets without necessarily taking account of the scheme's liability profile. This is often the case where schemes invest in pooled investment vehicles such as managed funds where the asset allocation is based on the "average" allocation for segregated funds.

Many pension schemes are now moving away from this peer group comparisons towards "liability driven" strategies. These investment strategies have, at their core, a "transparent linkage" between liabilities and assets. This allows trustees to define the investment objectives explicitly in terms of the liabilities. For example, a liability driven objective might be to match the change in liabilities plus out performance by x% per annum.

The liability driven approach also analyses the cash flows of the scheme and assesses which assets most closely mimic the characteristics of the liabilities. Also, many pension scheme risks can now be effectively hedged due to evolutions in financial markets. Overall, the liability driven investment objective should be viewed as a refinement of existing objectives rather than a completely new approach.

Several investment managers are now offering LDI products, where the costs can be paid as a one-off payment or phased over a number of years.

9.2 Mortality

CMI Working Paper 9 has now been published. This follows on from CMI Working Paper 4, providing analysis of the mortality of male pensioners in occupational pension schemes.

Key features of the analysis include:

- The overall amount of deaths equated to 110% of PMA92 for males and 116% of PFA92 for females (the tables being projected to year of use). This is significantly **heavier** than the recent findings for life office pensioners published in CMIR 21. This feature is partly explained by the experience below ages 65, which may be less relevant for some schemes' pensioner experience. For example, just looking at ages above 64, the ratios are 105% and 113%.

- The different industry classifications (where sufficient data is available) show overall amount of deaths for males, relative to PMA92 (projected to year of use), of 126% for Basic Industries, 99% for General Industries, 112% for Cyclical Industries, 114% for Information Technology, 98% for Financials and 143% for Local Authority.

- The mortality experience has been investigated separately for different bands of pension amount. The overall amount of deaths for males, relative to PML92 (note this is a lives table) were found to be 107% for pensions under £4,500pa, 102% for £4,501-£8,500pa, 80% for £8,501-£13,000pa and 66% for pensions over £13,000pa. The ratios varied considerably by age, being much closer at high ages than at young ages; further detail is provided in the Working Paper.

- This type of analysis raises the possibility of using mortality tables based on individual pension size, rather than traditional amounts tables, which imply an amount distribution in line with the population on which the mortality table was based.

The analysis is based on a large volume of data (2.35 million years of risk, 85,000 deaths and £11.88 billion of pension). The initial results may appear to indicate pensioner mortality heavier than PA92 (projected to year of use). However, it should be noted that these results represent data received in the first year of investigation only, so there could be selective effects in terms of which schemes have submitted data so far.

9.3 The Pensions Commission (Turner Commission)

The Pensions Commission, an independent body established by the Government to review the regime for UK pensions and long-term savings and to look into the need for compulsory pension saving, has published its first report.

The report highlights the demographic changes that will inevitably make pensions and other savings more expensive in the future. It suggests four possible consequences:

- pensioners will become poorer relative to the rest of society; or
- taxes/National Insurance contributions devoted to pensions must rise; or
- savings must rise; or
- average retirement ages must rise.

The report also concentrates on three possible ways to achieve adequate levels of saving:

- a major revitalisation of the voluntary system; and/or
- significant changes to the state system; and/or
- an increased level of compulsory private pension saving beyond that already implicit within the UK system.

The report does not set out a recommended solution but has invited comments from interested parties. The Commission plans to publish a final report in the autumn of 2005.

THE MORRIS REVIEW OF THE ACTUARIAL PROFESSION

Background

The Penrose Inquiry into Equitable Life, published in March 2004, criticised the actuarial profession on a number of counts. In response to these criticisms the Government asked Sir Derek Morris (recently retired Chairman of the Competition Commission) to conduct a review of the actuarial profession.

The terms of reference of the review were to 'consider what professional and 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'.

The Initial consultation

The initial consultation document was published in June 2004. This gave some background information about the actuarial profession, including the regulatory framework, professional qualification and GAD's role. The paper went on to pose a series of questions, calling for opinions from actuarial practitioners, users of actuarial services, GAD clients and consumer and trade bodies. The questions were mainly around reserved roles (roles that are reserved exclusively for actuaries), the accountability of actuaries and the market for actuarial services.

The Profession's response to the initial consultation

The Profession clarified that actuaries cannot predict the future, but build financial models to throw light on alternative future circumstances so that people can plan for a range of outcomes.

