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# A REVIEW OF THE LAW RELATING TO INSOLVENT LIFE INSURANCE COMPANIES AND PROPOSALS FOR REFORM

By G. E. Barrow, M.B.E., F.I.A.

and

D. G. R. Ferguson, M.A., F.I.A., Dip. Ag. Sci.

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## 1. INTRODUCTION

*I have welcomed many gentleman to these walls.*
William Dorrit, Father of the Marshalsea, in *Little Dorrit*

1.1. The initial object of this paper was to make general observations on the draft Insurance Companies (Winding-Up) Rules 1983 which were circulated for comment and would be made under Section 59 of the Insurance Companies Act 1982. They concern the identification of general and long-term assets and liabilities, and the evaluation of policyholders' claims, in a winding-up. The wider objective is to review insolvency law generally in relation to long-term insurers and in particular the interaction between the general law concerning companies and the specific law relating to insurance companies. This review leads the authors to set out the case for a radical new approach.

1.2. Section 2 of the paper outlines the development of the law of individual insolvency, including the distinction which came to be made between, on the one hand, personal insolvency and, on the other, the insolvency of individuals and groups of individuals brought about by commercial operations. Section 3 deals with the evolvement of the limited liability company and the development of the concept of corporate insolvency as an extension of the law of insolvency relating to trading partnerships. In Section 4 the paper considers the special case of insolvency in relation to long-term insurance and how this has led to insurance companies being subject both to general company law and specific insurance company law. Section 5 comments on the proposed new Rules in the context of the existing legal structure. Finally, in Section 6 the case for a radically new statutory approach to all aspects of insurance company law is argued.

1.3. A review of this nature naturally requires a good many references to statutes and sections of statutes. We refer to statutes either by their full title or a standard abbreviation. Thus the Insurance Companies Act 1982 is often simply 'the 1982 Act'. The 1982 Act is a consolidation Act which by definition introduces no significant new legislation, and repeals much, but not necessarily all, of what went before. The 1982 Act consolidated the 1974 and 1981 Acts; the 1974

Act consolidated the 1958 Act, the relevant part of the Companies Act 1967 and the Insurance Companies (Amendment) Act 1973; the 1958 Act consolidated the 1909 Act and miscellaneous intervening legislation. Wherever possible, references to insurance statutes are given in relation to the 1982 Act, except where the context requires the pedigree of a particular section to be traced.

## 2. INSOLVENCY OF INDIVIDUALS AND PARTNERSHIPS

*Will he pay all his debts before he leaves here? It seems to me hard that he should pay in life and money both.*

*Little Dorrit*

2.1. The law relating to the individual debtor has its roots in Common Law. An individual who obtained goods for his personal use and enjoyment, knowing that he would be unable to pay for them, was guilty of a form of fraud little removed from theft and society needed similar protection against such malefactors. The law provided the aggrieved creditor with alternative remedies against the debtor: he could seize such of the debtor's assets as he could lay his hands on in satisfaction of his claim; or he could have the debtor arrested and imprisoned in a debtors' prison, there to be detained until either he settled his debts or the creditor relented. The underlying logic was that a spell of imprisonment was an effective means of persuading a recalcitrant or fraudulent debtor to settle his debts. An individual creditor had to choose by which method he wished to proceed against a debtor; he could not have recourse to both. In practice, however, if a debtor was faced with a number of creditors, those who were first in the field proceeded against his goods and the latecomers against his person. If as a consequence the debtor was devoid of goods by the time he came to be imprisoned, extended imprisonment did not assist the creditor to recover his debt but could inflict disproportionate hardship not only on the debtor but also on his wife and children.

2.2. This Common Law system of dealing with the individual debtor, which had its origins in mediaeval times, continued well into the second half of the nineteenth century and was a theme used by a number of novelists, from Oliver Goldsmith to Charles Dickens.

2.3. However, although the principles established under Common Law for the treatment of debtors persisted until as recently as one hundred years ago, it was recognized much earlier that a person could be rendered insolvent not as a result of fraud or recklessness but through non-culpable misfortune. The class which was particularly exposed to such misfortune comprised those who were engaged in trading. As a result of their representations a distinction came to be drawn between traders, whose commercial activities involved the manufacture or the buying or selling of goods which necessitated the giving and receiving of credit, and non-traders, who had no such need of credit. The legal distinction was drawn by reference to the differing nature of their respective assets, the assets of the non-trader being predominantly immovable and those of the trader being movable. This distinction led to new laws directed against the absconding trader who, having obtained goods on credit, then decamped.

2.4. Under an Elizabethan statute of 1570 the Lord Chancellor was empowered, on the suit of a creditor, to seize and sell the assets of an absconding trader and to distribute the proceeds rateably among all creditors who had valid claims. Such Tudor statutes were the forerunners of the Bankruptcy Laws as they developed in England over three centuries up to the late nineteenth century. They related to traders, and their provisions were in sharp contrast to the remedies available under Common Law applicable to non-traders.

2.5. For example, under Common Law individual creditors proceeded on a 'first come, first served' basis by personal suits, whereas under the Bankruptcy Laws there was provision for equitable distribution among all the creditors who had claims; and under Common Law there was no machinery for investigating the nature and amount of the debtor's assets and liabilities, such as was required for the fair application of the equitable distribution concept under the Bankruptcy Laws.

2.6. Essentially the Bankruptcy Laws were designed to protect commercial creditors, but they also embodied principles directed at maintaining the probity of commercial transactions. A trader was expected to act in an honest and fair way and maintain proper books of account, and, if he fell short of these requirements, he put in jeopardy the principles on which the commercial community as a whole relied. Successive Parliaments showed themselves well aware of the adverse consequences if reckless or fraudulent traders were permitted to go unpunished and, as a consequence, a chain reaction of default were to result. Thus there was always a penal element in the Bankruptcy Acts and a trader who was adjudged bankrupt was debarred from participating further in commercial ventures. There was a definite stigma attached to bankruptcy, as there is today.

2.7. As a result of the development of the legislation relating to bankruptcy, bankruptcy and insolvency became two distinct situations in law. A non-trader could never be adjudged bankrupt, even although demonstrably insolvent, that is unable to pay his debts; a trader who was found bankrupt could subsequently be proved to be solvent.

2.8. This anomalous situation persisted until, by the Bankruptcy Act 1861 "to amend the law relating to bankruptcy and insolvency in England", the provisions of the Bankruptcy Acts were extended to non-traders and traders alike. Thus the removal of the distinction between traders and non-traders preceded the passing of the Bankruptcy Act 1883 which came about as a consequence of widespread dissatisfaction with the operation of the bankruptcy procedures. Prior to the 1883 Act the debtor and his creditors were the only parties to the administration of a bankrupt debtor's estate and in practice the disposal of assets was usually carried out by the creditors. and often led to the disposal of assets for much less than their true worth. Indeed some unprincipled persons derived their living from preying on bankrupt estates. A further abuse was that a minority of creditors could manipulate the administration of the estate for their own ends, to the disadvantage of the remaining creditors. A wider objection was that the public interest was wholly ignored.

2.9. The 1883 Act was directed to two ends: to ensure the honest administration of bankrupt estates, and to diminish the number of commercial insolvencies. An important aspect was the appointment of a public official to be known as the Official Receiver to investigate fully the causes of each bankruptcy and the conduct of the individual or individuals concerned. Although bankruptcy is not necessarily a crime, the public interest was seen to require that the circumstances in which it came about should be publicly revealed.

## 3. CORPORATE BODIES AND THE LAW OF INSOLVENCY

*At length, all these matters being arranged, a day was fixed for selling out and transferring the stock.*

*Pickwick Papers*

3.1. The three centuries spanning the period between the passing of the Tudor statutes which were the forerunners of the Bankruptcy Acts and the latter half of the nineteenth century were times of great commercial opportunities. The effective exploitation of these opportunities created needs for novel forms of commercial organization to enable the large amounts of capital which were required to be subscribed and the inherent risks to be spread among many participants. For example, the early voyages of discovery in the sixteenth century were financed by syndicates of entrepreneurs each of whom subscribed part of the initial capital and was entitled to participate in any profits of the voyage. For some enterprises Parliament granted a trading monopoly to groups of venturers subject to their undertaking to fulfil certain obligations. The great chartered companies fell into this category. Other enterprises were undertaken by joint stock companies. In law the early joint stock companies were no more than large unincorporated partnerships.

3.2. All of these arrangements suffered from the disadvantage that limited liability was not available, except in the case of certain chartered and statutory companies, and hence a litigious creditor could initiate an action against a single prominent participant, leaving him to involve his fellow partners or shareholders in his support if he could.

3.3. This situation was unsatisfactory and became increasingly so with the passage of time. Whilst investors were prepared to risk their capital in the hope of participating in speculative profits they were not willing to be held liable for debts should the enterprise fail. By the middle of the nineteenth century this reluctance was inhibiting the mobilization of capital for such business purposes as the building of railways, which were high risk enterprises requiring the investment of enormous sums. This difficulty was finally overcome in 1855 by the Limited Liability Act, which was almost immediately replaced by the Joint Stock Companies Act 1856. Thus by the time the consolidating and amending Companies Act 1862 was passed the way to the modern limited liability company had been opened.

3.4. However, even before this spate of legislation, procedures had to be developed for liquidating the affairs of companies which were insolvent, that is, unable to pay their debts. It was the Winding-Up Act 1844 which first formalized the principles for winding-up a company. It prescribed two methods, which are still the alternatives under current law. The first was a compulsory winding-up by order of the Court whilst the second involved a voluntary winding-up initiated by a resolution of the shareholders. This would be under the supervision of the members, if the directors declared the company to be solvent, or under the supervision of the creditors if the company was insolvent. A voluntary winding-up was not normally supervised by the Court.

## 4. INSOLVENCY IN RELATION TO LONG-TERM INSURANCE

*Then there are the life assurances without loans: the common policies. Very profitable, very comfortable. Money down, you know; repeated every year; capital fun!*

Tigg Montague Esquire, Chairman of the Anglo-Bengalee Disinterested Loan and Life Assurance Company, in *Martin Chuzzlewit*

4.1. Scientific life insurance is generally taken as dating from the founding of the Equitable Society in 1762, a full 100 years before the concept of limited legal liability received statutory recognition. The Equitable was founded as a society for the mutual benefit of its members, and as such there were no external guarantors of its ability to meet its financial obligations to its members. The organizers recognized from the outset the possibility of a deficiency arising even in a well-managed society as a consequence of some natural disaster such as a recurrence of the plague. In the Deed of Settlement it was provided that in such an event solvency should be restored by a rateable reduction in the sums insured under existing contracts. A similar provision was made when the Norwich Union was established some 40 years later.

4.2. The possibility of a deficiency affecting a body undertaking long-term insurance, and the development of equitable methods for dealing with such a deficiency, is thus of long standing, dating from the very birth of life insurance and pre-dating by a considerable margin the Winding-Up Act 1844.

4.3. However, not all life insurance was conducted soundly or on the mutual principle. In the middle years of the nineteenth century a number of joint stock companies were founded with the object of promoting life insurance. Setting up a life insurance company was attractive to company promoters as the outlay of capital required was limited and in the initial years the cash flow was positive.

4.4. The less successful of these companies were consumed by excessive expenses, to the extent that it was clear to the actuaries of the day that in the long term they would be unable to meet their commitments. However, although these companies were subject to the Winding-Up Act 1844, the provisions of that Act could only be implemented if the company had failed to meet its current obligations, i.e. those immediately due for payment; in other words if the money had actually run out and there was insufficient to meet the current claims of policyholders or other creditors. Shareholders of companies not protected by limited liability were aware that in such an event the unsatisfied creditors, including the policyholders, would have had a claim against them. In order to avoid this happening, shareholders of a company which was getting into difficulty sought relief by amalgamation with another company, thereby postponing the day of reckoning but inevitably jeopardizing the financial soundness of the company with which it had joined. Two companies, the European Life Assurance Society and the Albert Insurance Company, were prominent in taking over these ailing companies, the European taking over a total of 33 and the Albert 24.

4.5. By 1869 it had become clear that the European Life Assurance Society, a proprietary company, was in financial difficulty and two petitions were presented under the Companies Act 1862 for it to be wound up. A special feature of the European was that it had a considerable amount of uncalled capital relative to its potential liabilities but there had been only a partial response by shareholders when an attempt had been made to call up part of it. The principal petitioner in the winding-up proceedings was one of the directors who had been campaigning for a more stringent management of the company's affairs. Expert actuarial evidence called in support of the petition showed that, had the company been prudently managed, it would have had reserves of some £1 million and that something of this order was required if the company was to be sure of meeting its obligations under existing contracts. Nothing approaching this sum was available and the company was living from hand to mouth; in the actuarial sense it was insolvent.

4.6. The Court first had to decide whether it was competent to act, and thus to exercise its discretion to order the winding-up. Under the Companies Act 1862 one of two alternative propositions had to be demonstrated in order to meet the jurisdictional requirements. The first was that the company was unable to pay debts which were absolutely due, but as the European had met and was still meeting all current claims, by this test it was not insolvent. Alternatively, it had to be shown that it was 'just and equitable' that the company should be wound up. Under this test, the Court wanted to be reasonably certain that the existing and probable assets would be insufficient to meet the liabilities under existing contracts. It might be 'prudent' for the company to be wound up but that was insufficient for the Court. It had to be shown that it was 'just and equitable' before the Court could put an end to all existing contractual rights.

4.7. In pursuit of this argument the Court dissected the European's balance sheet. The asset relating to the sum expended in acquisition of the businesses taken over was rejected as being of no value. However, the Court decided that the uncalled shareholders' capital must be assumed to be available if called until the opposite had been demonstrated. Taking this into account, the Court ruled that it had not been demonstrated to its satisfaction that the company would be unable to discharge its future liabilities as they arose under existing contracts. Hence neither of the essential jurisdictional requirements had been met, and no winding-up order was made.

4.8. This judgement constitutes a leading case. For the first time the Court had to apply the tests of the then relatively new Companies Acts to the affairs of a long-term insurer. It is pertinent that the Court indicated its willingness to extend the concept of insolvency by taking account (under the 'just and equitable' head) of future liabilities arising under existing contracts, although it refused to speculate about the impact of future, as yet hypothetical, eventualities in the particular case of the European. The precedent established in the case has been followed in recent years both in relation to the affairs of a long-term insurer (in *In re Capital Annuities Ltd* [1979] 1WLR 170) and in a case which had nothing to do with life insurance (in *In re A debtor, ex parte The Debtor v. Allen* [1967] Ch. 590). In other words a decision handed down in relation to a life assurance company can be binding on future decisions of the Court relating to persons and companies other than life insurers.

4.9. One final comment on the decision in the European case is that the Court showed that it was aware of the undesirable consequences for the individual policyholder of voiding all existing contracts and offering him a lump sum in a winding-up rather than a continuation of his contract.

4.10. In 1869 the Albert Insurance Company also failed, but the Albert case was straightforward as it had run out of money to pay its current and immediate pecuniary obligations and was thus unequivocally insolvent by the first test of insolvency set out in the Companies Act 1862. The failure of the Albert exposed the inadequacy of the then existing legislation for dealing with insolvent life companies, and a special Act of Parliament had to be passed to enable its affairs to be brought to a conclusion by Lord Cairns, the appointed arbitrator, with the help of A. H. Bailey as his actuarial adviser.

4.11. The same event also led to the passing of the Life Assurance Companies Act 1870, which had four main features. These were:

(i) Segregation of life funds.
(ii) Submission of annual returns and quinquennial actuarial valuations.
(iii) Control of amalgamations.
(iv) Winding-up provisions for life companies.

These new statutory requirements precipitated the liquidation in 1870 of the European.

4.12. Both companies, the Albert and the European, collapsed from fundamentally the same causes, namely, that too large a proportion of the premiums received had been spent in meeting claims and expenses, leaving insufficient to set up reserves. However, an additional factor was that each company had pursued a policy of amalgamation with companies which were themselves experiencing financial difficulties. In the discussion of C. J. Bunyon's paper W. P. Pattison (who had been the actuarial architect of the 1870 Act) commented that in one case, had the company been allowed to collapse instead of being taken over by the European, the policyholders collectively would have had a claim of between £200,000 and £300,000 against the shareholders of the failed company.

4.13. The failure of these two companies, the Albert and the European, and the legislation resulting therefrom, caused a deep sense of shock, not least among the actuarial profession, and led to a number of papers being discussed at the Institute. There was a substantial consensus among the actuaries of the time that if a life office became insolvent it should not be liquidated in the same way as any other commercial trading company but should instead have its business run off as a closed fund. The unanimous view among actuaries was that the most equitable way of dealing with a deficiency would be to reduce sums assured without any corresponding adjustment to premiums, as provided for by the wise architects of the Equitable. Section 22 had been included in the 1870 Act to make this possible. It provided for a reduction of sums insured as an alternative to winding-up.

