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LIFE ASSURANCE UP TO AND BEYOND 1992

UNITED KINGDOM ACTUARIAL CONVENTION,
HARROGATE, 17–19 SEPTEMBER 1989

THE 3rd residential U.K. Actuarial Convention was held in Harrogate from 17 to 19 September 1989. The programme was wide-ranging, but, as the title suggests, there was a focus on forthcoming E.C. developments. The guest speaker at the convention dinner was Mr Bill Pool, O.B.E., who was formerly head of the Insurance Division DGXV of the European Commission.

The Convention was opened by the President, Mr R. D. Corley and he began by considering the form of future conventions. Should they concentrate on specialised topics or be more general? Should there be a forum to discuss important issues or should there be more emphasis on educating younger actuaries? The 1989 convention would cover, he said, three areas: Europe, financial control and regulation. 1972 to 1982 was a period when the role of the actuary changed from that of prudent calculator to fully established financial manager. The high inflation of that decade required greater attention to be paid to the financial mechanics of the life fund, and the concepts of 'bonus philosophy' and 'reasonable expectations' developed. Increased computer power enabled actuaries to undertake more sophisticated financial modelling. The concept of embedded values is a new answer to the old problem of new business strain.

Life assurance is now faced with a mass of regulation and there is a danger that 'regulation begets regulation'. The consequence is that rules replace professional judgement, thereby diminishing the role of the actuary. Innovation is reduced and, in the end, the public will suffer. It is important that actuaries play an active role in shaping regulations which affect their business. The Institute's own regulations, Guidance Notes, are being reviewed and we can expect to see a distinction drawn between mandatory and advisory Guidance Notes.

The European debate is whether the legislation will be based on harmonisation or on mutual recognition. The President considered firstly the position of actuaries working in a different European country from the one in which they qualified. Actuaries trained in other E.C. countries may work in the U.K., subject to a period of assimilation or a test of local knowledge. Also, actuaries holding a statutory position in the U.K. must be members of the Institute or Faculty.

There are great environmental differences between the different European countries in which life actuaries operate. The systems in the U.K. and Ireland have allowed the development of more innovative and investment-oriented industries, which, consequently, are larger than their continental counterparts. The profession has an interest in the changes that may occur, firstly, because it has a responsibility to provide the public with the best life assurance products and also because if the future holds a tightly regulated regime, then the need for actuarial judgement will disappear and the standing of the profession will fall. Politics will be an important factor in determining the form of the legislation.

The following summaries cover the larger open meetings on other subjects that took place at the conference.

EUROPEAN SESSIONS

There were two plenary sessions on Europe. At the first, three speakers gave an introduction to what may happen in the forthcoming life directives and what the consequences may be for the actuarial profession and the life industry. The importance of mutual recognition rather than harmonisation was again mentioned. There was a need for effective lobbying and Mr L. J. Martin urged involvement in the Groupe Consultatif. The Government Actuary told the meeting that the GAD was talking to the supervisory authorities in other European countries over these matters.

There followed eight workshops which considered various questions relating to life assurance and the profession in the E.C. The following morning Mr P. N. S. Clark reported back to the convention on the workshops, which he felt had been influenced by the themes of fear, prejudice and ignorance. Many of the discussions had been confused. He subsequently put forward four actions for improving knowledge and understanding, relating to actuaries learning more about what is going on in other European countries and informing the E.C. Commission, the European Parliament and the Economic and Social Committee about the U.K. insurance environment.

Mr R. E. Brimblecombe brought the convention up-to-date on the ABI's position on Europe and, in particular, referred to a preliminary survey of the comparative returns under endowment policies. These indicate that the U.K. and Germany are broadly first equal, with other countries a long way behind. The U.K. position has been adversely affected by tax. The session was completed by the President drawing a list of action points from the meeting. These included:

—input from actuaries with European experience,
—preparation of briefing documents on the U.K. and other insurance systems,
—a clear exposition of what the profession/industry wants,
—a working party on 'value for money',
—possibility of helping the Commission's resource problem,
—liaison with the Faculty, and
—attendees to brief colleagues about the current position.

The convention dinner was held, with Mr W. Pool, formerly head of the Insurance Division DGXV of the European Commission, speaking. Mr Pool emphasised the urgency with which the U.K. and Ireland must press their case.