The profession is concerned that in the new world the drive for transparency and its implementation has preceded the education of most consumers to handle the new information.

It was emphasised that there were a series of initiatives under way by the Profession to reappraise its role.

- Creation of an actuarial standards board, containing independent members, to oversee the process of setting guidance for actuaries
- Consideration of extending the concept of practising certificated to cover all actuaries giving advice on actuarial matters (these had formerly only been required for actuaries in statutory roles)
- Introduction of peer review in certain areas of actuarial work
- Institution of a more independent disciplinary process
- Implementation of a new education syllabus, which has been extended to cover techniques across a range of different business areas.

In closing, the Actuarial Profession had confidence in its view of the future provision and regulation of actuarial services.

The Interim Review

The interim review was published in December 2004 to summarise the feedback received during the initial consultation period.

Sir Derek admitted that he had no reason to doubt that the majority of Actuaries in the UK are dedicated, skilled professionals providing important and useful advice to the best of their abilities, with commitment, integrity and a strong sense of duty. However, he also identified some serious problems:

- The profession has been too insular. There has been insufficient contact with other professions and too narrow a professional training, which has meant that the profession has been slow to adopt new approaches and techniques.
- Too much has been expected of actuaries and too much has been promised by them. The future is uncertain but clients have looked to actuaries to provide certainty and actuaries have often appeared to provide it.
- There has been insufficient transparency in actuarial advice. The profession are aware of this issue and trying to deal with it.
- The appropriateness of reserved roles – the review questions whether actuaries are best placed to advise on asset allocation or fund manager selection.
- The review takes place against a background of concern that the populations' long term savings are substantially below the level required to meet their needs. The review is to take a view of the role of the profession in the emergence of such problems.

In the review, actuaries have been criticised for:

- Failing to allow adequately for the persistently downward path of inflation and interest rates in the 1990s
- Failing to allow for the subsequent precipitate fall in the stock market
- Not questioning sufficiently the prevailing orthodox at the time that high equity returns could be expected to provide healthy long term returns with a degree of confidence only suitable for bond investments
- Actuaries, as relevant experts, were too slow to adjust to the changing circumstances; were too inflexible to consider likelihood or consequences of large adverse movements, and thereby provided more assurance to customers and consumers than was warranted.

There follows detail about the central themes covered by the interim review

Competition

On the subject of competition the review proposed a number of policy options to:

- encourage greater market testing of actuarial advice by users
- discourage use of full-service appointments by pension funds
- improve communication to narrow the ‘understanding gap’ between actuarial advisers and their users
- increase level of user knowledge and understanding of actuarial matters
- introduce greater scrutiny and challenge of actuarial advice.

Regulation

The review identified areas of weakness identified in the regulatory framework:

- inadequate protection of public interest, for example, the problems that arose at Equitable Life
- professional standards that are too weak, ambiguous or limited and perceived as influenced by commercial interests
- no pro-active monitoring of members compliance against standards
- profession is too introspective, not forward looking enough and slow to modernise

To address these issues, the proposed model of regulation going forward is to have independent oversight of the profession’s self-regulation.

Reserved roles

The advantage of having reserved roles is that the statutory regulators can expect professional standards and codes of conduct to be adhered to and place specific whistle blowing and public interest duties on role holders. However, reserved roles create a professional monopoly, restricting competition and challenge from other professionals.

It is currently widely recognised that, as a group, only actuaries have the required skills to assess long-term liabilities of insurers and pension funds, so in the short term there is a need to continue to reserve specific roles for actuaries in life and pensions. In the longer term regulators may want to revisit this issue and consider opening up these roles to other suitably qualified professionals.

Public interest and accountability

Actuaries’ role in advising pension schemes and insurers are central to overall financial stability. There are conflicting responsibilities of duties to employer/client, duties to statutory regulator if holding reserved roles and duties to the profession for adherence to professional standards. There is confusion over whom individual actuaries are accountable to. The review needs to provide clarity over who actuaries are accountable to and for what, the hierarchy of accountabilities, guidance on when to whistle-blow and act in the public interest, and clear protections and incentives for whistle blowing.