4.14. Unfortunately this well-meant Section was unsatisfactory. In opening the discussion of George King's 1891 paper A. H. Bailey (who, it will be recalled, had been the actuarial adviser to Lord Cairns during the 20 years, no less, that it had taken to bring the affairs of the Albert to a conclusion) said that Lord Cairns had taken the view that he had been appointed to wind up the company and the alternative remedy was no longer available to him. He added that in his view the 1870 Act had been wrongly drawn. In Lord Cairns's opinion the reduction of sums assured should have been described "as a mode of winding-up" instead of as an alternative "in place of a winding-up order". In the view of the authors this may have been more than a mere drafting oversight. There have subsequently been a number of occasions when the statutory wording could have been brought into line with Lord Cairns's views but these opportunities were ignored.

4.15. As we shall see, the 1982 Act now additionally provides, pursuant to an amendment introduced in the 1973 Act, for a reduction of sums assured to be sanctioned by the Court when the company is in liquidation, as well as alternatively to liquidation. This provision under Section 56(5) is designed to assist the liquidator to carry on the business under Section 56(2) of the 1982 Act with a view to its transfer to another company.

4.16. We review these Section 56 provisions in more detail in Section 5 of the paper but at this point in the historical reconstruction of the current law it is worth recording that these provisions have not yet been shown to be ideal. To date the Courts have had difficulty in sanctioning a reduction in sums assured to facilitate running off the business, and Section 56 does not empower the liquidator to run off the business himself as a closed fund, other than with a view to transferring the business. The difficulties are exacerbated by the fact that the provisions are not yet operative, as we shall see.

4.17. In his 1870 pamphlet Bunyon argued that the application of the Winding-Up Acts, namely that of equitable division and distribution of the funds among the creditors, altered fundamentally the form of every policyholder's contractual entitlement by substituting a small sum of ready money to replace future provision for the policyholder's family. He pointed out that a reduction of sums assured had long been recognized as an equitable means of dealing with a deficiency and that it was the Companies Act 1862 which had had the effect of turning policyholders into 'mere creditors'.

4.18. With the benefit of hindsight we believe that a fundamental error was made when the Winding-Up Act 1844 was passed in not recognizing that the liabilities of a life office are so different from those of almost any other corporate enterprise that they cannot be dealt with appropriately under the principles which are valid for other companies. What is less excusable is that this still remains the position. The general law of corporate insolvency still governs life assurance companies, with only modest modification under the Insurance Companies Acts.

4.19. After the collapse of the Albert and the European and the passing of the Life Assurance Companies Act 1870, the next important milestone was the passing of the Assurance Companies Act 1909.

4.20. The 1909 Act illustrates the interaction between successive Companies Acts and the insurance legislation. Section 21 of the 1870 Act provided that in determining whether a company was "unable to pay its debts" the Court was to take into account its contingent and prospective liabilities but it was not until the Companies Act 1908 that the same insolvency test was extended to all companies. Thus, when the 1909 Act repealed the whole of the 1870 Act it did not re-enact provisions similar to those of Section 21 of the 1870 Act, since the Court possessed all the necessary powers under the primary legislation of the 1908 Act.

4.21. Interest in the law of insolvency as it relates to life insurance seems to wax following any insolvencies and to wane as soon as the particular difficulties appear to have been relegated to the past. The expansion of inherently unsound life assurance companies which culminated in the collapse of the Albert and the European led to the passing of the 1870 Act and to the papers to the Institute which followed.

4.22. It was the crash of the City Equitable, the City Life and certain other companies in the period immediately after the First World War which led to the setting up, in 1924, of a Board of Trade committee to review the working of the 1909 Act and make recommendations for its amendment. The committee, which became known as the Clauson Committee, had a strong actuarial as well as legal representation among its membership and additionally received evidence from a number of leading actuaries.

4.23. A vital Appendix to the Clauson Committee report, which was published in 1927, was a Draft Insurance Undertakings Bill which embodied its recommendations. The draft bill would have brought within its ambit all insurers transacting long-term insurance, whether constituted as companies or not. This bill was never presented to Parliament, but it is not clear whether it was pushed aside by the gathering economic crisis or as a result of opposition to certain of its recommendations, particularly those affecting composite offices.

4.24. The Committee considered that the growth of composite companies made it necessary to make detailed provision to safeguard the interests of life policyholders in the assets representing the life fund, particularly if the life fund was in surplus and the other funds in deficiency. Having concluded that the system of providing segregated funds without a corresponding separation of assets was inadequate, the Committee proposed the setting up of statutory funds, with the assets representing long-term business correspondingly separated from those of short-term business. It envisaged situations in which the long-term business of an insolvent composite company might be run off whilst the short-term business was wound up.

4.25. The draft bill also set out to provide that such part of what is described as the *prima facie* surplus as corresponded to the policyholders' equitable share (that is the prospective but non-contractual expectation) should be reserved for the life policyholders. Only that part of the life fund surplus which could be attributed to the shareholders' expectations would have been available in a winding-up to non-life policyholders, to general creditors, and to shareholders. This would have been an innovation with far-reaching implications. In effect it would have converted an equitable expectation into a legal entitlement.

4.26. Surprisingly, the report of the Clauson Committee was not discussed at a sessional meeting either at the Institute or the Faculty although it was the subject of a legal note in *J.I.A.*

4.27. One of the Committee's recommendations was that the Board of Trade should be given increased powers of intervention in the affairs of assurance companies. The need for this was demonstrated subsequently by the financial difficulties experienced by a number of insurance companies pursuant to the Road Traffic Act of 1930, and it led to the passing of the Assurance Companies (Winding-Up) Acts of 1933 and 1935.

4.28. During the years immediately preceding the outbreak of the Second World War the main preoccupation of the established United Kingdom life offices was with the maintenance of their rates of bonus. The war threatened solvency in two ways: the real possibility of a catastrophic number of war deaths, a risk parallel to the recurrence of the plague or other natural disaster recognized by the Equitable nearly 200 years before; and the effect on investment values which in the event was substantially mitigated by the Act of Parliament which provided compensation for material war damage. Despite these apprehensions the U.K. life offices survived the war years and the years which followed without any financial failures, leading to an enhancement of public confidence in the soundness of life assurance. Indeed, it was the growing feeling that the traditional offices were too conservative in their distribution policies which provided the opportunity for launching a number of new entrepreneurial offices, particularly those offering linked life assurance, during the 1960s and subsequently.

4.29. The collapse of two predominantly motor insurance companies, Fire, Auto & Marine and Vehicle & General, led to the drafting of a Policyholders' Protection Bill, and the subsequent failure of several, mainly new, life offices in the wake of the 1973–74 investment market falls resulted in the Policyholders' Protection Act 1975 applying to life as well as non-life policyholders. These failures of life insurers also involved a series of applications to the Courts which threw light on the unsatisfactory legal position of insolvent insurance companies.

4.30. The passing of the Policyholders' Protection Act marked a watershed in the statutory protection of life policyholders. It reflected the strong public feeling that any life policyholder in the U.K. should be able to depend on the performance of his contract. There was also a recognition that it was unreasonable to hold the policyholder culpable for lack of foresight if the office failed many years after the policy had been effected. The provisions of the Act clearly assumed that running off the portfolio would become the normal method of dealing with a life office in difficulty. In practice that proved not to be the case, for reasons which derive almost exclusively from the treatment of life insurers as part of the general law of corporate insolvency.

4.31. Any scheme for a running off as an alternative to a winding-up would need to be approved by the Court under what is now Section 58 of the 1982 Act. In *In re Capital Annuities* the Court was asked to approve such a scheme in an application which was supported by the Policyholders' Protection Board. The authors understand that the Board and the Department of Trade regarded the application as a test case to obtain a ruling on various questions which arose on what was then Section 50 of the Insurance Companies Act 1974, and is now Section 58 of the 1982 Act.

4.32. In that case Mr Justice Slade (as he then was) decided:

(a) that "unable to pay its debts" in Section 50 meant the same as in Sections 222(e) and 223 of the Companies Act 1948;
(b) that although it had been proved that the company had insufficient liquid assets to pay its presently payable debts, it had not been proved (as those provisions required) either that any such debt had been demanded but remained unpaid (which we term 'commercial insolvency') or that the company's total assets would not realize enough to meet all its liabilities present, contingent and prospective (which we term 'overall insolvency'); and accordingly
(c) that the company had not been shown to be "unable to pay its debts" in either of the relevant senses of the phrase.

He concluded that the Court thus lacked the authority to consider the scheme submitted for his approval.

4.33. It does not of course follow that, where a case for insolvency can be made out which could give the Court jurisdiction under Section 58 of the 1982 Act, it would on the same facts order the winding-up of a life office.

4.34. Furthermore, lack of liquidity at any given moment would not appear to be a ground on which the Secretary of State could petition for winding-up. The essence of overall insolvency is that the present contingent and prospective liabilities of the company exceed the present value of its assets. By contingent and prospective liabilities is meant liabilities not immediately due but arising out of current contracts and commitments of the company. It is not part of the Court's task, as Sir William James said in *In re European Life Assurance Society*, to look into the future. The Court will not in any case take into account possible liabilities or profits which may accrue in respect of future business. It is the present value of the company's assets which is set against existing and future liabilities under contracts existing at the date of the petition.

4.35. The new-business-generating potential of an office could be a substantial but intangible asset which a prospective purchaser might take into account, as might any tax loss carried forward in the form of unutilized management expenses (excess 'E'). However, although of potential value, such contingent assets are excluded from any legal assessment of solvency, in so far as account cannot be taken of them in the liability valuation basis.

4.36. Proof of insolvency is a jurisdictional requirement which must be satisfied before the Court can consider exercising its discretion in favour of a scheme of reduction under what is now Section 58 of the 1982 Act as an alternative to a winding-up order. Further, if a winding-up order has already been made, it must be discharged before a scheme for reduction can be approved under Section 58.

4.37. There is, however, a further point. The Court would be most unlikely to approve a scheme of reduction which might result in a certain class or classes of policyholder being treated less favourably than they might have fared in a winding-up. It would thus be unusual for the Court to sanction a scheme unless there had been an opportunity for all policyholders or classes of policyholder to be heard or, alternatively, unless the scheme proposed was clearly beneficial to all policyholders, and other creditors were not disadvantaged. As a practical consequence, the necessity for holding policyholders' meetings greatly increases the expense and complexity of dealing with an insolvent or potentially insolvent life insurance company by means of a scheme of reduction.

4.38. These complexities arise from the interaction of insurance law with the general law relating to corporate insolvencies. There is a further hurdle in that the Policyholders' Protection Act imposes a duty on the Policyholders' Protection Board to demonstrate that, if assistance is to be given to continue a company in being, such assistance would be less costly than under the alternative of winding-up. That proposition can never be easy to demonstrate.

## 5. CURRENT LEGISLATION IN RELATION TO THE WINDING-UP OF LONG-TERM INSURERS

*No, no, my dear, mine. You shall have the books.*

Fagin in *Oliver Twist*

5.1. The primary legislation governing the winding-up of a company which carries on long-term insurance business is the Companies Act 1948. One hundred and seventy-three of the four hundred and sixty-two sections of this Act deal with winding-up and numerous regulations have been promulgated as Statutory Instruments pursuant to it.

5.2. Sections of the Insurance Companies Acts relating to winding-up supplement and, where necessary, supersede the provisions of the 1948 Act. All the Insurance Companies Acts, from 1870 to 1982, refer to three aspects of winding-up: instigation; rules for valuing the claims of policyholders; and the reduction of contracts to permit continuation of the business. All references can be considered under these three headings.

5.3. The 1982 Act is the current statute but it continues the position under the 1973 and 1974 Acts that the innovations in relation to the conduct of a winding-up introduced in the 1973 Act will not affect a winding-up commenced before the first Rules have been made under what is now Section 59(2) of the 1982 Act concerning the special case of a composite insurance company which is being wound up.

5.4. Section 59(1) of the 1982 Act provides for rules to be made, under Section 365 of the Companies Act 1948, for valuing the claims of policyholders in a winding-up, and until these rules are made such claims will continue to be valued under the Third Schedule of the 1958 Act. Draft Rules under Section 59(1) and 59(2) have been prepared by the Lord Chancellor but have not, at the time of writing, been laid before Parliament or come into operation. They are discussed below.

5.5. The other legislation directly affecting winding-up is the Policyholders' Protection Act 1975. This Act provides protection for policyholders at a level of 90% of benefits less, if proved, any 'excessive benefits'. The protection for long-term policyholders is afforded by power to make a levy on the life insurance industry not exceeding 1% of premiums on long-term policies effected after 31 December 1974.

5.6. It may be noted that it was held in *In re Capital Annuities Ltd.* that the Policyholders' Protection Board is not obliged to give effect to the recommendations of the independent actuary called upon to advise it in respect of 'excessive benefits', even though in the Capital Annuities case they did in fact do so, and further that the Court may approve a scheme which provides for other than a uniform percentage reduction in benefits for all policyholders.

*Instigation of winding-up*

5.7. Under Company Law, as we have seen, winding-up may be compulsory or voluntary. The Insurance Companies Acts desirably exclude (or will do so when the relevant provisions become operative) the possibility of a long-term insurer being voluntarily wound up. An application for compulsory winding-up may be presented by the Department of Trade or, by leave of the Court after a *prima facie* case has been established, by ten or more policyholders owning policies of an aggregate value of £10,000. In the latter case, the Secretary of State for Trade will be entitled to be heard in the petition.

5.8. The restricted powers given to a group of dissatisfied policyholders are a useful democratic safeguard to ensure that the Department is not dilatory in its defence of the policyholders but, as the Joint Working Party of the Law Reform Committees of the Senate of the Inns of Court and the Bar and the Law Society has pointed out, this section needs to be tidied up. The figure of £10,000 has not been increased since 1909; no definition of 'aggregate value' exists, and it would be preferable for policyholders to have some simple method of working out for themselves whether they qualify to petition, in terms of total premiums paid for example; and the procedure for establishing a *prima facie* case needs to be prescribed.

5.9. Despite this caveat, there is wide acceptance for the principle that the Department of Trade should effectively control petitions for winding-up the affairs of a company which transacts long-term insurance business, and that it should have wide grounds for presenting a petition as provided for in the 1982 Act.

5.10. There are six different grounds on which the Court may order the compulsory winding-up of a company under Section 222 of the Companies Act 1948. Of these, by far the most common is that the company is 'unable to pay its debts', for which purpose contingent and prospective liabilities are to be taken into account. This phrase presents special problems in relation to a life insurance company. An actuarial valuation which, on a statutory basis or otherwise, demonstrates liabilities in excess of assets is not necessarily sufficient legal 'proof' of inability to pay debts.

*Rules for valuing the claims of policyholders*

5.11. The Third Schedule to the 1958 Act repeated the rules for valuing the claims of policyholders in a winding-up which appeared in the 1909 Act. They differ only marginally from the 1872 Act rules. An unmodified net premium value is prescribed for assurances, taking explicit account of declared, but not future, bonuses. An office premium value is prescribed for annuities, on the basis used at the time the consideration was paid, although the Court has discretion to vary this basis if the office premium basis is considered inappropriate.

5.12. These short rules have sufficed remarkably well for 110 years, and with actuarial ingenuity and legal goodwill can still be interpreted to give equitable results, but it is not surprising that they now need a major review including specific reference to 'new' types of contract such as linked policies.

5.13. The new draft rules are certainly more voluminous than the existing rules, running to 30 pages compared with 4 paragraphs. They prescribe the following:

(i) Identification and determination of which assets and which liabilities of a composite insurer are attributable to its long-term business when it is not clear from the company's records. The proposals follow closely the system introduced by the Insurance Companies (Identification of Long-Term Assets and Liabilities) Regulations 1973.

(ii) Provision that any excess of assets in either fund of a composite insurer may only be distributed at the direction of the Court.

(iii) Limitation of the liquidator's remuneration to a 'time and rate' basis. Attention was drawn in Ferguson's paper (*J.S.S.* **22**) to the scandalous effect of applying scale 1948 Act fees to the remuneration of the Official Receiver, Liquidator, Special Manager, and the Department of Trade for auditing the Official Receiver's and Liquidator's accounts and for purchasing government securities. The authors hope that the limitation in the proposed rules to only the liquidator's remuneration can be extended prior to the rules' adoption.

(iv) Administrative matters such as the organization of creditors' meetings and the notification to policyholders of the value of their claims in the liquidation as calculated by the liquidator.

(v) The valuation basis to be used in establishing a policyholder's claim in a winding-up. Separate rules are given for non-linked policies (Schedule 1); linked policies (Schedule 2); immediate annuities, capital redemption policies, and deposit administration schemes, and a long-stop paragraph for all other non-defined types of policy (Schedule 3); and general business (Schedule 4). The rules are adjusted for the special points in Schedule 5.

5.14. The valuation basis for non-linked assurances and deferred annuities is a modified net premium reserve on mortality and interest assumptions that 'the court may direct'. The basis explicitly provides for a reserve for options (other than surrender) and for a reserve for expenses which cannot be met from the difference between gross and net premiums. The zillmer is prescribed as either 3·5% of the sum assured or the allowance in the premium basis, if lower than 3·5%. The value cannot be negative and cannot be less than the value of any right to surrender the policy within 12 months of the date of the winding-up order.