The draft directive on mass risks must be published in 1990 for the insurance legislation to be in place by 1992. The actuarial profession has to work together with the ABI to present and explain its case to the Commission. Undoubtedly continental insurance companies would prefer a tightly regulated environment which would protect them from the British.

THE ACTUARIAL MANAGEMENT OF A LIFE OFFICE

Mr S. Thompson's introductory paper for this potentially wide-ranging open meeting referred to a number of areas: capital management, surplus distribution, legislation, actuarial techniques, financial control, product design and disclosure. He suggested that perhaps insufficient attention had been paid to the rates of return involved in certain ventures made by life offices and cited offices which had been bought for high prices in recent years and the money spent on securing distribution systems. The paper stated that the monitoring of key variables will be of increasing importance to the successful management of a life insurance company.

The discussion centred around communication. There was a need to explain actuarial topics clearly to management colleagues. The requirement to produce a statement of 'bonus philosophy' was seen as valuable for this purpose and will help clarify thought. There was also consideration of the position of the Appointed Actuary within a financial conglomerate. An actuary may be well qualified to be the Financial Director, but certainly has no right to the position.

FINANCIAL SERVICES ACT, PAST EXPERIENCE AND FUTURE IMPLICATIONS FOR COMPETITION AND PROTECTION

The paper by Mr P. C. Vaughan highlighted two aspects of the Financial Services Act which particularly affect actuaries. There has been no direct interference with product design, but the requirements of best advice and the illustration of surrender values have or may have led to product changes. The paper suggested that it was perhaps inevitable that a policyholder will regard the lower of two illustrations as his minimum expectation, and this may have implications for the Appointed Actuary, who must consider 'reasonable expectations' when determining bonuses. Other areas referred to in the paper were the Maximum Commissions Agreement, disclosure and SIB's approach to regulation.

The meeting had a broad consensus that the overall concepts of investor protection, as introduced by the Act and self-regulation, were well conceived, but there was a danger that criticism of detail might lead to a loss of sight of the fundamental principles. The main concerns expressed at the meeting were over inconsistency, between unit-linked and with-profits business and, for instance, between PEPs and similar products.

UNIT-LINKED VALUATION AND REGULATIONS

The discussion was based on the report by the Joint Working Party recorded in *J.I.A.* **115,** 555. There was widespread support for the discounted cash flow approach and it was noted that there should be some scenario testing. Most of the profession seemed to prefer the use of gross rather than net growth rates. Mr D. E. Purchase indicated that the regulations were likely to require a maximum 2% differential between the assumed growth rate and the rate of inflation of expenses. There was some discussion of the mismatching test and, in particular, what assumption should be made regarding dividend yield when a change in asset values is assumed.

PRODUCT DESIGN AND PRICING FOR THE 1990S

Compliance with the plethora of recent legislation has curtailed the scope for innovate product design. There are currently a number of areas of uncertainty surrounding the premium basis: AIDS, rates of commission and taxation.

It was generally felt that the costing of unit-linked business must change in the immediate future. It had not done so already because offices were protecting their market share and because commission rates had not yet settled down. It was also suggested that corresponding changes will have to be made to with-profits business in order to preserve equity. Reference was made to the problem of determining the right tax basis following the 1989 Finance Act.

For the future it was felt that there would be a move towards simpler products, health-related policies and non-insurance savings products.

CORPORATE STRUCTURE AND FINANCING OF GROWTH

This session considered the background to, and consequences of, a life office being part of a group, as many now are. The main reasons for this development have been legislative, the Financial Services Act and Section 16 of the Insurance Companies Act 1982, though financial and management control reasons have played a part. The efficient use of non-equity capital and the taxation implications of a group structure were also considered.

The discussion noted that management agreements should be legally precise and clear on the apportionment of expenses. There was some concern over the conflicting objectives of the corporate structure, for instance, between financial and management control. A group structure involving a holding company might be adopted, so that indemnity commissions can be treated as an asset. Other ways of financing new business strain such as bank borrowing, reassurance financing and subordinated debt capital (the last item is not effective in the U.K.) were discussed.