Education and CPD

The review has identified several weaknesses with education and CPD (continuing professional development) in the profession:

- The past syllabus has failed to take full account of developments in actuarial and non-actuarial thinking or give sufficient attention to communication and general business awareness skills
- There have been failures in the exam process
- Time taken to qualify has been lengthy
- Education follows a predominantly work-based part-time education model that may contribute to an insular profession predominantly orientated towards traditional areas of pensions, life and general insurance
- There has been little provision of actuarial education through the university system. Benefits of this could be enabling actuaries to work in non-traditional areas with greater emphasis on independent actuarial research that has not been commercially sponsored
- CPD content has been of variable quality and compliance with CPD inadequately monitored.

To address the syllabus issues, possible options are to reform the existing governance structure to promote greater academic and non-actuarial input, or, to establish an independent body with oversight of the Profession's syllabus development.

To address examination issues the options are to reform the existing governance structure to improve quality control, involve full-time dedicated professional examiners or involve an independent oversight body in exam setting and marking.

Standard setting

The review is critical of current approach to standard setting. Criticisms are that:

- professional standards have been weak and ambiguous
- there has been failure to resolve contentious issues
- there have been inconsistent approaches across practice areas
- there are perceived conflicts of interest in the process of standard setting.

The review believes that profession, as it is proposing, should establish an independent Actuarial Standards board to set, revise and regularly update professional actuarial standards.

Scrutiny and discipline

Given the understanding gap between users of actuarial advice and their advisers it is essential to introduce formal scrutiny through audit or peer review.

GAD

The review is considering de-regulating the functions which the government actuary or department are currently statutorily obliged to provide, that is, advising the majority of public sector pension schemes, to give users of these services a choice of provider.

The government actuary currently advises parliament on NI contributions and state benefits. For these functions, where there is a need to preserve public confidence in the system, there is a need to retain independent sign-off. However, the review may explore alternative mechanisms to ensure independence.

GAD produces long-term population projections for UK and conducts survey of occupational pension schemes. The review will look at the possibility of transferring demographic data collection to ONS (office of national statistics) and occupational pension scheme survey to the Pensions Regulator.

The profession's response to the interim review

The profession submitted its response to the interim review in February 2004.

It considers the overall balance of the review to be fair, in terms of criticism and support for the profession. It does not agree with every detail of the review and, in a different forum, might have wished to dispute some of the findings, but the purpose of this submission is to focus on the profession's future, not its past.

The profession feels it can support the review's central proposal of independent standard-setting, combined with independent oversight of the professional body's remaining self-regulatory functions. The details of this need to be worked out in due course.

The review has asked some questions on the duties of individual actuaries to the public interest and the accountability of individual actuaries. The review has offered some possible answers in relation to reserved roles but left the question open in relation to other actuarial roles. Obtaining clarity on this issue will be one of the most critical outputs from the final report.

What next?

The review is gathering the feedback received following the interim report and is due to publish its conclusions in spring 2005.

Press coverage of the interim review has, predictably, seized upon the criticism of the profession, and lets face it there is plenty of criticism to choose from. The old clichés of actuaries being described as 'anoraks' and 'boffins' have been scattered liberally throughout the articles, along with a summary of the failings of the profession over the last few years.

Let us not dwell on the mistakes of the past, but look to the future. We, as a profession and as individual actuaries, need to address the issues that have been hi-lighted by the Morris review and embrace the changes that will, no doubt, arise as a result

WITH PROFITS BONDS - MAYBE THE GRASS ISN'T GREENER

(This article first appeared in Scottish Widows' techtalk magazine – a magazine aimed at Financial Advisers. It is included here to give students a flavour of the issues surrounding With Profits Bonds – a line of business which has fallen out of favour as stock markets (and bonus rates) have fallen).

Maybe the grass isn't greener…

It is with regret that I have to announce the death of the with-profits bond. Really? Well, no – not yet. This once corner stone of investment planning has been with us a good while now, and has taken a lot of stick in many areas of the media recently. So much so, in fact, that new business figures for with-profits bonds have fallen substantially year on year for the last few years right across the market place.

To compound this, there have been many voices suggesting that clients should look seriously at surrendering their with-profits investment and choosing alternative investments. This could all be a bit of a knee-jerk reaction to falling bonus rates, however.

After all, did we not recommend this product on the back of its valuable guarantees, it's smoothing of the downs and ups of investment markets, and its generally lower risk profile than its unit-linked cousin. So has it really done that badly for our clients? When considering this – and the question of whether or not your client should be surrendering their with-profits bond – it is important that advisers make a fully informed decision.