5.15. No explicit provision for future bonuses is made, yet guidance seems necessary on this point. For the last 110 years the weight of legal and actuarial argument has favoured no provision for future bonuses, but this was before the introduction of the concept of 'reasonable expectations of policyholders' in legislation. Since Valuation Regulations for solvent companies, as supplemented by Professional Guidance Notes, and the Department of Trade intervention powers under the 1982 Act both acknowledge the need to provide for future bonuses, and since bonus loadings have increased substantially in recent years, a good case can be made out for a revision of previous practice.

5.16. The introduction of a zillmer is the main departure from the 1958 rules. While a zillmerized basis is appropriate for measuring solvency, the arguments in favour of an unmodified reserve were that, in theory, it puts the policyholder in a position to purchase a replacement policy and further that policyholders will want to relate their value to premiums paid. The authors agree that on balance it is now better to move to consistency with the *status quo ante* and adopt a solvency basis. This implies that the basis should be zillmerized and use realistic interest and mortality assumptions.

5.17. The basis for linked assurances and deferred annuities is the sum of the value of the units, funded where appropriate, and the sterling reserve. No specific mention of a reserve for maturity guarantees is made but the non-linked reserve is to be determined "on actuarial principles and prudent assumptions" and this wording is perhaps sufficient to admit a maturity or other guarantee reserve where appropriate.

5.18. It is outside the scope of this paper to make detailed comment on the Rules, which are still in draft form. However, although the proposed Rules will overcome some of the shortcomings in the existing 1958 Act rules which were commented upon in Ferguson's paper they are still bound to fall short of being exhaustive. Furthermore, the larger and more specific they are the more likely it is that they will have to be regularly updated to keep pace with new policy design.

*Reduction of contracts to permit continuation of the business*

5.19. Section 58 of the 1982 Act provides for the Court "in the case of an insurance company which has been proved to be unable to pay its debts", to "reduce the amount of the contracts in force on such terms and conditions as the court thinks just, in place of making a winding-up order". The wording is virtually identical to Section 22 of the 1870 Act and appears in every subsequent consolidation Act.

5.20. The section appears to provide the sought-after solution of permitting an insurance company in financial difficulty to be run off as a closed fund. Read in connexion with the support provided by the Policyholders' Protection Act it appears to guarantee that no life insurance company need ever be wound up since a reduction of benefits and future premiums to 90% of their original level, adjusted for 'excessive benefits', automatically ensures solvency. It hardly needs to be reiterated that there is virtual unanimity amongst actuaries and others who have studied the problem throughout the last two and a quarter centuries that a life insurance company in financial difficulties should have its business run off as a closed fund, with reduction of benefits if necessary, rather than be subject to a cash winding-up.

5.21. However, there remains the hurdle that the jurisdictional competence of the Court has first to be established by demonstrating that the company is unable to pay its debts. In earlier cases this proved a stumbling block even when by any actuarial test the company was manifestly insolvent in the sense that it would be unable to meet its contractual obligations to its policyholders. Subsequently the legal criteria have been clarified. The difficulty now and for the future is that in respect of a company subject to U.K. supervision the alarm bells will start to ring long before a company is demonstrably insolvent in the legal sense because the regulations, framed under the Insurance Companies Acts in the interest of policyholders, set out to establish a higher standard of financial soundness.

5.22. In his judgement in the Capital Annuities case Slade J (as he then was) ruled that the words 'unable to pay its debts' in Section 58 of the 1982 Act should be interpreted as having the same meaning as the same words in Sections 222 and 223 of the Companies Act 1948, one of the grounds being that it has been proved to the satisfaction of the Court that the company is unable to pay its debts, account being taken of the contingent and prospective liabilities of the company as well as its current liabilities. However, in the interest of the policyholders, intervention should take place at an earlier stage, as soon as there is any substantial doubt about the company's ability to meet its contractual liabilities. In short, the financial standards which it is sought to establish under the Insurance Companies Acts are at variance with the concept of insolvency embodied in the Companies Acts.

5.23. Section 56 of the 1982 Act incorporates the amendments first introduced by the 1973 Act, and produces a solution to some of the technical difficulties associated with Section 58, but it still relies upon a concept of insolvency importantly different from that established under the Insurance Companies Acts. The key Section 56 sub-sections are:

(2) The liquidator shall, unless the court otherwise orders, carry on the long-term business of the company with a view to its being transferred as a going concern to another insurance company, whether an existing company or a company formed for that purpose; and, in carrying on that business as aforesaid, the liquidator may agree to the variation of any contracts of insurance in existence when the winding up order is made but shall not effect any new contracts of insurance.

(5) The court may, if it thinks fit and subject to such conditions (if any) as it may determine, reduce the amount of the contracts made by the company in the course of carrying on its long-term business.

5.24. Here is the rectification of the 'drafting error' spotted by Lord Cairns over a century ago. But it is now pertinent to ask whether the correction is sufficient. It would be surprising if it were, and nothing could be learned from experience and specifically the experience of the companies which failed in the 1970s. While not wishing to hold up the activation of these sub-sections by further delaying the introduction of the rules, and specifically the rules under Section 59(2) of the 1982 Act, the authors draw attention to the following drawbacks under the proposed new arrangements:

(i) Cost, delay and uncertainty. The legal winding-up procedures are costly and involve delay and uncertainty to policyholders of the insurer in difficulties. Furthermore, despite the provision for recourse to actuarial advice, it is not obvious that a liquidator is the right person to take charge of carrying on the business of a long-term insurer, and that he will be aware for example of the need to calm existing policyholders and satisfy them in relation to the continuation of premium payments.

(ii) Tax. For tax purposes a company in liquidation is assessed separately for the two periods prior to, and after, the date of the winding-up order. Furthermore, an insurance company in liquidation appears to be taxed on the same basis as any other commercial company. This not only means that any tax assets such as unutilized management expenses of the failed insurer are lost once a winding-up order is made, it may also mean that the taxation of the continuing business will be different. For example, there will be no separation of the life assurance, pension annuity and general annuity funds.

(iii) The danger that while the Insurance Companies Act winding-up provisions remain a subset of the Companies Act provisions, any change in the latter, by virtue of E.E.C. harmonization, the Cork Commission or future unknown stimuli may have an unwelcome impact on insurance companies. The converse is also true. For example, the Joint Working Party referred to in § 5.8 has commented that the rules for winding-up an insurance company proposed under the E.E.C. draft Directive on the Winding-Up of Direct Insurance Undertakings "cannot be brought within the winding-up code of the Companies Acts". They suggest that a way out of the problem would be to provide for 'winding-down' instead of winding-up and that the necessary provisions should form a self-contained code in the Insurance Companies Acts. What wise advice. It was given prior to the passing of the 1981 Act, and the authors regret that it has not so far been taken.

5.25. In the next section of the paper we will argue the case for adopting the direct route of carrying on the business of an insurer in financial difficulties rather than having matters hamstrung by the provisions of general Company Law and the need to cross the *Rubicon* of a winding-up order.

5.26. Before doing so, however, it is necessary to complete the synopsis of the current legal position with a reference to the innovations introduced in the Insurance Companies Act 1981 and the Insurance Companies Regulations 1981 which were both so admirably covered by Pickford (*J.S.S.* **26**). The 1981 Act was a consequence of the E.E.C. Life Directive of 5 March 1979, as was to some extent the part of the Regulations which deal with the valuation of liabilities.

5.27. The 1981 legislation gives the Department of Trade two formalized intervention points which should precipitate remedial action from an insurer which is sliding towards insolvency. The first is when the actual solvency margin falls below the required solvency margin and the second is when it falls below one-third of this figure, commonly known as the Guarantee Fund. The solvency margin is the difference between assets and liabilities, both valued in terms of the Regulations.

5.28. Since the assets are thus valued at market value and the liabilities on a net premium 'adequacy' basis the result will not necessarily tell anyone much about the actual state of solvency of the company. We would certainly argue that if the application of the Regulations resulted in there being no solvency margin, i.e. liabilities exceed assets, then this should not be taken as 'proof' of insolvency. Even in relation to Section 58 of the 1982 Act we would argue against this test being sufficient grounds for a reduction of sums assured.

5.29. Nevertheless, taken in context, these Regulations provide sensible grounds for Department of Trade intervention to demand, in the first instance, a business plan which shows the restoration of the company's solvency margin and, at the second trigger point where the Guarantee Fund starts to be eroded, immediate action, which we take to mean the subscription of further capital in the case of a proprietary company. If this latter demand is not heeded, we feel that shareholders would have reduced cause for complaint if their rights in relation to existing capital were diminished in the event of subsequent remedial action being enforced, particularly if real insolvency then existed.

5.30. The bases for the valuation of assets and liabilities in the 1981 Regulations have been designed to produce a conservative measure of solvency, in the best tradition of U.K. actuarial practice. The conservatism is even greater to the extent that the reasonable expectations of participating policyholders are taken into account in the valuation basis.

5.31. We do not therefore regard the 1981 Act and Regulations as having a direct bearing on our main topics of insolvency and winding-up. However, they have an important indirect influence in two ways. First, they will provide evidence that a company in financial difficulties has been given ample opportunity to correct the situation, with official prompting, on at least two occasions prior to actually becoming insolvent. Secondly, in the E.E.C. context, it needs to be stressed that in most E.E.C. countries the corresponding tests in relation to the solvency margin and Guarantee Fund are interpreted as real tests of solvency.

5.32. The danger is that the analogy will be carried to the next stage, and the U.K. will be drawn into copying other E.E.C. countries in the current legal trend towards providing for a cash winding-up instead of a run-off of the portfolio. This was not always the case. In early drafts of the E.E.C. Bankruptcy Convention life insurers were specifically excluded but this no longer applies in more recent drafts. At present most countries provide for running off the portfolio, under what is known as administrative winding-up, as opposed to the U.K. practice of a judicial declaration of insolvency under general rules applying to all business, but the draft E.E.C. Directive on the Winding-up of Insurance Undertakings now favours the current U.K. system of a cash winding-up.

5.33. It is thus even more urgent to put our house in order and consolidate the legal basis for a standard procedure of running off a closed portfolio of an insolvent life insurer before we are pressured in the other direction by our fellow members of the E.E.C.

## 6. THE CASE FOR A RADICALLY NEW STATUTORY APPROACH

*Mr Tangle, have you nearly concluded your argument?*

The Lord High Chancellor in *Bleak House*

6.1. At the time of writing we await a further draft of the Winding-Up Rules to be made under Section 59(1) and (2) of the 1982 Act. It is possible that this may be available before this paper is submitted for discussion. Our researches have, however, made us increasingly sceptical as to whether the law will be adequate, even when all the provisions of the 1982 Act are rendered operative by the introduction of these Rules.

6.2. The new provisions will represent a significant advance over the existing procedure, but they must still operate in the context of concepts for the most part embodied in, or deriving from, general Company Law. In the opinion of the authors this fundamental constraint needs to be removed.

6.3. We feel strongly that there is a justification for insolvent life insurance companies to be singled out for special treatment. A long-term policy is a cornerstone of the financial security of families of both ample and modest means. Hence the failure of a life insurance company, has profound social repercussions. Surely it was recognition of this aspect which led Parliament to pass the Policyholders' Protection Act 1975 which imposes on the Policyholders' Protection Board certain duties in relation to companies in liquidation, including those of making available protection or financial assistance to holders of long-term policies, and empowers the Board, without imposing a duty, to assist the policyholders of a company in financial difficulties. It is, we suggest, this Act which opens the way to a radical new approach to the legislation governing life insurers in financial difficulties.

6.4. Furthermore, since the life insurance industry is required by this Act to offer a financial guarantee to all U.K. policyholders, it is in their interest, and in the wider national interest, that such assistance should be given at the minimum cost consistent with attainment of the objective.

6.5. The interaction of the Companies Acts and the Insurance Companies Acts militates against the mounting of economical and effective rescue operations. There is general recognition that running off as a closed fund, with reduced benefits if necessary, is preferable for the great majority of policyholders to claiming as an unsecured creditor in a cash winding-up. However, a cash winding-up under the Companies Acts remains the primary remedy. Hence, properly, the Court has shown itself as likely to test schemes of reduction of benefits proposed under the Insurance Companies Acts by reference to the principal remedy, a cash winding-up under the Companies Acts. The application of this test involves cost, delay and, worst of all, uncertainty.

6.6. In particular,

(i) First the Court requires to have it demonstrated that the company is indeed insolvent so that the jurisdictional requirements are met and the Court is empowered to act.

(ii) Then it needs to be satisfied that the proposed scheme of reduction will not leave any policyholder worse off than he would have been in a winding-up. This may be relevant where some groups of policyholders have guaranteed surrender values on unduly favourable terms, or where unit-linked values plummet after the date of the winding-up order.

(iii) Further, the Court requires to be satisfied that any scheme is equitable as between different groups of policyholders, and thus that all groups of policyholders are properly represented when the scheme is before it. The Court has had to consider whether there should also be meetings of policyholders before a scheme of reduction can be approved. It was decided that such meetings are not an essential requirement but that only in exceptional circumstances would the Court sanction a scheme without policyholders' meetings. In only one case to date has such approval been given, and then only after the judge had satisfied himself that no policyholder could have a valid financial objection to the scheme of reduction submitted for his approval.

6.7. A further area of difficulty has been the determination of the relative position of policyholders whose contracts have become due for payment, and whose claims thus rank *pari passu* with other unsecured creditors and other policyholders whose policies have not yet become due, although perhaps imminent. It has been decided that benefits which have already become due for payment lie outside the ambit of any scheme of reduction.

6.8. In recent cases, furthermore, the Court has needed to consider the Policyholders' Protection Act and whether any proposed scheme for the reduction of the liabilities of a company in financial difficulties which placed a financial obligation on the industry would be in breach of any of the three restrictions on the Board's discretion: these are, briefly, that it should not benefit shareholders; should not be more expensive than allowing the company to go into liquidation; and should have regard to the provisions of Section 17 relating to 'excessive benefits'.

6.9. Lawyers regard this process of testing as both inevitable and salutary and make light of the procedural difficulties, but actuaries and others involved in the administration of life insurance find it not only vexatious, time consuming and unduly expensive but also an obstacle to securing a solution satisfactory to policyholders' interests generally.

6.10. A new radical statutory approach could remove or mitigate most of these problems. Our proposal is for a new unifying statute governing companies transacting long-term insurance. For such companies the new statute would replace the Companies Acts, the Insurance Companies Acts and the Policyholders' Protection Act, which would cease to apply in their entirety, the relevant parts which it was wished to retain being re-enacted in the new statute.

6.11. Proposals have been made to consolidate the existing Company Law into several separate statutes, one of which would deal with winding-up, and if this separation takes place it should facilitate the substitution, for long-term insurers, of a different approach to 'winding-up', as a possible compromise solution.

6.12. We advocate that the new statute should give the Court jurisdiction in the event of a company failing to maintain the requisite E.E.C. solvency margin, and that this criterion would replace the need to prove inability to pay debts. The Court would then have power to appoint an Administrator to replace the existing management and directors and run off the existing business. The Court would act on a petition from the Secretary of State and we envisage that the Secretary of State would not petition the Court until he had satisfied himself both that the existing management was incapable of drawing up and implementing a business plan to restore the solvency margin, and also that the shareholders, if any, were unwilling or unable to make good any shortfall.

6.13. Although normally the Secretary of State would petition the Court on the grounds that the company was unable to maintain the requisite solvency margin, he would be given similar powers if the company was in breach of its statutory requirements.

6.14. The Administrator would need wide powers, similar to those of a liquidator, to act under the jurisdiction of the Court. He would need protection against immediate creditors, including surrender of policies, while he assessed the financial position and decided what reduction of benefits was necessary, if any. He should have power to run off the business himself as a closed fund, not merely to continue it with a view to its being taken over.

6.15. The Administrator's first priority would be to keep the business going, including payment of current claims in full or on account, and to advise policyholders concerning the desirability of continuing premium payments.

6.16. He would then investigate, with actuarial advice, the extent of the deficiency, if any, and the need to reduce benefits to restore solvency. He would also decide whether he needed to raise a levy on the industry similar to that provided for under the Policyholders' Protection Act. The Administrator's scheme of rehabilitation would then have to be submitted to the Court for approval. At that stage there would be the opportunity for any party which judged itself to be adversely affected by the proposed scheme to be heard by the Court but, if the statute is well drawn, any grounds for objection should be restricted.

6.17. This could be achieved by limiting the rights of shareholders, policyholders and creditors, and enforcing the obligations of the industry, within the statute. Often, the only policyholder limitation required in practice will be a reduction in guaranteed surrender values, leaving the primary (death and maturity) benefits unchanged. This reduction in surrender values and other secondary benefits might turn out to be temporary if the financial condition of the company improves. A precedent for the reduction of surrender values in extreme circumstances by order of the control authorities already exists in countries such as France and Australia.