UNITISED WITH-PROFIT FUNDS: CONTRACT DESIGN AND RESERVING

Mr D. E. Purchase's paper defined a policy as unitised with-profits if the design is "unit-linked (or mirrors a unit-linked design) but the growth in the (investment-related) benefits is allocated by the actuary (or the company acting on the actuary's advice) at regular bonus distributions, with complete or very wide discretion".

The reasons for offices introducing unitised with-profits policies vary. For the traditional with-profits office the lower new business strain is important and it might be seen as a way out of potential over-distribution. For proprietary with-profits offices there may be problems in making sufficient transfers to the shareholders. For unit-linked offices it widens their range of products, but they are likely to have problems matching the returns of unitised with-profits policies sold by traditional with-profits offices.

Most current products are for pensions, as there are difficulties in obtaining qualification certification for life policies on account of the switching options. All products guarantee that unit prices will not fall and some guarantee a minimum rate of increase of the order of 4% p.a.

Much of the discussion revolved around whether these products should be treated as unit-linked or with-profits policies for valuation and reporting purposes. Most of those present used a non-linked approach for determining mismatching reserves and thought this was appropriate, given that capital growth was not guaranteed to go to the policyholders and given the use of terminal bonuses.

EMBEDDED VALUES AND APPRAISAL VALUES

The introductory paper, presented by Mr N. J. Dumbreck, concentrated on the rates of discount, taxation, disclosure and the methods of determining an appraisal value. The embedded value will include margins, either in each experience assumption, or overall in the discount rate. The former is easier to explain and demonstrates the sources of surplus more clearly. Frequently the rate of discount will allow the embedded value to increase conservatively, i.e. with a gradual emergence of profit. Other items affecting the rate of discount might be the published valuation basis and the pattern of bonus distribution. Having said that, a discount rate of 15% p.a. has been used with remarkable consistency.

The Working Party on Embedded Values has taken the view that new business should be disregarded in assessing future tax liabilities which might be considered as giving rise to distortion.

The standard approach to the appraisal value is to calculate the goodwill by reference to the sales organisation and the embedded value of the most recent year's new business. More recently, Mr J. C. Fagan has suggested the 'earnings multiple' method, which determines the appraisal value as a multiple of the embedded value earnings.

TAXATION DISCUSSION OF THE 1989 FINANCE ACT

The meeting considered the practical implications of the changes included in the 1989 Finance Act, which were outlined by Mr P. J. L. O'Keeffe, and speculated on further changes which were expected to be announced shortly. The major problem was the formula for the shareholders' and policyholders' fraction, which, because of the differential rates of tax, means the effective rate of tax can only be determined in arrears. The formula is expected to change. The differential rate, however, still appears disadvantageous to proprietary unit-linked offices. Other areas where announcements were expected were apportionment of income and gains, and reassurance commissions.

PHILOSOPHY OF BONUS DECLARATIONS AND FUTURE BONUS EXPECTATIONS IN CHANGING INVESTMENT CONDITIONS

The changes to GN1 will require the Actuary to have regard to his office's policy on bonus distribution and SIB Consultative Paper No. 27 proposes the company booklet which will refer to, amongst other items, bonus philosophy. Mr G. K. Aslet's paper mentioned these and then considered bonus philosophies and bonus trends. He asked whether marketing factors and also contributions to the estate should be considered in conventional bonus philosophy. As far as equity is concerned, the paper raised questions of balance between policyholders who surrender their policies and those who do not, and between reversionary and terminal bonuses. The paper also referred to various authors who have commented on the merits of a two-tier reversionary bonus system.

Most of the discussion was concerned with the statement of bonus philosophy to be given in the company booklet. There was some feeling that the statement would not say much initially, though it would evolve with time. There was also concern that the booklet might be incomprehensible to policyholders.

MORTALITY, AIDS AND OPTIONS

The paper by Mr D. J. Le Grys stated that there has always been considerable uncertainty regarding mortality experience under policy options. Such options require substantial reserves, though reserves can be mitigated if the office has the right to alter rates for existing business. AIDS has made policy options much more hazardous, both because of the higher mortality level and because of the greater possibility for anti-selection.

During the discussion it was suggested that AIDS deaths in the U.K. may be under-reported by around 50%. Options on policies were now more limited than previously. It was, however, felt that there was need for guidance on the valuation of options. A number of situations susceptible to anti-selection were cited: broker offices selling aggregate rates term assurances, short proposal forms for re-mortgage business and the United States of America select/ultimate renewable-term assurance products.