Bonds once broken can be difficult to re-form, and surrendering a with-profits bond could be more harmful than you think. Before crossing to the other side, advisors should consider the whole picture – not just the current bonus rates – to determine whether the grass really is greener.

Bonus rates

So why are bonuses so low at the moment? In order to make an informal decision regarding whether or not clients should stay invested in their with-profits bond or surrender, it is important for advisors to understand exactly what happened to the policy and the underlying investments.

Despite the up-turn in 2003 and relatively flat markets in the first half of 2004, the value of FTSE 100 index (which can be taken as a guide to the value of equities held in a with-profits fund) still declined by 36% between 1 January 2000 and 1 July 2004. Despite these adverse market conditions regular bonuses continued to be added to many with-profits bonds through most or all of this time period. This has increased guaranteed minimum benefits by, in some cases, 15% or more during a time of stock market decline, a demonstration of the value of with-profits investments.

All this means that the guaranteed cash benefits (i.e.., the original investment plus regular bonuses to date) for many policies are worth much more than the underlying policy values. It would therefore, not be fair to policyholders as a whole if life offices continued to increase the level of guaranteed benefits without the underlying investment performance to justify it.

Similarly, if guaranteed values are increased too quickly the investment strategy could become constrained towards assets which are a better match for the guarantees, which could mean lower investment returns and lower payouts for with-profits policyholders as a whole (including a reduced prospect that the eventual payout on the with-profits bonds themselves will exceed current guaranteed levels).

It is unlikely that some of these policies will see anything other than lower regular bonus rates at best for some considerable time. It is also unlikely that, even once underlying fund values recover, the prospect of regular bonuses as high as we have seen in the past will occur again. There is an expectation in the market that in the low inflation and low investment return environment that we find ourselves in, offices will need to declare lower regular bonuses in the future in order to ensure that sufficient terminal bonuses could be expected to build up. This will reduce the chances of any over-commitment to guaranteed cash values in the future.

Moreover, regular bonus is only one element of the total return from a with-profits policy such as the with-profits bond. A final bonus will also be paid if finance returns result in smoothed fair shares of the assets underlying policies exceeding the guaranteed cash benefits.

So what are the prospects for future bonus rates? Well, this is going to depend on the with-profit fund in question, what its investment experience has been like over the turbulent last few years, and how much the guaranteed values of the with-profits bonds were increased against a backdrop of failing investment returns – thus widening the gap between guaranteed policy values and underlying fund value.

Future bonuses will also depend on the asset mix and the charges made upon them in with-profits funds. Nearly all with-profits funds have reduced equity exposure. The fall in the value of equities over the last five years has led to a natural reduction in the proportion of equities in the funds. In addition, many offices have sold equities to reduce the potential impact of further possible stockmarket falls in uncertain times.

The reduced equity exposure may slow the rate of recovery on bond values if stockmarkets improve. Put another way, with profits bonds may have lower underlying asset mix which may lead you to ask the question is it worth giving up the guarantees for? To answer that we need to look at the guarantees and alternative product strategies.

<u>MVR Guarantee</u>

With guaranteed values often now being greater that the underlying assets in the with-profits bond, many with-profits bonds now carry Market Value Reductions (MVR).

Perhaps most importantly, many with-profits bonds written in the 1990s have valuable guarantees which advisors will need to take into consideration when making investment decisions with, and on behalf of their clients. Details of clients' MVR guarantee differs from provider to provider so care and planning should be taken if advisors intend to exercise such a guarantee.

Some companies offer a guarantee on particular anniversaries, usually the fifth or tenth anniversary of the policy. This can be a one-off guarantee or a recurring guarantee, such as on the tenth anniversary and every fifth anniversary thereafter. It is also very important to check how long the guarantee is open for. Some life offices will apply the MVR free guarantee on the date of the anniversary and only that date – in which case the life office will need to be notified earlier than this in order that they can carry out clients' wishes. Other life offices have said they will offer up to a month’s grace period after the anniversary in which an investor can inform the office of their wish to surrender.

The way the guarantee is applied will also affect the decision advisors and clients come to in deciding whether to surrender or not. Some guarantees are more valuable than others and advisors will need to check thoroughly how they are applied. There are a number of ways these guarantees can apply:

- The easiest, and most common, way of applying the MVR guarantee is simply to waive the MVR on the date(s) at which the guarantee applies;
- Other life offices apply an MVR guarantee by way of a money back guarantee, whereby the investor can have the value of their original investment back.
- Other types of guarantee can apply and policy conditions should be checked to determine how they are applied.