6.18. It should be noted that the procedure proposed would eliminate any anomaly between the treatment of matured and unmatured policies. Further, it would provide protection for creditors. Trade creditors for goods and services supplied *bona fide* would need to be protected in full in order for the new statute to be generally acceptable. We do, however, foresee scope for abuse if 'connected persons' or highly paid executives holding service contracts were to be automatically accorded the same security as genuine trade creditors. If the new statute incorporated provisions similar to those at present contained in Section 16 of the

Policyholders' Protection Act 1975 any claims for excessive compensation could be resisted by the Administrator.

6.19. The same section ensures that shareholders cannot benefit from any assistance given by the Policyholders' Protection Board, and it seems right that this principle should be retained.

6.20. If the actuarial investigation consequent on the appointment of the Administrator disclosed the probability of a deficiency arising at a future date the principle is now established that additional assets must be made available by the remainder of the insurance industry. Such assets could either be a straightforward subsidy or take the form of cumulative preference stock. Pursuant to the principle that shareholders should not benefit from any reduction of benefits to policyholders, there ought also to be statutory provision for benefits to be restored in full before any dividends are paid on the ordinary shares.

6.21. So far we have advocated the case for unified legislation from the standpoint of achieving greater efficiency in dealing with a life insurer in financial difficulty. A major review of life insurance legislation would, however, present the opportunity to reconsider other aspects of greater and lesser relevance to our main theme.

*Composite insurance*

6.22. As will be appreciated acceptance of our arguments for making running off the standard method of dealing with an insolvent long-term insurer would create a dichotomy between long-term insurers, on the one hand, and general insurers, on the other, for which winding-up under the Companies Acts would remain the normal way of dealing with a deficiency. Already we have reached the position in the U.K. where no more composites are being authorized, and the E.E.C. Life Directive only permits existing composites to continue for a period of ten years, with a review of the position at that stage. It appears to us that the new statute would have to ensure that within a limited period all existing composites would be segregated into their long-term and short-term components. The principle is inescapable, and in accord with a recommendation of the Clauson Committee.

*The inclusion of Friendly Societies*

6.23. In this paper we have limited our scope to considering companies operating under the Insurance Companies Acts and have disregarded life insurers constituted as Friendly Societies. There is, we think, a case on two grounds for bringing Friendly Societies within the compass of the same statute. First, members of a Friendly Society ultimately depend on the soundness of the financial management of the Society for the payment of the benefits they expect. We think societies should be subject to similar supervision and consider that it is anomalous that there is no system of mutual support between societies similar to that imposed on life insurers operating under the Insurance Companies Acts. Secondly, there has been a recent tendency to offer more exotic forms of contract through organizations established under the Friendly Society legislation. If the new statute were to become law without including Friendly Societies which offer insurance, then it is likely that advantage would be taken to exploit any anomalies in the two systems of supervision.

*The respective roles of actuaries and auditors*

6.24. An Institute Guidance Circular to members, reprinted in the Year Book, states "In the opinion of the Councils of the Institute and Faculty, the relationship between auditors and appointed actuaries is not adequately dealt with in the legislation."

6.25. The existing legislation imposes a general duty on auditors to express an opinion as to whether the published accounts express a true and fair view of the company's finances, a duty which was probably introduced to prevent auditors from being obliged to certify accounts which, while arithmetically correct, were designed to mislead. However, whatever its origins, the requirement has now been elevated to become part of the professional ethos of the accountancy profession and we can sympathize with their view that they are not exonerated from this general requirement under the Companies Acts by anything contained in the Insurance Companies Acts.

6.26. However, it is clear that any accountant who holds this opinion is in some difficulty in auditing the accounts of a long-term insurer. A 'true and fair view' opinion which, explicitly or by implication, disregards the actuary's investigation of the long-term financial position is unsatisfactory at the least and at worst may seriously mislead shareholders. Yet an auditor who attempts to take account of the actuary's report finds himself in the unenviable position of expressing an opinion as to the soundness of the work performed by a member of another profession, an opinion which he is not qualified by training or experience to express, and on a matter which is fundamental to an understanding of the insurance company's finances.

6.27. In our view it must be in the public interest that the two professions should agree to a mutually acceptable division of responsibility on this sensitive issue. We offer the view that it would be inappropriate for the appointed actuary to report directly to the members, whether they be the shareholders of a company or the policyholders of a mutual society. His professional duty should be to communicate to his principals, the directors, in the clearest possible terms his opinion as to the progress and future prospects of the fund. No director who is literate and numerate should ever be able to claim that he failed to comprehend the purport of the actuarial report or that material matters were omitted. It would, we suggest, then be for the auditors and directors to determine a mutually acceptable form in which these results could be summarized for disclosure to the members.

*The reasonable expectations of participating policyholders*

6.28. As Redington has pointed out, the very size of the bonus loadings now paid by participating policyholders of established U.K. offices is such that equitable expectations are thereby created. Concern that life offices should be conducted in such a way as not to jeopardize the fulfilment of policyholders' expectations has manifested itself in two ways.

6.29. First, the Regulations concerning the valuation of liabilities have been designed to prevent offices relying on the bonus loadings contained in future premiums in demonstrating their ability to meet contractual liabilities. Indeed, the test is one of prudent actuarial management rather than a test of solvency, in continuation of the traditional actuarial view that if an office is prudently managed it is automatically solvent; the greater encompasses the lesser. Pursuant to the E.E.C. Life Directive, offices are also required to show an explicit solvency margin.

6.30. Secondly, the Secretary of State has a residual power to intervene in the affairs of an office. Section 45 of the 1982 Act provides that he "may require a company to take such action as appears to him to be appropriate for the purpose of protecting policyholders or potential policyholders of the company against the risk that the company may be unable to meet its liabilities or, in the case of long-term business, to fulfil the reasonable expectations of policyholders or potential policyholders".

6.31. This power is potentially far-reaching, not least because there is no attempt to define policyholders' reasonable expectations. A further disquieting aspect is the inclusion of potential policyholders. Furthermore, although the apparent initiative for any action under Section 45 rests with the Secretary of State, in practice it might be very difficult for him to resist pressure from an organized group of participating policyholders who considered that bonus distributions fell below their expectations.

6.32. We agree that there must be a recognition that the high loadings currently being paid do create a valid equitable expectation for the participating policyholders. They have become more than just providers of equity who have passively to accept the fortunes of the office, good or bad. However, we are uneasy for the State to take upon itself, or to have thrust upon it, the primary responsibility for monitoring the mode of distribution of surplus, and we think Section 45 ought to be subjected to critical scrutiny before it is embodied in any new statute. Our preference would be for this aspect of an office's affairs to be monitored by a return to 'freedom with publicity' as the primary mode of supervision. We believe that this could be achieved by two steps.

6.33. The first would be a requirement for an office to explain its bonus policy to incoming participating policyholders. We note that some U.K. offices are already taking this course. In that prospectus, intending policyholders would have to be made aware of the extent to which participating policyholders' funds were at risk in guaranteeing benefits of other segregated funds should such funds prove insufficient to meet the contractual rights of policyholders. Particular examples which come to mind are any guarantee of minimum benefits in connection with linked life assurance or a guarantee of rates of premium at which variable future contributions will be accepted under pension contracts. The existence of such mandatory disclosure requirements would reduce cross subsidies.

6.34. Secondly, we recommend that it should be a statutory requirement for the appointed actuary to report to the directors on the occasion of any bonus distribution or transfer to shareholders' funds. That report should cover such matters as the significance of any change in the actuarial basis and the prospects for the maintenance of the current level of bonus, in the light of the office's expansion plans, for example. It would then be for the board of directors, with the concurrence of the appointed actuary, to agree the terms in which that report should be communicated to policyholders, and to the shareholders, if any. We believe that the matters to be covered in such a 'State of the Fund' report could safely be left to evolve as a matter of professional guidance to the appointed actuary.

*Solvency tests*

6.35. A change from cash winding-up to running off as the normal method of dealing with an insurance company in financial difficulty would open the way to a different approach to the solvency of long-term insurers. First, in relation to the valuation of assets, it is only in a cash winding-up that market values are relevant. The obligation on the rest of the insurance industry to protect policyholders of an ailing company sets the U.K. apart from other members of the E.E.C. and greatly strengthens the case for the acceptance of a different approach to solvency testing.

6.36. Secondly, the solvency test could be directed unambiguously towards ascertaining a company's ability to meet its contractual requirements to existing policyholders. The purposes of the U.K. domestic regulations and the E.E.C. solvency margins should be regarded as complementary. For a company to meet U.K. domestic regulations it should be required to demonstrate its ability to meet its primary contractual obligations to all existing policyholders in a wide range of circumstances, either because it is matched as regards assets and liabilities or else because there is adequate free capital to cover the adverse consequences of any deliberate or inadvertent mismatching. The main purpose of the additional explicit E.E.C. solvency margin is to provide the regulatory authorities with an early warning of a company becoming unable to meet this test.

6.37. The present U.K. domestic regulations are designed to establish that a long-term insurance company is being conducted on sound actuarial lines with due regard both to the equitable expectations of policyholders and to their contractual entitlements. The test we have proposed would concentrate on the ability of the office to meet its contractual obligations, leaving the continued ability of the office to fulfil the legitimate expectations of participating policyholders to be demonstrated as a separate aspect of domestic supervision.

## 7. CONCLUSION

*At last it is all gone. Nothing is left but scattered leaves of catalogues.*
*Dombey and Son*

7.1. In developing this paper we have been concerned with a number of themes. The one which was predominant in our minds was to advocate that running off should become the normal way of dealing with a life insurance company in financial difficulty, and to ensure that the Law gave effect to this course. We thought that the principle established in the Policyholders' Protection Act that the policyholders of ailing life offices should be aided by a levy imposed on other life insurance companies should facilitate this approach. We set out to test whether the Law will achieve this end once the new Rules proposed under Section 59 of the 1982 Act render the winding-up provisions of that Act fully operative.

7.2. We reached the conclusion that so long as the legal framework remains that of 'winding-up' it is doubtful whether running off can become the automatic solution which we contend should be the case. This is essentially because, to deal with a company in financial difficulties under the Companies Acts, the Court has first to be convinced that the company will be unable to pay its debts, whereas the solvency standard which is prescribed by the regulations made under the Insurance Companies Acts is very different. It is aimed at providing for alarm bells to ring whenever there is significant doubt about the financial soundness of the company.

7.3. This conclusion leads to our proposition that there should be a new statute taking long-term insurers right out of the winding-up provisions of the Companies Acts. We considered whether such a process could be simply administrative without recourse to the Court. We came to the conclusion that it would have to be under the supervision of the Court, both as a matter of natural justice and in order not to promote the opposition of the Lord Chancellor's Committee.

7.4. Such a radical change would inevitably lead to a reconsideration of the regulations relating to the valuation of assets and liabilities, and to a rethink as to the precise purpose of life insurance solvency supervision. In our view it should be directed unambiguously towards establishing whether a company could meet its contractual obligations to its existing policyholders in a wide range of situations.

7.5. Such a solvency test would leave unanswered the question of whether the office was being conducted in such a manner as to have regard to the reasonable expectations of its policyholders. We advocate a return to 'freedom with publicity' in this respect.

7.6. We have speculated briefly about this important subject, which is outside the main scope of this paper but is a subject to which we return in a forthcoming paper to the International Congress in Sydney.

7.7. Any paper touching on the legislation relating to life insurance concerns the legal and accountancy professions as well as the actuarial profession. By reason of training each profession approaches a problem from a different angle. As actuaries we become aware of these differences, and of the need to reconcile them, when we are acting as expert witnesses, as appointed actuaries, advising on the apportionment of funds, and in many other fields in which actuaries operate.

7.8. At quite an early stage in the preparation of this paper we recognized our need for help, particularly regarding legal aspects, and we wish to acknowledge the generous assistance we have received from Professor L. C. B. Gower, Mr Ralph Instone and Mr Charles Ashcroft.

7.9. We also wish to thank fellow actuaries who have commented and contributed so helpfully and constructively at various stages. Some have asked specifically to remain anonymous but we would like to place on record that we are greatly in debt to them all. The final views expressed are, as is customary, our own.

*Something will come of this. I hope it mayn't be human gore.*
Simon Tappertit in *Barnaby Rudge.*

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## ABSTRACT OF THE DISCUSSION

**Mr D. G. R. Ferguson** (presenting the paper): This paper is being presented a week after the publication of Professor Gower's report on investor protection. Two comments in that report caught my attention. The first was that self-regulation of the life insurance industry had to be excluded from his recommendations, to comply with current and forthcoming E.E.C. legislation. The second was that only one large Bill per parliamentary session relating to the Department of Trade's responsibilities is likely in the next two years. Thus, there is already competition to see which will come first, the implementation of Professor Gower's investor protection recommendations or the Cork Commissions' insolvency recommendations.

My reaction to the first of these items is that it greatly strengthens our case for treating life insurers as a unique and special category in law, distinct from both ordinary trading companies on the one hand and all other investment media on the other. My reaction to the second is to wonder if it is too forward to ask if we can book third place in the queue for a Life Insurance Bill to implement our recommendations.

The law for dealing with life insurers in financial difficulties has been a mess for a long time because life insurers are subject to both general company law and specific insurance company law, in that order. Well-meaning efforts to improve the situation wax in the wake of a crop of insolvencies and wane in the long intervening periods, but the efforts have never been strong enough to get the law amended.

The present position illustrates the point. The provisions of what is now Section 58 of the 1982 Act were found to be unworkable over a century ago. If a company is in difficulties, it cannot reduce benefits until it has been proved to be insolvent, and by the time it has been made insolvent it is too late to apply the Section and reduce benefits.

Then we come to the measures in Section 56, whose antecedents reached the statute book in 1973, but which are still not operative because Rules have not yet been laid before Parliament to bring them into force more than 10 years later. Is it a coincidence that legal draftsmen of limitless ingenuity have failed to give effect to the repeated desire for running-off to be the normal solution for a life insurer in financial difficulties, or is it, as we suggest, the fact that running-off is in direct contradiction to the primary legislation which requires a cash winding-up?

During the passage of the Policyholders Protection Bill through Parliament in July 1975, the then Under-Secretary of State for Trade explained in the House of Commons that he was very conscious of the deficiencies in the law relating to winding-up insurance companies and that the Department was making a detailed study of the subject in full consultation with the industry. We are aware that the industry has put forward constructive views which are in many respects consistent with our own, but we do not know when this detailed study will result in a fruitful conclusion.

The position has been complicated lately by the need to harmonize United Kingdom legislation with European law and practice, as envisaged by the draft E.E.C. Directive on the winding-up of Direct Insurance Undertakings.

We hope that one unequivocal conclusion from the discussion will be that life insurers in financial difficulties should always have their business run-off, or wound down, with whatever reduction of benefits is necessary, after taking into account the external financial support available.

**Mr Michael Arnold** (opening the discussion): It is somewhat surprising, in spite of periods when some life insurance companies have run into severe difficulties, such as in the mid-1970s, that it is more than 50 years since this subject has been discussed at a sessional meeting of the Institute, although one of the authors, Mr Ferguson, has presented a paper to the Students' Society (*J.S.S.* **22,** 1).

The first four sections set out in a fairly detailed manner how the current legislation has evolved. Not only do they provide a history of the development of the law of insolvency, but they also illuminate some interesting facets on the development of life insurance generally. The situation for promoters of new life insurance companies in the middle of the nineteenth century could not be more different than it is today, when the initial capital requirements for the formation of a life insurance company are extremely significant. The initial cash flow is anything but positive, particularly if large volumes of regular premium policies are to be written where initial commissions and expenses can absorb more than the first year's premium.

The heart of the paper is contained in §§ 5 and 6. The authors argue strongly for a radical new approach to the legislation that would provide for the running-off of insolvent insurance companies as the principal course of action. In doing so they outline two principal objections to the current legislation. They point to the difficulty of proving that a life insurance company is unable to pay its debts, which is a prerequisite for the Court before it can recommend the running-off of an insurance company; and they highlight the inherent cost and time delay that is inevitable in the various procedures that are required under current legislation.

I agree with § 5.20, that there is virtual unanimity amongst actuaries that a life insurance company in financial difficulties should have its business run off as a closed fund, with a reduction of benefits if necessary, rather than be subject to a cash winding-up. To the extent that current legislation does not provide for running-off as a principal remedy, the implications are that reform is required. However, I (and, more importantly, the authorities) are always a little sceptical of any 'pressure' or 'special interest' group claiming special treatment, and that it should only have specific laws enacted to suit its own particular circumstances. The general public may think similarly and would probably not recognize the need for any such special treatment for life insurance companies. Accordingly, I think the better approach would be to seek ways of achieving a solution within the general law, if this is at all possible.