SCENARIOS FOR THE LIFE INDUSTRY

It was agreed that the key to the industry's future was securing distribution channels on a cost-effective basis. It was suggested that the independent financial adviser market would be dominated by a few companies. The discussion focused on the future of the small mutuals for which there were three main options:

—tie to a building society or similar organisation,
—merge with another mutual, or
—become involved in an arrangement with a European or other overseas provider of capital.

Under the first option it was suggested that demutualisation and takeover by the building society would be inevitable.

The meeting then considered some of the problems associated with demutualisation and the transfer of long-term business between companies. That relatively few problems had arisen so far was, it was suggested, because no cases had involved any substantial estate. It was essential that policyholders are given a true and fair description of the scheme of arrangement. The expectations of the with-profits policyholders are important and it was considered that they should get not less than they would if their own mutual fund sat alongside the open proprietary fund, together with any benefits they previously enjoyed from the non-profit business.

DISCLOSURE AND THE STRENGTH OF OFFICES

This session considered the recently published SIB report covering the disclosure of expenses and on the proposed company booklet.

The meeting addressed:

—whether the proposed information might be misunderstood and if so to propose changes,
—whether there were any material omissions from the profession's draft reply, and
—whether the proposed advisory roles were appropriate.

It was generally felt that actuaries should be involved in the allocation of expenses, but there was a need for professional guidance.

Form 9 was not mentioned in the draft response and some contributors felt this was an omission, for, as though not perfect, it was better than other information.

A number of areas where the information might be misleading were mentioned, including the point that the yield reduction approach gave longerterm policies an apparent advantage, which was certainly incorrect for those surrendering their policies early.

THE ROLE OF THE FINANCE DIRECTOR

The paper by Dr M. J. Lawrence, F.C.A. began by stating that, for traditional life business, the finance director has a greater need for actuarial skills rather than general financial management capabilities. He went on to consider the consequences of life offices diversifying into non-insurance activities, and then to examine the function of the finance director, his relationship with the Appointed Actuary and more generally the financial management of long-term business.

There was a range of views on who was most suitable to be the finance director of a life office, and it was pointed out that in the U.S.A. he was commonly neither an actuary nor an accountant, and was most heavily involved in strategic issues. There was some discussion on whether there was a conflict for the person who held both the finance director and Appointed Actuary roles, in balancing the interest of the shareholders and the policyholders.

ASSET SHARE TECHNIQUES AND THE CONTROL OF TERMINAL BONUSES

The discussion paper arose out of a series of meetings held by a group of Appointed Actuaries of large with-profits offices. Although the concept of 'asset share' is simple—'the amount accumulated by a policy', there are many theoretical and practical problems, resulting in a range of different approaches. The paper set out the various methods that were used to determine the pool of assets and the investment return. Asset shares are usually calculated only for 'average' policies, with expenses being determined from the office's expense investigation.

Asset shares are used in the construction of terminal bonus scales, in the determination of surrender values and in the internal bonus reserve valuation. Comparison of asset shares with the published reserve is useful in measuring the capital tied up in the business.

COMMISSION AND PRODUCT DESIGN CONSIDERATIONS OF POLARISATION

This session concentrated on the ending of the Maximum Commissions Agreement, which was widely held to mean increased costs. Commissions would need to rise towards 130% of the MCA levels to return to the pre-June 1988 position. There was considerable debate of the shape of future commissions and the effects on product bias. Dual-pricing was another important issue, and the point was made that single pricing almost certainly implies cross-subsidisation between the different marketing channels. For the future, it was generally felt that products will continue to have large front-end loads and that these products show comparatively well when expenses are illustrated as a yield reduction.

EXPENSE CONTROL

Expense control systems are used to determine expense loadings in pricing, in profit measurement, for expense control purposes, in the ABI expense investigation and for disclosure purposes. The discussion paper set out the various methods of analysing expenses and the problems in doing so.

In the discussion the importance of allocating as much of the expenses as possible and reducing 'overheads' was stressed. The meeting felt that in measuring the performance of sales staff it would normally be sufficient to measure the level of sales. Analysis of surplus was considered still to be an essential tool.

J. P. CLIFF