Most with-profits bonds also carry an MVR guarantee on the death of the life assured. That is, in the event of the death of the life assured, no MVR would apply and the proceeds of the bond will include all regular and terminal bonuses applicable and no MVR will be applied.

Alternative investments

Advisors should think very carefully before switching out of a with-profits bond. I’m assuming that if it is recommended that a client should surrender the bond it is with the aim of finding an alternative suitable investment. Has the risk profile of the client changed since the original investment?

If it was originally advised that a with-profits bond was the most suitable investment for the client, has their situation changed enough that is no longer the most suitable? If a with-profits bond was recommended as part of a larger investment portfolio, it would be important to look at the asset allocation of the portfolio to ensure that it is not upset by any new investment.

Advisors must consider that the main potential advantage from surrendering to switch to another product is any excess investment return advisors / clients think might be earned from the assets in their chosen funds in any new policy, versus what can be achieved in the with-profits fund (net of any differences in product changes).

Remember, the value of a with-profit bond may not just be what it is worth today if it is surrendered, but what the value is guaranteed to be at a date in the future where an MVR guarantee may be applicable. The table shows an actual case study of an investment into a Scottish Widows with-profits bond. The example shows a with-profits bond originally invested in 1998 (six years old at the time of writing).

The table demonstrates the potential value of the guarantees in place in the with-profits bond contract. The third column shows the value of the policy that is already guaranteed at the 10th anniversary of the policy whether or not an MVR is in force at that date. Dependent on future investment conditions, additional regular and final bonuses may be added to the policy.

*The final columns show the value of the with-profits bond being surrendered and the surrender value being invested in a typical** unit-linked bond up to the date where the 10 year guarantee on the with-profits bond would have applied. In this particular case, the potential gain by surrendering the with-profits bond and re-investing into a typical unit-linked investment bond (at a 6% growth rate net of tax) is a minimum of £938, up until the original guarantee date of the with profits bond, though a greater gain may be made at a higher growth rate. The £36265 is 'money in the bank' as long as it is kept there until the guarantee date. Indeed, this value may be increased if investment conditions were to permit additional regular bonuses and/or terminal bonus to be added. Whether chasing the extra £938 is a sufficient enough carrot to risk surrendering the with-profits bond is a risk/return issue the advisor will have to think about very carefully.

If customers surrender a with-profits bond out-with the guarantee date they lose the guarantee underpin – and they may re-start a series of early exit penalties too if they re-invest into another investment bond, cutting their flexibility (any new product's design that a client switches into will include a charge structure that recoups the costs of sale – which of course won't be incurred in a continuing policy).

Other options

There is, of course, the withdrawal facility on many (though not all) with-profits bonds, often taking out up to 7.5% per annum, and without the application of any MVR. This may enable clients to drip money out of their with-profits bond if they need to do so MVR 'free'. There may be an immediate tax charge, however, if more than 5% or the original premium is taken out in a single year.

Summary

There are billions of pounds out there in with-profits bonds. There is a huge variety in the market in the types of with-profits bonds, their performance, their prospects and their policy conditions. This means that advisors will have to conduct a full review of each individual client's policy before deciding whether to surrender it or not. It is impossible to have a general criteria for deciding which clients are left in the with-profits bond and which clients are advised to surrender. Advisors will need to study the policy conditions, if and when a guarantee applies, the value of the guarantee and the client's own situation.

In advising clients on whether or not to surrender a with-profits bond, you need to weigh up the possibility of greater return by investing the riskier assets, against giving up the guaranteed value underpins which apply to their existing with-profits bond. For some clients surrendering a with-profits bond incorporating a guarantee may be the right thing to do, for many others it will not. Given the stock market volatility of recent years I believe most customers place a high value on guarantees. Advisors will need to think very carefully before surrendering a with-profits bond whether the grass really is greener on the other side.

Original investment (1 July 1998)	Surrender value at 1 July 2004	Current guaranteed amount (at 10yr anniversary date – 1 July 2008)	Projected value from surrender and re-investment (see * below in main text)		
			4%	6%	8%
£30,000	£30,826	£36,365	£34,474	£37,203	£40,091

**Unit-linked bond based on 1% amc, 6.5% initial commission, nil establishment charge and allocation rate of 99.5%.