The authors point out in § 5.21 that it is difficult to prove to the Court that the company is unable to pay its debts. This is the same difficulty as that which recurs throughout the first four sections of the paper. Could not the problem be solved simply by providing in the legislation, or by regulation, an adequate definition of proof of inability to pay debts? Admittedly, this would still require specific definitions and regulations for life insurance companies, but this could be achieved whilst retaining the interdependence of the insolvency legislation as it pertains to life insurance companies in the General Companies Acts, and is thus less to ask of the legislators.

I would be in favour of a clear, unambiguous and fairly stringent definition of inability to pay debts in this context, and with the introduction of E.E.C. minimum solvency margin requirements and minimum guarantee funds, together with minimum valuation bases, I believe we have the basis of any such test. I accept that these go far beyond requiring a demonstration of the ability to meet contractual or primary benefits, but I believe that most of us would not be happy to allow a company to continue to operate and write new business if it could not meet the minimum guarantee fund on the minimum statutory valuation basis and, furthermore, could not provide the Secretary of State with an adequate plan (as required under Section 33 of the 1982 Act) demonstrating that the minimum guarantee fund and solvency position can be restored.

Thus, if a definition of inability to pay debts along these lines were to be introduced, and, with the emphasis in the current legislation towards the liquidator having the authority to transfer the business of an insolvent insurer to another existing insurer, I believe that the ideal solution referred to in the paper could be achieved within the current legal framework.

Legislation has changed considerably since the troubles of the mid-1970s, and the main thrust of the new legislation has been to give the authorities significantly more information. While there will always inevitably be a time delay between the submission of statutory returns and their thorough investigation by the regulatory authorities, the introduction of valuation of asset and liabilities regulations together with the additional power and guidance notes given to the appointed actuary, has meant greater emphasis on self-regulation. I believe that the circumstances that led to the mid-1970s problems are far less likely to give rise to the same type today, but herein lies the difficulty, legislation is enacted to meet one set of past circumstances, only for a quite different set to arise. In this new climate I believe that provision for a transfer of the business of an insurance company that could not meet the minimum guarantee fund requirements to an existing insurer is the correct approach.

The authors recommend a new statute that would make the principal remedy for a life insurance company that runs into difficulties a reduction in benefits, if necessary, and subsequent run-off of the existing portfolio; they do not say whether they would retain the current emphasis towards the transfer of the business. If they would not, then surely problems would eventually arise. They do not address themselves to the situation that would ultimately arise when the administrative cost of servicing the remaining business could simply not be supported by the business left on the books. Do they envisage, in these circumstances, that there would be further support from a Policyholders Protection Act type of fund in order for the reserves to be maintained to provide for benefits to be paid out at the 90% level? It seems that the industry would be better served, and it should certainly prove less costly, if the principal remedy could be the transfer of the business to another insurance company for it to be run-off as a closed fund, and surely this must be the ultimate result, even if initially the business was run-off in isolation. Furthermore, the policyholders would benefit, at least to some degree, from the marginal costing of administration expenses. In order to protect its own policyholders, the receiving company would need to have recourse to a Policyholders Protection Act type of fund, provided it can satisfy the authorities of the need for such support.

Under the authors' proposed new statute there would be a number of reports and requirements placed on the administrator; these are set out in §§6.14–6.16. An independent actuarial report, advising on the extent of any deficiency and the need to reduce benefits to restore solvency would still be required. A scheme of rehabilitation is proposed and would be submitted to the Court for approval, at which time any objections could be lodged and considered. These requirements do not differ materially from the existing ones, and thus I cannot see any significant scope for a reduction in costs. Similarly, there is still bound to be a period of delay and uncertainty which could upset and unsettle existing policyholders.

The drawback referred to in § 5.24, relating to tax, would not arise if the company were run-off as a closed fund; but presumably under current legislation, any excess would be lost if the closed fund were to be transferred to another insurer. This is an area that would ideally need revision in the case of enforced transfers of business. The interaction of the legislation under the General Companies Act and Insurance Companies Act cannot be avoided, although it could be greatly minimized if the type of definition that I have referred to earlier could be incorporated.

I agree with the authors that the present limit of £10,000 on the aggregate value of policies owned by 10 or more policyholders, which is required before such a group of policyholders can petition for a winding-up of an insurance company, is both unrealistic and inadequately defined; both these areas need revision.

It seems desirable that Friendly Societies, whose position is discussed in § 6.23, particularly modern commercial Societies, should be subject to similar legislation to that imposed on life insurers operating under the Insurance Companies Act. I find it difficult to believe that the general public are fully appreciative of the differences, particularly with regard to the security of their policies, between a life insurance company and a modern tax-exempt Friendly Society soliciting business through the media. However, most Friendly Societies provide in their rules for both reduction in benefits and an increase in contributions in the event of the society running into financial difficulties, so it may be rather difficult to bring them into the ambit of the proposed legislation. Maybe some form of 'Government Health Warning' attaching to Friendly Society policies and literature would be appropriate.

In §§6.24–6.27, the somewhat thorny and sensitive issue of the relationship between actuaries and auditors is considered. We are aware of the difficulties that can arise when actuarial reports and results are distributed and summarized through third parties and the authors' suggestion seems, potentially, to fall into this trap.

The subject of the reasonable expectation of with-profit policyholders is discussed in §§6.28–6.34. At the outset, prospective policyholders should be made aware of the possibility that future bonuses could reduce to zero. This philosophy should not be changed simply because bonus levels and bonus loadings have increased to their current levels. There should be a statutory responsibility for the appointed actuary to comment on the future bonus prospects and each participating policyholder should be made aware of any such comments. There is considerable scope for the industry as a whole, hopefully voluntarily, to improve its liaison with policyholders, both existing and prospective, in this regard.

In addition to the more specific solvency testing directed towards ascertaining a company's ability to meet its contractual liabilities (i.e. primary benefits) to existing policyholders as recommended in

§§6.36 and 6.37, I would like to see more guidance on the availability of the solvency margins in the event of an insurance company running into difficulties as a result of some unforeseen calamity. I am thinking in particular of the relationship between the solvency margin requirements and, for instance, any excess expense reserve which the appointed actuary considers necesary on a closed fund valuation basis. To what extent can the appointed actuary rely on recourse to the solvency margin in the ultimate run-off of a closed fund?

**Mr M. J. Burns:** On the main theme of the paper the authors have, in my view, made an overwhelming case for change. I wish to underline an unfairness of the winding-up procedure which I think they have not brought out explicitly. The policyholder who receives a cash payment on winding-up may not be able to obtain similar benefits at similar cost to himself. The new policy may not be qualifying. More important, he may be in bad health or a bad risk for some other reason. Incidentally, it seems to me that the second condition set out in §6.6 for a scheme of reduction of benefits—that no policyholder may be left worse off than in a winding-up—is virtually incapable of fulfilment in the case of any office with a significant number of annuities in course of payment. Those in very bad health would be worse off even with full annuity payments than with a cash payment based on average mortality. To be equitable, the cash payments would have to depend on the state of health of each life assured or annuitant, but clearly that is impracticable.

I was interested in the comments on the respective roles of actuaries and auditors since I have been involved, on behalf of the Institute, in discussions on this subject with representatives of accountants. As I understand it, the main problem is that there is a risk that the auditor could be held to have been negligent if he relies on valuations by members of other professions without making reasonable checks that lie within his competence. This applies not only to actuarial valuations but also to others; for example, the valuation of a property portfolio. Of course, it is illogical and unsatisfactory for the auditor to check what he can and ignore what he cannot, but that appears to be what the law requires of him. The remedy lies in amendment of the legislation to permit the auditor to rely on a report by the Actuary, as the regulations now allow, in respect of returns to the Department of Trade and Industry. Perhaps the authors will include this in the draft bill which they will presumably prepare, following Professor Gower's example.

I agree with the authors that it is very unsatisfactory that there is no definition of the vague expression 'reasonable expectations', but I am doubtful about their proposal that an office should have to explain its bonus policy to new policyholders. Such a statement, to be of any value, would have to be relevant throughout the duration of the new policies. Conditions and markets change and such a statement could well prevent the office, at some future time, from taking a course which would be both sensible and beneficial to policyholders and shareholders. If our predecessors had made such statements 25 years ago, would we have been inhibited from introducing the variety of bonus arrangements now in force? I do not think that would be to the advantage of our policyholders. It would be better for the term 'reasonable expectations' in the legislation to be replaced by more precise wording. At present we do not know what is required to fulfil a policyholder's reasonable expectations. Can they be affected by illustrations given when the policy was taken out? If so, what is the effect of the various types of cautionary wording on the illustrations? Some offices now say that in certain situations, which are described, it would be unreasonable to expect the bonus to be as high as illustrated. On the other hand, ignoring illustrations, are the reasonable expectations of a new policyholder of an office, whose profits have been very good, higher than those of a policyholder of an office whose profits have been indifferent?

I believe that reasonable expectations should not extend to such aspects. Surely an office should not have to distribute to a policyholder, in order to fulfil his reasonable expectations, more than provides a return which is fair in the light of the profits which the company has in fact earned during the period that the policy has been in force. If a higher amount can be required in certain eventualities, then the actuary may decide for that reason to hold higher reserves. That could result in a holding back of bonus from other policyholders, which does not seem reasonable. The authors appear to have particularly in mind the situation where an office uses an excessive part of its profits to finance new business at the expense of bonus allocations. I would accept that this should be prevented in extreme cases, but I think that wording on the lines I have suggested could embrace such a situation.

**Mr M. A. Pickford:** There are three points that I wish to consider. The first concerns the roles of the Actuary and liquidator in a life company being wound up and the difficulties caused through the interaction of the Companies Act and the Insurance Companies Act. The role of the actuary is well established in primary legislation for a company which is carrying on life business in the U.K. He is required to make a valuation of the liabilities each year, and unless his report is challenged by the Secretary of State as not meeting the minimum standards required under the regulations, those liabilities are accepted as being the liabilities relating to insurance contracts at the valuation date. When a company is in liquidation, however, the position is not the same. The liquidator, very often an accountant, is responsible for determining the liabilities and the assets of the company being wound up, and the role of the actuary becomes less well defined. In the first draft of the winding-up rules sent out by the Department of Trade the only reference to an actuary was implicit in the requirement that the value of policies should be determined on actuarial principles and prudent assumptions, which are phrases familiar to appointed actuaries.

The new draft rules will include a paragraph which should be more acceptable to actuaries than the rather indirect references made in the first draft. Although it would be wrong for me to discuss any of the details of the draft rules, particularly as the latest version has yet to be circulated to the representative bodies, I can say that the paragraph will require the liquidator to obtain and consider advice from an actuary, including obtaining an estimate of the value of a policy. The principle is maintained, therefore, that the liquidator is the person who determines the value of a policy, but he must obtain advice on this from an actuary. Clearly the Court will wish to see the report of the actuary to the liquidator, and if the liquidator wishes to propose a different value for a policy from that advised by the actuary, the Court will wish to hear the arguments of both the liquidator and the actuary before it makes the final decision. This awkwardness between the roles of the liquidator and the actuary is just one further example caused by the interaction of the Companies Act and the Insurance Companies Acts to which the authors refer in their paper.

My second point concerns the proposals made in §6 on the present position arising from the interaction of the Companies Acts and the Insurance Companies Acts. I believe that the authors have correctly summarized in §§5.26–5.29 the broad framework within which the Department of Trade will normally act when a company fails to maintain its required solvency margin. However, what is not mentioned is that, under Sections 11(1) and (2) of the 1982 Act, the Secretary of State may stop a company from writing new business on the grounds that it appears to him that the company has failed to satisfy an obligation to which it is subject by virtue of the Act. As I stated in my paper, 'The Insurance Companies Act 1981 and Some of the Associated Regulations' (*J.S.S.*, **26**, 69), one of the obligations that a company has is to maintain the required solvency margin that is included in Section 32 of the 1982 Act, and it therefore follows that the Secretary of State can close a company to new business when it fails to meet its required solvency margin.

The relevance of this is that the same form of words is in Section 54 of the 1982 Act. Thus, Section 53 states that the Court may order the winding-up of a company in accordance with the Companies Act 1948 (i.e. all the provisions for petitioning under the Companies Act can be applied to a life insurance company), but in addition the company may be ordered to be wound up on the petition of 10 policyholders, as mentioned by the authors. The next section then goes on to state what powers the Secretary of State possesses, and, in addition to petitioning on the grounds that the company is unable to pay its debts within the meaning of Sections 222, 223 and 399 of the 1948 Act, he is also given power to petition for the winding-up of an insurance company if it has failed to satisfy an obligation to which it is subject by virtue of the Act. These are the same words as appear in Section 11, and I think it must mean that within the Act there is power for the Secretary of State to petition for the winding-up of an insurance company when that company is not keeping the required solvency margin. It would appear that the Court does not now need to have it demonstrated that a company is insolvent before it can act. Thus, the authors' advocacy in §6.12 of a new statute to give the Court jurisdiction in the event of a company failing to maintain the requisite E.E.C. solvency margin is already contained in existing insurance companies' legislation.

My third point concerns the statement in §6.5 that "there is general recognition that running-off as a closed fund, with reduced benefits if necesary, is preferable for the great majority of policyholders to claiming as an unsecured creditor in a cash winding-up". One of the problems of a company being run-off is that the best employees tend to leave the company fairly quickly after it has stopped writing new business (in fact there could be a general exodus of employees beyond those whom the liquidator wishes to make redundant) and, as a consequence, investment expertise, for example, may suffer. Also, I do not think we should lose sight of the fact that a growing proportion of policyholders are more concerned with investment potential than with life cover. Consequently, for both these reasons, I doubt if we should assume that it might always be better to run the company off as a closed fund. Some flexibility is required to meet the needs of each situation as the Court and the liquidator find it.

It can be argued that the 1982 Act gives this flexibility. Section 56(6) states that the Court may on the application of the liquidator or the Secretary of State or the manager brought in by the liquidator, appoint an independent actuary to investigate the long-term business of the company and report on the desirability or otherwise of that business being continued and on any reduction in the contracts made in the course of carrying on that business that may be necessary for its successful continuation. As the business went off the books (and could not, of course, be replaced by other new business), the position would eventually arise whereby the margins available to cover expenses would not be sufficient to cover the overheads, including professional fees, and reassurance of the business or a transfer of the business to another company would be essential.

I think that the legislation allows the Secretary of State to stop a company from writing new business when it no longer holds the required solvency margin and to allow the company to run itself off, and also allows him to petition for the winding-up of a company when it ceases to hold its required solvency margin and put a liquidator in to supervise the winding-up. There is power in the Act to appoint an administrator other than a liquidator. The liquidator, the special manager and the Secretary of State can petition for the benefits under the contracts to be reduced while the long-term business is being carried on, as well as to give flexibility as to how long that business can be carried on before a transfer of the business is made or a cash winding-up takes place.

I agree with the authors in their idea to rationalize the statutes in regard to the winding-up of life companies. I am frequently confused by the interaction of the Policyholders Protection Act and the winding-up provisions of the Insurance Companies Act, and I think some amalgamation here is desirable.

**Mr S. Benjamin:** My main subject is 'excessive benefits', which I understand exist if the premiums are very low in the market at the time the policy is issued. If, of course, at the time of issue there was enough capital and surplus in the company to support the new business strain, then the policy could not have been the cause of the insolvency of the company later on, and that is also true of any policy whether the premium rate is heavy or light. I think that excessive benefits is another of those concepts introduced into legislation after a scientific revolution has taken place, and the legislators have not caught up with it. The concepts in the legislation are completely out of date. Does the profession have a duty in a situation like this because it is known, or it can be ascertained, when a policy is issued, whether it contains excessive benefits? Should the appointed actuary give a warning to policyholders that this policy could come into that class, and that if the company gets into difficulties then that policy could be singled out for a reduction as compared with other policies held by other policyholders? I think perhaps we should address our attention to that professional duty.

Another subject which I would like to mention is that there are some interesting examples where winding-up seems to be better than running-off and that perhaps a totally sweeping attitude to this is undesirable.

With regard to the 'reasonable expectation' of the with-profits policyholders, it is a pity that this subject ever got mixed up with legislation on solvency. It is a totally different aspect of the subject of running an insurance company.

**Mr T. H. M. Oppé:** Considering § 5.20, where it says that life insurance companies in financial difficulties should have their business run-off, the trouble is that the alternative of a cash winding-up can be in the interests of some policyholders. This is an important point to bear in mind when considering any schemes which can override minority interests.

In § 5.32, the reference to the earlier drafts of the E.E.C. Bankruptcy Convention is quite correct because it did specifically exclude life insurers, but the new draft also allows for the exclusion of business subject to specific directives, provided those directives prescribe variations from the Rules in the Convention. Insurance and credit institutions are cases in point.

Turning to the radical new approach, the present position is that insolvency law is laid down in the Companies Act, the Insurance Companies Act and the Policyholders Protection Act. The latter Act means that the life assurance industry and its policyholders have a direct financial concern in winding-up procedures, because a levy can be imposed under the Policyholders Protection Act to enable the Policyholders Protection Board to carry out its statutory duty of assisting policyholders of insurance companies in financial difficulty. The Policyholders Protection Act has worked well, and to a considerable extent has protected the industry from adverse criticisms which were very apparent in the early 1970s before the Act was passed. It is now thought that policyholders generally get a fair deal in the circumstances. In particular, cases of hardship have largely disappeared because of the Board's discretionary powers to make interim payments. The cost to the industry has been relatively small, £1.5m., bearing in mind that the Board has had to deal with four long-term insurers since its inception.

Turning to the proposed new statutory approach in § 6, this is broadly in line with industry thinking because it proposes the appointment of an administrator who would carry on the long-term business of an insurer in financial difficulties. I agree with the opener that caution is needed when recommending special treatment for insurance companies, but a more flexible approach to insolvency procedures was recommended in the Cork Committee's report of 1982, about which the Government is shortly to issue a White Paper. Thus, subject to the White Paper, Cork could help us to fit in the proposals to general insolvency procedures. However, I am unhappy with the idea of 100% rescue at the expense of the industry, which means the policyholders, which is implied in §§ 6.17 and 6.20. In particular, if dividends are to be restored to shareholders of failed companies following a recovery of assets, they should not be restored before any levy raised from the industry is returned, with interest, to the companies that have paid it.

I would be strongly opposed to any scheme which weakened the disciplines imposed under the Policyholders Protection Act, namely a 10% reduction, or more in the case of excessive benefits, in contractural liabilities and the cost test imposed on the Policyholders Protection Board so that any discretionary action it takes does not cost more than the cost of meeting the Board's statutory obligation after a winding-up. The earlier part of the paper suggests amendments to existing law to deal with the difficulties that have been experienced over the reduction of benefits, and I support these. However, I feel that any residual sympathy with policyholders and shareholders of failed companies must be balanced against the interests of the policyholders of insurance companies who have to pay the levy.

**Mr N. D. Freethy:** When the affairs of the European Life Assurance Society were examined, the Court accepted actuarial liabilities to existing policyholders in their *test of solvency* balance sheet, but then allowed uncalled capital to be brought in as an asset, which gave the Court an excuse to put off a winding-up action. Certainly in the case of the European, and possibly indirectly in the case of the Albert Insurance Company, the Court refused to take the ultimate step of winding-up until it could find no excuse to defer such action any longer. In each case the winding-up came too late to prevent irrevocable damage and, as the paper's view of the very latest legislation makes clear in § 5, little has changed.

During those 20 years the Albert, no doubt to those in the know, would have been viewed as a dubious company. Despite this, the Albert continued to bring in business for 20 years from an unsuspecting public.

The situation in many overseas territories in which F.I.A.'s operate is perhaps very similar to the circumstances described by the authors that existed in the U.K. 100 years ago. This affects the Institute because U.K.-qualified actuaries lead the world as exporters of actuarial services. The European was allowed to exist because of the possibility of uncalled capital being brought in, which would now be classified as an inadmissible asset. In many overseas territories today, particularly in the Third World, there are still no such things as inadmissible assets. Fellows of the Institute are often invited to certify solvency where a major asset is money owed by brokers in the form of premiums due but unpaid, and there is no legal requirement for this asset to be excluded, even though we may scale down its value, or offset it against the company's reduced liability to pay claims under such circumstances. We are concerned with the insolvency situation in other countries where we operate, as well as with the situation in the U.K. The existence of that most valuable piece of legislation, the Policyholders Protection Act, makes 90% of this debate academic to the U.K. consumer. Insolvency overseas, as far as the policyholder is concerned, is *for real.* U.K. policyholders are very fortunate by comparison.

The Actuary's principal concern with an insurance company which is nearing insolvency is whether or not he should put his signature to the standard certificate, bearing in mind that he may suffer at least embarrassment and at most disenfranchisement if he signs and the company immediately becomes the subject of an insolvency case. Also, he receives no help from the existing legislation and has to contend with the absolute unpredictability of State intervention.

I would like to end with a recent case history, where a company had written virtually no new business since 1979, was operating on a care and maintenance basis, and had cut its expenses to an absolute minimum. We calculated that it could keep going at this level of expense on sensible assumptions for at least five years. On this basis, and having revealed all to the D.T.I., we signed the standard annual Actuarial Certificate. At the same time negotiations were commenced to try to sell the company and a firm bid was received, in line with the authors' recommendation. In the middle of all this the D.T.I. decided to withdraw the company's operating licence, despite its self-imposed very tight control on expenses. This meant, in effect, that not only was the company of no particular attraction for an acquirer, but there was the additional stigma attached that a new licence would have to be applied for and all the normal procedures gone through applicable to any new company. The business was small and complex and not particularly attractive to a reassurer, so this appeared to rule out that particular solution. The attitude of the D.T.I. was ostensibly to contemplate the company soldiering on until its ultimate inability to continue would cause it to founder on the bedrock of the Policyholders Protection Act. Meanwhile, policyholders would continue paying premiums not knowing that the D.T.I. had indirectly acted so as to ensure eventually that they would receive at the most 90% of their benefits possibly at an unscheduled time. We pointed out all these risks in a letter to the D.T.I. and requested a meeting. When we pointed out that this year the Actuary would almost certainly have to switch to a valuation on a solvency, or rather insolvency, basis the D.T.I. then decided to bring forward the reporting date for the annual actuarial valuation from 30 June to 31 March, which would ensure that the negotiations could not be completed by the time the axe might fall.

Not just the legislation, therefore, but the powers and the timing of State intervention are completely unpredictable. The authors are absolutely correct in their contention that reform is necessary.

**Mr G. G. Newton:** The statement in §6.22 that "the E.E.C. Life Directive only permits existing composites to continue for a period of 10 years" is incorrect. The exemption of existing composites from the prohibition on composites is not qualified in any way as to time in the Directive. It provides for a report by the Commission at the end of 10 years on the operation of composites and specialist companies which would re-open the argument on this issue, but there is no implication in the wording of the provision for this review, no doubt intentionally, that an unfavourable report from the Commission would lead to the termination of the exemption for existing composites. This would require a new Directive, which would again have to be agreed by all member states.

I would also comment on the authors' reference to the drafts of the Bankruptcy Convention and the Directive on the Winding-up of Insurance Undertakings in the E.E.C. I believe that both of these are still a very long way from being agreed and implemented. The Bankruptcy Convention is largely procedural, and I understand that the reason insurance companies are no longer exempted in the latest draft is solely to avoid having to repeat these procedural provisions for a Community winding-up in the Winding-up Directive itself, so no great significance should be attached to that change. As regards the Winding-up Directive, I do not think the authors are quite correct in saying that it favours a cash winding-up. The draft Directive does provide for this, but it also provides for life contracts to continue and for their transfer to another company.

The authors draw attention to the difficulty of proving inability to pay debts in the legal sense by means of an actuarial valuation. They deal at length with the Capital Annuities case, where the application by the company and the Policyholders Protection Board for a reduction of benefits under what is now Section 58 of the 1982 Act, was rejected on the grounds that it had not been shown that the company was unable to pay its debts.

I think it would be wrong, however, to cite this case as evidence of the inherent difficulties in demonstrating that a life company is insolvent by means of actuarial valuation. The judge's rejection of the petition was on the grounds that the evidence put before him was out of date. The valuation of assets and liabilities related to a date some two years earlier, since when both interest rates and property values had changed markedly, and I do not expect there was close matching. The judge went out of his way, however, to indicate that he did not expect that, given an adjournment, the applicants would find great difficulty in producing evidence to his satisfaction that the company was insolvent and indicated that he was not seeking full formal revaluations, but would accept evidence as to approximate up-to-date values of the company's assets and liabilities. Although, therefore, the petition was rejected on the grounds that the company had not been shown to be unable to pay its debts, I think it is reasonable to assume that the decision of the Policyholders Protection Board and the company not to proceed with the petition was on account of other difficulties arising with their proposed scheme as a result of Mr Justice Lane's judgement.

In the circumstances I would like to ask the authors whether, in the course of their researches, they have come across any cases in the last 10 or 20 years, where conceptual difficulties in establishing insolvency by means of actuarial valuation have arisen.

I was rather surprised that a number of speakers seem to think that there was no need for a concept of reasonable expectations for with-profit policyholders in the event of winding-up in the legislation. Without something of that sort, I suspect it would be *ultra vires* to provide even for a very prudent valuation under the Valuation Regulations. The nature of the with-profit policy has changed quite dramatically from the position at the beginning of the century and particularly over the last 25 years. When bonus loadings were of the order of 10%, this could be regarded as an equity interest similar to share capital and largely ignored in a winding-up and in the legislation. Today, even for a 20-year endowment assurance, the with-profit premiums are some 70% higher than the corresponding non-profit rates and the differential is even greater for policies with longer terms, certainly a typical whole-life policy. So we are now thinking in terms of, bearing in mind that the non-profit rates themselves will obviously contain contingency margins, with-profit policyholders paying roughly double the premium required to meet the expected value of their basic benefits. It seems totally unrealistic in those circumstances to think that what the company does with the other half of the premium can be totally ignored in the legislation. Indeed, it appears that there would be great dangers to policyholders, both in the event of an asset stripper or a winding-up situation, particularly a winding-up of a composite where the life fund should properly be reserved for the benefit of the life policyholders. I agree with the authors that the new rules should perhaps be more explicit in drawing the Court's attention to the position of the with-profit policyholders, obviously the discretion must be with the Court, rather than that any idea of reasonable expectations, or treating the benefits secured by half the with-profits premiums as a liability, should be removed from the legislation.

**Mr G. A. Weiss** (a visitor): I am a chartered accountant and was the liquidator of the Nation Life Insurance Company in 1974.

As a liquidator you are the first person to become aware of the enormous tragedies to members of the public that the failure of a life insurance company brings about, particularly to those who had invested not so much in life policies, endowment policies and the like, but much more to those in receipt of annuities, income bonds, etc; elderly people, retired people, whose day-to-day income is cut off from one day to the next. I think it did something for the present legal system when Lord Templeman really did force us to work through the night in order to get a scheme out quickly, at least to get people some money. It was based on the old scheme which, to some extent, has been rightly criticized, but there was an awareness throughout that something had to be done quickly.

The opener talked about the undesirability of special pleading, and Mr Oppé pointed out the possibility of one of the Cork Committee's recommendations, the administrator, being accepted by the Government. In the Republic of Ireland, when an insurance company problem arose recently, legislation was rushed through the Irish parliament in 48 hours just to make possible the appointment of an administrator, who was then appointed the next day, just to deal with this kind of problem. I sincerely hope that in the course of general legislation this will be adopted, because it will be very useful for life insurance companies.

Where I am slightly more doubtful is in the proposals to compel a liquidator, or administrator, to carry on the business with a view to transferring its engagements to another company. We had enormous problems in 1974 and failed, although at that time those attempts were really to save the good name of the insurance industry. The Policyholders Protection Act resulted from the 1974 problems, so that now the take-over of a relatively small insurance company would really be for the benefit of the insurance industry as a whole, who would be supporting the Policyholders Protection Act and the companies that provide the levy.

**Mr C. N. Smith** (a visitor): This paper makes reference to the Policyholders Protection Board, of which I am chairman, and it is appropriate that I should make some comment.

From the actions which the Board have taken it will be seen that we have endeavoured to arrange the run-off of a long-term fund, outside liquidation. We have adopted a similar approach to that which has been suggested, namely, orderly administration, but where liquidation has been inevitable, the policyholder has had the option to stay in the liquidation.

The paper refers to the case that first came before the Board—Fidelity Life. Here, we did succeed in dealing with an insolvent company outside the process of liquidation, but it was a special case. The company was in dire financial straits because of an exceptional loss of assets. Despite a guarantee from the American parent, the company was unable to continue its business because the parent company itself was in grave financial difficulties. In the case of Fidelity Life, the Board procured some contribution from the American parent, and made a decision to support the run-off of the fund without any reduction in policyholder benefit. This support was given on the basis that new directors were appointed, the American parent share interest was neutralized and the fund was run-off and managed by Norwich Union. Perhaps they were the first administrators. The American parent recovered, and it was able to pay up in full and compensate the Board entirely for its support. It was a very satisfactory case, but it was unique, as there would be a normal requirement to reduce benefits to 90% under the Act. The 100% run-off was possible only because of the American guarantee, and I do not think this is a situation that it likely to occur again.

There was no such guarantee for the Capital Annuities case. Whilst we again set out to achieve a run-off outside liquidation, we firstly had to obtain the reduction to 90% of benefits. The paper deals with the reasons why the Court was unable to assist under Section 50 as it was then. Mr Newton's comments are apposite because, even if the Court had reduced the benefits at the time, there is another point which relates to what we called 'straddlers', that is the actual liabilities to policyholders at the date of liquidation as distinct from policy benefits accruing in the future. The position of the straddlers was very difficult, as the Court was unable to reduce those liabilities. Whilst an argument could well have been forthcoming to have paid 100% to non-policyholder creditors in the company, it could hardly have been equitable to have paid, say, 100% to a policyholder whose policy had matured the day before liquidation and only 90% to policyholders whose policies matured the day after. So there were considerable difficulties apart from establishing the presumption that the company was unable to pay its debts. The only alternative to accepting the liquidation process in that case would have been a scheme of arrangement. Such a scheme, where there were many different claims and classes of policyholders, exacerbated by possibly differing excessive benefit provision, was impractical. We ruled it out on the cost test basis even after taking into account the increased cost and tax disadvantage of liquidation.

All our experience in these cases has been put forward to the Department when it was reviewing the provisions of the Act and at other times.

The paper draws attention to the cost delay and uncertainty involved in the present winding-up procedures, and our experience endorses this. I would mention that the proposal that liquidators should charge by reference to time formalized what has been common practice for a long time in the liquidation business, and is certainly what liquidators have done in each of the cases where the Policyholders Protection Board has been involved.

As an accountant and auditor, I agree with Mr Burn's remarks on §§6.24–6.27. I think auditors might welcome a change in the law that would allow them to rely on actuarial reports.

**Mr J. B. Clemetson** (a visitor): I am the Senior Official Receiver. I read this paper with great interest and felt that it drew together a lot of aspects of the winding-up of life companies which cannot be found anywhere else. I ought to say that I cannot bind my Department to the views I shall express.

I would like to endorse the remark made by Mr Weiss in regard to the time and the general difficulty of getting a grip on a life company when it is ordered to be wound up. I generally come into this as provisional liquidator before the winding-up order is made, and the general order in the High Court is to protect and preserve the assets. It is not possible to do this with a life company. It has been mentioned by previous speakers that the present winding-up legislation does not mention the Policyholders Protection Act and that the two are apparently quite separate, but, in practice, any liquidator or provisional liquidator must work with the Policyholders Protection Board, or he would find that the duplication of work is greater than it need be.

I think that no liquidator or provisional liquidator is ever going to deal with a life company without consulting actuaries. To value the policies he has to get the Court's decision as to the interest rates and the mortality table. There has to be an application made and this must be supported by an actuarial report of some sort. I think the authors do not realize the extent to which any liquidator would have regard to an actuary's point of view.

The failure of insurance companies seems to be an 'act of God', which I do not think an actuary would ever admit existed or could not be provided against, and it is failure of the management. Either management has gone wrong on its investment policy, or the terms of the policies have not been correct, so that more has been given away than can be provided. The other thing to consider is the company's expenses and administration expenses. I took my present job in 1975 when the effects of the 1973 property collapse and the general economic situation then was beginning to be known. I do not know how anybody could have predicted what happened over such a short time when property values and other values of assets declined, not only for insurance companies but for other companies. Companies were being wound up simply because their assets were no longer sufficient to support the loans which had been given as security. I think that companies that come into liquidation have failed to get both those aspects of the business correct.

As to the running-off of a business, this is a much more difficult context than people are generally prepared to admit. The time taken in which to arrive at a decision as to whether it ought to be run-off is one aspect. The valuing of policies, ascertaining the assets and valuing them, is a very difficult and protracted job. In addition, if there is an open-ended commitment to provide any money that is required, of course, it is fairly easy to run-off anything. The company just soldiers on and pays the obligations that become due and, if the money runs out someone else will provide it, but I cannot really think that such a situation would ever come about. There has to be a decision taken and, I do not think always that the policyholders would benefit from running-off the company, particularly if there is a reduction in their benefits. When a policy has matured the policyholder has carried out his side of the bargain absolutely.

A winding-up is a costly job. There is much work to be done and many professional people, actuaries and accountants, to be employed.

**Mr F. R. Wales** (closing the discussion): As the opener pointed out, it has been 50 years since this subject was discussed at a sessional meeting. The paper has presented us with a lengthy and fascinating summary of historical events that most people have found considerably interesting.

In his introductory remarks Mr Ferguson referred to the length of time of well over 100 years that the unsatisfactory features had been present in legislation. The Institute is asked to comment in confidence on any legislative proposals. We have been asked to comment on the proposed changes to the winding-up rules, and the Institute and the Faculty together have not lost the opportunity to express their views as to the unsatisfactory features of the present legislation.

The historical summary made me reflect that we consider our pace of life to be fast and the rate of change these days to be unprecedented. However, the nineteenth century could justifiably be considered to have been more revolutionary than our own. Indeed, what could be more revolutionary than the concept of the limited liability company. Only 15 years after that concept had been blessed by Act of Parliament, the Life Assurance Companies Act, 1870, was passed, and despite the flaws relating to winding-up provisions that Act has been the basis of insurance company legislation right up to the present day. It is only the advent of unit-linked life assurance that has resulted in the need for radical re-thinking.

Considering the current winding-up legislation, the authors refer to the scandalous effect of the 1948 scale of fees and point out that the new draft rules do not fully correct this position. However, the Senior Official Receiver has reminded us that winding-up cannot be done cheaply, and that there will be substantial costs involved in any event.

In § 5.15 the authors refer to the need to provide for future bonuses in the valuation bases on winding-up. They were supported by Mr Newton, who drew attention to the fact that bonus loadings these days are a significantly higher proportion of premiums than they were in the days when legislation was first framed. It is interesting that the paper points out in § 4.25 that the farseeing Clauson Committee made an explicit recommendation that the policyholders' equitable share of the *prima facie* surplus should be reserved for them.

A number of speakers drew attention to the authors' conclusion that the Companies Act winding-up provisions are not an appropriate basis for dealing with an insolvent life assurance company because they involve, *inter alia*, cost delay, uncertainty and adverse tax consequences. Mr Burns emphasized the inequity of making cash payments to policyholders on liquidation. However, Mr Benjamin and Mr Oppé both pointed out that there could be classes of policyholder for whom cash was more desirable, and the general conclusion seems to be that flexibility, not rigidity, needs to be the order of the day.

The authors make a case for a radically new statutory approach and suggest in § 6.10 a new Long-term Insurance Act to replace the existing legislation by way of Companies Acts, Insurance Companies Acts and the Policyholders Protection Act. However, the opener felt, and I agree with him, that this was special pleading and was really not likely to attract public sympathy. Mr Oppé pointed out how well the Policyholders Protection Act has worked in practice.

The opener asked us for a statutory definition of inability to pay debts, although he linked this to the statutory minimum valuation basis. The authors themselves, in § 6.12, propose that the Court should have jurisdiction in the event of the company failing to maintain the requisite E.E.C. solvency margin, although Mr Pickford pointed out that this power does already exist. I feel that this test is far too stringent because even the minimum statutory valuation basis itself is a test of adequacy, not mere solvency. This was the basis on which the original proposals for the statutory basis were considered. In most cases, companies that just fail to meet the E.E.C. margins manifestly could pay their debts in most conceivable circumstances. The Court should be the last resort after administrative measures by the D.T.I. have failed, and in my view probably the appropriate time for this is when the E.E.C. solvency margin is actually exhausted.

The opener felt that the proposal in §6.23 about Friendly Societies was not appropriate because their rules permitted variation of benefits.

The authors suggested that actuaries and auditors should agree to a mutually acceptable divison of responsibility, but quite rightly Mr Burns has reminded us of the overriding responsibilities of auditors under present legislation. In practice, the two professions have consulted with each other, and as a consequence have given mutually agreed guidance to their respective memberships. However, I am not clear as to why it should be inappropriate for the appointed actuary to report directly to the shareholders of the company. I see his position in this respect being very similar to that of the auditor, the only difference being that his appointment is not subject to ratification by the shareholders. Perhaps it should be. I think that Mr Freethy was extremely unfair to the Department of Trade in his remarks. He objected to the way in which they dealt with the closed fund with which he had been dealing and the fact that they wished to withdraw that company's authorization. It seems to be a perfectly reasonable move by the Department because to a prospective purchaser, since the company had been closed to new business for many years, there could be no sales force to contribute to a goodwill element of value. Therefore, presumably, a would-be purchaser was hoping to buy an authorization and thus evade the normal requirements for somebody wishing to enter the business. In my own dealings with the Department, I have found that generally they have very good reasons for the objections they may raise to proposed courses of action and it is always possible, with goodwill, to find a solution that will satisfy both parties.

Mr Weiss pointed out the real hardships involved in the case of annuitants whose particular requirements tend to be neglected in this sort of discussion.

The main thrust of the paper is that life insurance companies should not be wound up but should be run-off, but it has been pointed out that running-off is not a very easy task. Usually it is an unsatisfactory solution and a transfer of business is the best answer. Mr Pickford also felt that run-off is not always possible, so we do need flexibility in the legislation.

I feel that the authors have done a valuable job in pointing out to us the very serious defects in present legislation. However, I think the general conclusion of the discussion would be that it is possible to find a way to correct these defects without going to the lengths of introducing comprehensive legislation, especially for the life insurance industry.

**The President (Mr C. S. S. Lyon):** I think it has been abudantly clear to all of us from this debate that there are no easy answers to deal with the insolvency or the potential insolvency of a life insurance company. Certainly, there is no way of avoiding at least a temporary hardship for some of the policyholders concerned. That really leads one to the conclusion that prevention is better than cure.

Effective supervision by the authorities, and we have much more effective supervision today than we did 15 years ago, and effective actuarial monitoring of the financial condition of life assurance companies, and again I think we have been strenghtening our guidance to members on how they should exercise that monitoring function, are two ways in which we can minimize the risk of insolvencies on any significant scale now and in the future. We will not avoid them altogether, but I think we are in a much better position today than we were at the time about which the authors have written.

We owe congratulations and a warm debt of thanks to both the authors for the way in which they have written this paper and for the discussion tonight, for which they have every good reason to be pleased.

**Mr G. E. Barrow** (replying): In the paper we, the joint authors, have argued that running-off rather than winding-up should be the normal way of dealing with the long-term insurer which gets into financial difficulties, and that steps should be taken to remove any legislative obstacles to that approach. I think there may have been some misunderstanding over that. We certainly did not favour running-off as an independent concern in preference to a transfer of engagements. Either would be acceptable to us as a means of securing the policyholders' interests. Our opposition was directed against winding-up for a cash sum.

We further argue that the duty which has been placed on the life insurance industry by the Policyholders Protection Act should facilitate this change. In §4.30 we describe the passing of the Policyholders Protection Act as a watershed, a statutory recognition in the limited concept of life assurance of the general evolvement of English law in response to public opinion, away from *caveat emptor* towards the modern concept of consumer protection. As recently as 40 years ago the prevailing doctrine in English law, as I understand it, was let the buyer beware and the courts were reluctant to set aside or disturb a commercial contract freely entered into unless it could be shown that there had been misrepresentation by the vendor. Although that proved satisfactory whilst both parties had roughly equal economic power, it was seen to be unfair when, to an increasing extent, the vendor was a corporate body and the purchaser remained an individual. It is noteworthy that the swing towards the protection of the consumer has taken place in virtually every country with a legal system based on English common law principles, notably the United States, Canada, Australia, New Zealand and the Republic of Ireland. I believe that change now to be firmly established, and there is overriding public support for the proposition that the policyholders in British life assurance companies should be able to rely on fulfilment of essential elements of their contracts, and I was glad to hear Mr Oppé's endorsement of the working of the Policyholders Protection Act.

The guarantee to policyholders must surely be given either by the Government or by the remainder of the industry. If it was given by the Government, then we would have to accept a much tighter statutory supervision of life assurance which would effectively preclude all innovation. Hence I regard the collective guarantee, in some form or another, as being an essential price which has to be paid by the industry for the retention of a degree of freedom to innovate. In return, I think life offices are entitled to expect that the Government should continue to pay close heed to their representations. However, the nature and extent of the 'lifeboat' imposed on the remainder of the U.K. insurance industry should be modified.

After the scheme of rehabilitation, which we proposed in § 6.16, had been sanctioned by the Court, we would look to external support in order to restore certain of the benefits which had been reduced. We think that outside assistance should be limited to restoring sums insured payable on death or on maturity, and that these should be paid in full without reduction; that is, the rest of the industry should not normally be required to support secondary benefits such as guaranteed surrender values, alternative settlement options and the like. In that context of limited support the contentious concept of excessive benefits could be jettisoned. In order to secure the support of the legal profession to the changes we propose, some protection would also have to be extended to trade creditors. That is the point made in § 6.18. Given that premise, we argue that financial monitoring of an insurance company can be directed unequivocally to establishing the ability of a company to meet its contractual obligations to existing policyholders in wide-ranging circumstances. This aspect of the U.K. domestic requirements should be framed so as to conform with the additional E.E.C. solvency requirements. However, that in itself would not suffice, in our view, to meet our U.K. domestic requirements, particularly in regard to those offices having a large element of traditional with-profits business and very substantial equitable expectations of the with-profits policyholders. That is an aspect which we discuss in §§ 6.28–6.34.

Our present U.K. regulations attempt to deal with that in two ways: first, by ensuring that offices should not take future bonus loadings into account; but, secondly, by the overriding duty placed on the appointed actuary by Regulation 54, and by the profession's insistence that actuarial principles require that the appointed actuary should pay due regard in his valuation to the future interests of with-profits policyholders. Our misgiving is that this may not go far enough in ensuring that policyholders' reasonable expectations are fulfilled, a concept which we discuss later in the paper. Ultimately the degree of protection of the policyholders' expectations would depend on the interpretation placed by the individual appointed actuary as to what are the reasonable expectations of the policyholders. That phrase has never been defined nor, we believe, is there unanimity within the actuarial profession as to the principles by reference to which the policyholders' reasonable expectations should be quantified.

The Clauson Committee's report as regards the reasonable expectations of traditional with-profits policyholders envisaged the formation of statutory funds. I think a different approach would be necessary for linked life assurance.

The general concept of reasonable expectations is something which also affects other countries; for example, the Republic of Ireland and Australia. It is a subject to which Mr Ferguson and I have addressed ourselves in a paper to be presented later this year to the forthcoming International Congress of Actuaries.

May I close by suggesting that you, Mr President, and the President of the Faculty, should consider appointing a working party to consider the nature and extent of policyholders' reasonable expectations, not only on winding-up but for an on-going office, so that there should be at least the beginnings of a consensus within the profession. We would also urge that this is a subject to which actuaries alone are not uniquely qualified to contribute, and that invitations to participate in such a working party should be extended to those who are concerned with all aspects of investment protection, to lawyers and to accountants.

## WRITTEN CONTRIBUTIONS

**Mr A. E. M. Fine:** This paper is of particular interest to me since I have been involved over the years with giving actuarial assistance to a number of life companies in financial difficulties—for instance, as actuary to a liquidator or supporting a group of policyholders in a class action in a winding-up —the case Mr Weiss referred to in the discussion. My recent experience as actuary to a liquidator of a life insurance company has prompted me to comment on a number of matters discussed by the authors in their thought-provoking paper. The company in question, Underwriters National Assurance Co. (U.N.A.C.) is an American company with a U.K. branch. The company was ordered to be wound up in 1981 following a D.O.T. petition in 1980. The company wrote long-term disability policies almost all of which incorporated riders providing for a proportionate return of premium dependent on claim experience. Typically the rider provided for a payment of 80% of premiums less 100% of claims during a 10-year cycle if claims did not exceed 20% of premiums during that cycle. The rider benefit is of no particular interest to us in our discussion tonight but a number of aspects of that job are of interest.

Firstly, I can report that the nature and importance of the rider benefit was such that I felt obliged to carry out the calculation of claim values using a simulation method and that this caused no particular problem when my report was approved by the Court, although (following on Mr Clampton's comments on costs) justifying the cost of the simulation method to the liquidator and the Committee of Inspection was quite another matter.

But there were a number of other problem areas. The Third Schedule of the 1958 Act was clearly not designed for use in determining claim values for the contracts in question and there was much discussion as to whether the business constituted life business or accident business for the purpose of applying the Third Schedule. Also there was the potential problem that the Third Schedule valuation rules do not provide for an explicit reserve for future expenses which could have led to the anomalous situation of the company being clearly insolvent on any reasonable standard but a surplus arising in a winding-up. The authors refer to draft new rules under Section 59 of the 1982 Act and I am pleased to hear that we shall see a draft of these shortly. The new rules must cope with the different types and complexities of contracts currently being sold and should as much as practicable reflect guarantees such as surrender guarantees written into the contracts.

Another interesting aspect of the U.N.A.C. case is that whereas the U.K. branch was being wound up the U.S. side of the operation was subject to a Rehabilitaton Order in the States. The D.O.T. might well be concerned with the solvency of the whole company (worldwide) but the U.K. liquidator is, of course, primarily concerned with assets and liabilities within the jurisdiction of the English Courts.

A further interesting feature of the U.N.A.C. case (where, of course, the Policyholders Protection Board was involved) is that it highlights the difficulty of determining whether a particular benefit is excessive when there is little to compare it with in the market. The return of premium rider benefit as issued by U.N.A.C. is virtually unknown in the U.K. but is much more common in the States.

The authors say in §5.20 that there is virtual unanimity amongst actuaries and others that a life insurance company in difficulties should have its business run off as a closed fund with a reduction of benefits if necessary. Obviously this should be the aim to avoid a forced realization of assets and to retain insurance cover for policyholders but we should recognize that this is not always the most practicable and best solution. Take the case of U.N.A.C., for example. Here was an example of a company where it would not have been practicable to have carried on the business. Firstly, it is unlikely that any life company would have accepted a transfer of U.N.A.C.'s policies. Secondly, if the business had been transferred the reduction in benefits required to enable this to be achieved might have been greater than the reduction specified under the Policyholders Protection Act. Thirdly, it would have been difficult for the Policyholders Protection Board to demonstrate that the cost of assistance to continue the company would have been less costly than under the alternative of winding-up. The solution actually reached (surely the correct one in the circumstances) was that through the good offices of the P.P.B. substitute policies with a major life office were offered to the U.K. policyholders of U.N.A.C. I understand that about half the policyholders accepted the substitute policies and assigned their winding-up rights to the P.P.B. whereas half opted for cash in winding-up. This emphasizes the valuable role played by the Policyholders Protection Board in fulfilling its statutory functions. It can look at each case on its merits and decide on the appropriate method in the light of the circumstances. A transfer to another office might be suitable in one case, an offer of substitute policies with the P.P.B. taking over the policyholders' role as creditors in a winding-up in another. And while mentioning substitute policies and behind-the-scenes arrangements a word of praise for the major life offices who individually or through consortia have helped out in many cases behind the scenes and without much publicity both before and after the Policyholders Protection Act: for instance, when offering substitute policies, no pedantic quibbling about policyholders selecting against the new office. As another example, the Scheme of Arrangement for London Indemnity under Section 206 of the 1948 Companies Act could not have been implemented successfully without the help of a consortium of major offices.

The authors in section 6 of the paper propose a new unifying statute and, in particular, that certain sections of the Companies Acts should no longer apply. I am no lawyer and cannot judge whether these proposals are legally sound or not. But I would be reluctant to do anything to remove from policyholders their rights as creditors (individually or as a group) who have entered into contracts with a life office in good faith. Also it seems inappropriate for someone other than the policyholder in question to decide what aspects of a particular policy are important to that policyholder. What motivates a policyholder to effect a policy is a complex matter. Some policyholders are insurance minded, some very much cash minded. The existence of a guaranteed surrender value or a unit-linked guaranteed maturity value might be the main contract feature from the policyholder's point of view. My feeling is that the present system of allowing the Insurance Companies Acts to sit on top of the Companies Acts is the correct one but that the applicability of Sections 56 and 58 of the 1982 Act should be clarified and rules formulated for Section 59.

In § 6.18 the authors, recognizing the significance of non-policyholder creditors, say that trade creditors would need to be protected in full in order for the new statute to be generally acceptable. But this would surely be quite unfair given the principle of treating policyholders and trade creditors in all respects *pari passu*. We have always accepted that policyholders do not have a claim on a life fund in priority to trade creditors. There is no argument now for saying that the reverse should apply.

The authors' proposals would seem to stem from their laudable general aim to avoid wind-ups and go instead for winding-downs. However, we have seen that winding-up is sometimes the only practicable course. The authors may have been influenced by the rehabilitation procedure in the U.S. But this procedure is not without its problems. I recently read an interesting case study by Dr James Athearn (Professor of Insurance at the University of South Carolina) on the failed South Carolina life company New South Life. The case study not only throws up weaknesses in the South Carolina Insurance Code and in the supervisory function of the South Carolina Insurance Department but also makes comments on the rehabilitation procedure. Dr Athearn is particularly scathing with a procedure which can allow shareholders to gain by rehabilitation and the management to continue to manage. But he is convinced that New South Life should not have been rehabilitated and instead should have been liquidated. He concludes his case study with the following remarks: "On the basis of a careful analysis of available data, and the views of experts in the field of insurance regulations concerning the procedure which should be followed when an insurance company becomes insolvent, it appears to this writer that New South Life should have been liquidated as soon as possible after its disastrous financial condition was discovered."

Finally, what about the future now that we have moved into the era of the E.E.C. life Solvency Margin? What the Solvency Margin gives us is a number of trigger points. Firstly, the Solvency Margin itself. Then the Guarantee Fund, then the strong solvency (or standard of adequacy) trigger point which is the point at which the value of assets falls below the value of liabilities, both valued in accordance with the 1981 Regulations. Finally, the weak solvency trigger point below which we must be thinking in terms of winding-up or some of the possible alternatives to winding-up.

**Dr H. Kinloch** (a visitor): I make this contribution not as an accountant or a lawyer or indeed an actuary but as a manager who through no efforts of his own has had at various times to live on the edge of the definition of solvency. My points are two in number: they are short and I hope pragmatic.

It seems to me that the whole thrust of the debate on this paper and the objective which should arise out of it is that stated simply and starkly in § 5.33.

This section states: "It is thus even more urgent to put our house in order and consolidate the legal basis for a standard procedure of running off a closed portfolio of an insolvent life insurer before we are pressurised in the other direction by our fellow members of the E.E.C."

It seems to me if that is the objective which comes out of this paper and I believe that it is, those within the industry who wish to see results, i.e. the objective achieved, must look very carefully at some things which might divert us from this objective or allow us to be diverted.

I take the view that any attempt to take winding-up or indeed 'winding-down', provisions for insurance companies out of the overall context of the companies Acts would be such a diversion. I can readily see that we could find ourselves engaged in an interesting intellectual exercise on the side-lines of the main debate.

At the tactical level it must be wrong for us to seem to be trying to create another special situation or even dispensation for the U.K. within the overall context of E.E.C. legislation. We have all at some time had the experience of watching discussions run into the sand. I believe that to try to take this particular element of the legal structure supporting life insurance in the U.K. outside the general company law would be an error leading to a nil result for any reform.

My second point relates to a statement made in § 6.27. This statement boldly says that "his (i.e. the actuary's) professional duty should be to communicate to his principals the directors in the clearest possible terms his opinion as to the progress and future prospects of the fund".

Though I am aware that many actuaries and managers who live in what one could call the conventional offices, regard solvency as an interesting perhaps even keen intellectual pursuit but ultimately an occasional one. However, as Mr Weiss has indicated that "those of us who lived through the collapses of 1974 and were involved at the sharp end in the restructuring and rescues of that period know that it was a raw and sometimes distressing time".

My plea then is based on that simple statement from § 6.27. When a company and its management are wrestling with the effects of near insolvency (for whatever reason) to the ever-increasing sound of sonorous warning bells it is often to them, by no means clear where the responsibilities lie as between auditor and actuary. I am relieved to hear that conversations clarifying the position have taken place between the professions. May these definitions now be published in order that the rest of us may also be clear. I also suspect that such clarity could also be helpful in conversations aimed at producing new legislation.

**Mr P. N. Downing:** I welcome this paper. As the authors say, interest in this subject tends to wax and wane and I am possibly slightly disappointed that it has taken so much time since the failures of the mid-1970s before we have had an opportunity to debate this issue. However, this may have given us the opportunity of taking stock, and learning our lessons, so that hopefully changes which are advocated this evening will be a major step forward in this critical area.

Not so long ago we discussed valuation of liability regulations. One of the key issues was whether the regulations should be drawn on a going-concern basis or whether a valuation for solvency should be on a discontinuance basis. One of the key assumptions in an Actuary's valuation of the liabilities of an insurance company relates to the expected future rates and basis of taxation. In those discussions, discontinuance clearly implied running-off but, more particularly, under a tax regime comparable to that applicable to a going-concern life insurance company. If, however, we have to accept that the normal expectation on discontinuance is a winding-up, and that the tax basis applicable immediately following a successful petition for the winding-up of an insurance company is that applicable to an ordinary trading company, and that all carried forward tax reliefs are foregone, this could fundamentally change the value of a portfolio on a discontinuance basis with, I suspect, some very surprising, and disturbing, results. For there to be a reasonable chance of a successful running-off of a life insurance company in financial difficulties, I think it is essential that appropriate amendments are made to our income tax laws to ensure beyond doubt that the basic taxation principles applicable to a life company running-off in liquidation are the same as those applicable to the going-concern state, and that carried-forward reliefs, e.g. excess management expenses, are fully retained.

I would briefly like to return to the phrase 'the reasonable expectation of policyholders'—but used in a less conventional way. Mr Burns and Mr Weiss referred to the frustrations and hardships experienced by annuitants in a winding-up—their reasonable expectation of a regular flow of income has been frustrated. Furthermore, Mr Burns referred to the difficulty of applying a cash value test to appropriately compensate annuitants, at least on an individual basis. It seems to me that the reasonable expectation of policyholders, in this sense, are likely to be even more frustrated in the case of persons with term assurance. Such contracts are issued, not with an expectation of an investment return, but rather because a life insurance company is the only financial institution which can guarantee renewability of death insurance cover on predetermined terms: not only is this the intrinsic characteristic of term assurance, it is its *raison d'être*. The concept of a value of a policy to be discharged by a cash payment is totally incompatible with the product itself, and it must be questioned whether an actuarial value, based on collective principles of probability, has any relevance or meaning to an individual who has bought death insurance protection. As a class of policy-holders in a winding-up, should they be expected to give their consent to any scheme which does other than maintain—possibly at a 90% level—their insurance cover? As Mr Burns mentioned in the case of annuitants, the state of health of such term-assurance policyholders would vary substantially from one to another, and it would surely be impossible for individual policyholders to replace their cover on the existing terms and without medical evidence. At the very least, powers should be available for such policyholders to have their expectations fulfilled by way of reinsurance, or some similar transfer of obligations, in lieu of a compulsory cash settlement.

For any arrangement for the winding-down of an insurance portfolio as a closed fund, the powers and responsibilities of the liquidator/administrator will need careful research. I am not persuaded that the concepts which, by tradition and precedent, have been shown to work well in the liquidation of ordinary trading companies are necessarily appropriate to a life insurance company. Even if this is true only to the extent of making sure that such administrator pays full regard to the time value of money and the difficulty of applying collective probabilities to individual policies, both of which are key intrinsic concepts of life assurance, then the need for a careful reappraisal in this area is manifest.

Given that it is more likely that a small company runs into financial difficulties, there must be quite a high probability that there is a significant amount of reinsurance in force. If it is proposed to run-off the portfolio, I would submit that maintenance of the reinsurance is essential. However, this can bring us into major conflict with what I understand to be established principles applicable in liquidation. I have heard it argued that the liquidator feels unable to pay continuing reinsurance premiums on the grounds that the assets which he inherits must be used for the collective benefit of all members. He has questioned whether the use of part of those assets for the maintenance of reinsurance is a legitimate use of such assets—particularly if there is eventually no reinsurance recovery! On the other hand, if reinsurance is maintained, and a policyholder with a very large policy dies, should the reinsurance recovery be passed specifically through to the beneficiaries of that policyholder, or should the recoveries become part of the general assets of the liquidator for the benefit of all policyholders? If the latter position applies, clearly the ultimate value of a policyholder's interest in liquidation is a function of the mortality of policyholders with large policies! Furthermore, if it was expected that policyholders would only receive 80% benefits in liquidation, it seems to me that reinsurers would have every right to suggest a reduction of 20% in the amount of reinsurance bought.

I have also heard the argument advanced that reinsurance is not relevant in a run-off situation. However, if we postulate a closed fund with a decreasing number of policyholders and, presumably, a decreasing quantum of 'free' assets, it seems to me that the reinsurance requirements increase as the size of the closed fund decreases. Arising from the right and proper desire of the administrator to reduce his mortality exposure, he will wish to increase the amount of reinsurance on individual lives. As this will be done without medical evidence, and on an ultimate portfolio, I doubt whether reinsurers will be competing against each other to acquire such a portfolio on highly competitive terms. Any proposals for establishing a separate legal framework for the run-off of life insurance companies in financial difficulties should contain clear guidance in relation to the powers of the administrator to maintain, and increase, the amount of reinsurance, and how reinsurance recoveries should be used for the benefit of policyholders, individually or collectively.

Mr C. N. Smith referred to the case of Fidelity Life, expressing satisfaction at the eventual outcome. From the point of view of the Policyholders Protection Board, I am sure that he is quite right: to suggest, however, that all parties involved were equally satisfied would be misleading. At the time at which Fidelity Life ran into difficulties, there were existing various reinsurance treaties with five major British and European reinsurance companies. Taking account of the obligations under those treaties, reinsurers were the major creditors. Negotiations commenced with reinsurers, and a scheme of arrangement was eventually devised which provided, *inter alia*, for reinsurers to be paid out at 70%, whereas other creditors were to receive payments at the 90%/100% level. As I have already alluded, the time value of money does not seem to be an acceptable concept in such circumstances. Reinsurers were told quite clearly that they were getting 70%—despite the fact that their settlement, unlike those of other creditors, would be deferred five years. Making some allowance for interest, most actuaries would have argued that the present value of such settlement was, therefore, only about 50%. It was not accepted, however, by those involved in the arrangement, that reinsurers were effectively reducing their claims by 50%.

Furthermore, when the American parent, as Mr Smith has already mentioned, finally honoured their commitments and sold the company to the administering company, they did indeed settle with reinsurers ahead of the five-year deferred period—but insisted on discounting the amount to reflect the earlier date of settlement! In the light of their treatment in the Fidelity Life situation, I doubt whether reinsurers will be prepared to be so 'helpful' on a future occasion.

I think it was Mr Weiss who stated that time is of the essence when a life insurance company gets into financial difficulties. This is particularly so in the case of term assurance policies, where renewal premiums, to maintain policies in force, become due. If regard is to be had to the reasonable expectation of policyholders—in the less conventional way in which I have used this phrase earlier—it is essential that the position of term assurances, and in particular the status and value of renewal premiums, be clarified. Under a normal liquidation, there may be circumstances under which a company can continue trading: for a life insurance company continuing trading would probably mean transacting new business (which it almost certainly would not do), and I am not sure that there is an existing concept comparable with maintaining policies in force. Clarification of this issue might considerably assist in the clarification of the rights and/or desirability of the administrator continuing reinsurance arrangements.

I would just like to raise the question regarding the position and status of reinsurance companies themselves. Within the E.E.C. generally, reinsurance companies are not covered by insurance legislation: in the event of a winding-up they are treated like any other greengrocer. Within the U.K. on the other hand, reinsurance companies are, in my view rightly, deemed to be part of the insurance industry, and therefore subject to insurance company legislation. If, however, it is right to protect the reasonable expectation of policyholders in terms of their mortality risk, it would seem desirable that the position of reinsurance companies in financial difficulties, should be clearly identified as falling under the same legislation as primary companies.

In conclusion, given that the life insurance industry is the only sector of the financial services industry which can provide policyholders with a sharing of their mortality risk, whether as annuitants or as term assurance policyholders, in order that their reasonable expectations may be fulfilled, albeit at a level lower than 100%, I find the case made by the authors that insurance companies, particularly life insurance companies, should be a unique special category in law as distinct from normal trading companies for the purpose of winding-up legislation, irrefutable.

**Mr D. E. A. Sanders:** I wish to point out a serious practical objection to the treatment of insolvent insurance companies as described in the paper. Whilst I sympathize with the view, in the case of a company experiencing difficulties, that the policyholders' interests are best served by a run-off of liabilities, this may prove, in practice, to lead to problems regarding conflict of interest between certain classes of policyholders. The legislation which would provide for a run-off would have to encompass all cases, regardless of the current solvency position of such company.

Particular problems arise with those companies with a Foreign Life Fund and those companies which are composite in nature. There are a substantial number of companies which hold portfolios of overseas business. These are either Foreign Life Funds in respect of residents abroad, or as a result of a branch office established in a Commonwealth Country many years ago.

Policies covered under the Policyholders Protection Act, are confined to U.K. policies, and are furthermore restricted to all long-term business, compulsory insurance policies, and policies held by private policyholders. In general, policies issued under a Foreign Life Fund or non-compulsory general insurance policies issued to corporations are not covered. In addition, reinsurance treaties are not covered.

We are working in a scenario whereby the Policyholders' Protection Plan is applicable only to a proportion of the actual business transacted. This could create anomalies in the benefits granted to different classes of policyholders in the event of a wind-up if the provisions of the Act have to be implemented at any stage, and this imprecision would need to be rectified in any legislation covering the winding-up of an insurance company.

Let us now consider a company experiencing financial difficulty. Under Insurance Companies legislation we have a solvency margin, which is precisely what this means, a margin over and above a conservative estimate of the long-term liabilities. If an insurance company fails to meet its obligations in respect of the solvency margin, and furthermore fails to arrive at an adequate short-term plan of operations to reinstate the solvency margin, the Secretary of State has many powers, one of which is effectively to run the company off as a closed fund. Let us assume that route is taken. There is, at this stage, no need to reduce liabilities due to the existence of a conservative valuation basis and a margin of solvency (although inadequate for the purposes of the Act).

During a period, further problems could arise regarding expenses, early encashment of assets, high surrender rates, and so on that could erode margins so that the company's ability to meet its obligations is in doubt. For technical reasons it may be difficult to undertake alternative strategies like sale of the company, reinsurance on a care-and-maintenance basis and so on. At this stage the company is technically insolvent, that is at some time in the future assets will run out before liabilities. So that all policyholders receive something, benefits must be reduced. The problem arises regarding the level of such reductions. We are not capable of producing perfect answers. So as a result, at a future time, benefit levels will require to be adjusted either upwards, or downwards to a level at which the Policyholders Protection Act applies. If benefits are increased upwards, it can only be at the expense of those policyholders who have received less than their contractual obligations and there could be some come-back from this class. It would be a necessity to pay back any shortfall to past policyholders to maintain some degree of equity. If the condition of the company deteriorates further we get to the 90% level at which technically, the Policyholders Protection Act comes into play, but only in respect of the restricted classes. This could cause ill will in respect of those policies not covered by the Act, and those policies covered by the Act who have seen higher benefits paid to existing policyholders whilst the company was technically insolvent.

Finally, although we might believe that the problem regarding composites will be solved by segregated and separate companies, this is not necessarily the case. Certain companies have parents, and creditors could look to this company. If an insurance company which is composite in nature experiences problems on its non-life side, this could create an adverse reaction to its long-term portfolio with higher surrenders and so on and help create an adverse trading position for an otherwise sound operation through bad publicity. The creation of separate companies does not solve this type of problem.

**Mr L. M. Eagles:** I feel that the remarks on the inclusion of Friendly Societies in §6.23 are too sweeping. As I understand the authors they are suggesting that Friendly Societies in general which offer insurance should be brought within the orbit of insurance company supervision, even though in the earlier part of the paragraph they seem to be considering Societies which offer life insurance only. Of these the modern commercial tax-exempt Societies are examples. With this latter view I have considerable sympathy where the business is substantial, but it is necessary to be far more discriminating with Societies which offer sickness insurance as well.

In fact, the Sickness insurance in the traditional Society is usually the principal source of contribution income to the Society. The Societies established as Orders will consist of numerous small autonomous branches with the right to rely on a central contingency fund and, conversely, rights for central funds to raise levies on the self-supporting branches. Would it be appropriate to adopt the same principles for supervision of such Orders, apart perhaps from central life insurance funds, as insurance companies? I hardly think so. Again there are centralized Societies on the Holloway principle where, in need, the management committee can have recourse not only to reserve funds but also to the provisional allocation to member's surplus which otherwise is not distributed until a retirement age. Do these really require long-term valuation? We should consider carefully whether the extra expense of supervising such bodies in exactly the same way as insurers would benefit the members. Especially this must be so since, as Mr Arnold stated, a Society has itself the right at a general meeting to alter and, in particular, reduce the benefits; the very remedy proposed by the authors. This is an area which warrants much careful investigation.

**Mr P. L. Duffett:** Paragraph 6.3 shows the authors' strong feelings for a new treatment of insolvent life companies have some root in long-term policies being regarded as the cornerstone of the financial security of families of both ample and modest means.

An examination of many leading life assurers' returns will show that substantial numbers of policyholders terminate their policies each year. I expect few companies have more than a quarter of their total annual premium from policies taken out at the same premium 10 or more years ago and I suspect that many will not have half that amount.

The willingness of policyholders to terminate and top-up their life assurance should be fully recognized by the authors.

It may well be more equitable to pay out policies than introduce further inequity between those that rub along with the insolvent company maintaining minimum servicing and those that do not. The cost of maintaining even minimum administrative systems can be substantial for a company devoid of new blood and perhaps high administrative costs could further reduce an already reduced payout.

As Charles Dickens said through Trotty Veck in *The Chimes*.

> There's nothing more regular in its coming round than dinner-time, and nothing less regular in its coming round than dinner. That's the great difference between 'em. It's took me a long time to find it out. I wonder whether it would be worth any gentleman's while, now, to buy that observation for the Papers; or the Parliament!

He was only joking, but the authors would do well to avoid the spectre of an insolvent life company as a closed fund failing to pay its benefits at the proper time.

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