

## Chapter Three

### Guaranteed Annuities and Solvency of Insurance Companies

#### Part 1

#### Guaranteed Annuities

##### 3.1 Introduction

- 3.1.1 The origin of the problem which was eventually to lead to Equitable Life's closure to new business was a guarantee which had been included in a significant number of with-profits pensions policies issued by Equitable Life between 1957 and June 1988. In order to understand how these guarantees had such a substantial impact on Equitable Life and to put the events described in Chapters 4 and 5 in context, it is necessary to describe the nature of these guarantees. This Chapter also describes how the guarantees became increasingly valuable during the 1990s and the approach which was adopted by the Board of Equitable Life to deal with this problem. In Chapter 2 we described the elements of the regulatory regime applicable to insurance companies. The latter part of this Chapter describes the way in which the solvency regime set out in the ICA 1982 operates and the way it applied to these guaranteed annuity policies.

##### 3.2 Equitable Life

- 3.2.1 As a mutual society, Equitable Life has no shareholders. The members are its with-profits policyholders who, in signing a policy proposal form, agree, once the relevant policy is effected, to become a member subject to the Articles of Association. Until the House of Lords' decision in July 2000, Equitable Life was committed to retaining its mutual status.
- 3.2.2 At 31 December 1998 Equitable Life's funds under management exceeded £28billion. Of that sum over £21billion represented the funds backing with-profits policies.

##### 3.3 Long-Term Insurance

- 3.3.1 Insurance policies provide a significant part of the long-term savings market in the UK. In 1999 funds invested in long-term insurance policies in companies and friendly societies amounted to £992billion.
- 3.3.2 Long-term insurance (or "life insurance") policies are of various types including pure protection policies (for example, term insurance), savings policies (for example, endowments) and policies for the provision of an income (for example, annuities). The policies may be paid for by regular defined premiums, a single premium or a succession of "recurrent single premiums" which can vary as the policyholder chooses. If an insurance policy meets certain requirements set by the Inland Revenue, it can be regarded as a pension policy and investors can obtain tax relief on the premiums paid into such a policy.
- 3.3.3 If a policyholder stops paying (regular) premiums before the maturity date specified in the policy, the policy may remain in-force but become "paid up", although

reduced benefits may be paid. Alternatively, the policy may be surrendered or, in the case of pension policies which may not be surrendered for tax reasons, the policy may be transferred to another insurance company.

- 3.3.4 These policies divide between with-profits policies and non-profit policies. Non-profit policies are either “traditional” policies (where the policyholder pays a defined premium for a defined benefit) or unit-linked policies (where the premiums are invested and the policyholder receives the value of his investment).

### **3.4 With-profits Policies**

- 3.4.1 The key feature of a “conventional” with-profits policy is that the premiums paid by the policyholder are greater than required to pay the sum assured. Any profits made (from the extra premiums or elsewhere) allow bonuses to be declared, effectively increasing the sum assured. With a “unitised with-profits” policy, the policyholder’s with-profits account starts with a zero balance and is increased by the premiums paid and by bonuses (which are expressed as percentages of the value of the account). It is the unitised with-profits pension policies sold by Equitable Life which are most relevant to this Report.

- 3.4.2 Typically, two types of bonus are paid:

- (a) A “reversionary” bonus which is declared regularly (usually each year) during the life of the policy. Once allocated to the policy, these bonuses are guaranteed and cannot be taken away even if the value of the underlying investments falls.
- (b) A “terminal” (or “final”) bonus which is determined only when a claim is paid and is not guaranteed. As set out in more detail below, the discretionary nature of the terminal bonus means that it does not have to be backed by prudent reserves (i.e. provisions made by an insurance company to cover liabilities arising under or in connection with contracts for long-term business).

- 3.4.3 Since terminal bonuses were introduced in the late 1960s, the balance between reversionary and terminal bonuses has changed so that terminal bonus now represents an increasingly higher proportion of the benefits paid to the policyholder. In recent years at Equitable Life, terminal bonus has risen to about 40% of total policy proceeds.

- 3.4.4 Each year the policyholder receives a bonus notice which gives details of the reversionary bonus for the year and sets out the bonuses which have been allocated to the policy to date.

- 3.4.5 One of the advantages of with-profits policies is that they are generally considered to provide investors with the opportunity to benefit from stock market growth without taking the direct risk of investing in equities. The policyholder receives a combination of a growing level of guaranteed benefits over the life of the policy, a lower risk of exposure to stock market down turns and the potential of higher returns at maturity. Although it is not possible to be certain of the final value of a policy until it matures, the value is less volatile than that of an equivalent unit trust or unit-linked policy.

- 3.4.6 The principal disadvantage of with-profits policies is considered to be lack of transparency. The lack of transparency arises for two reasons: firstly, a wide discretion is given to the directors of life insurance companies in setting bonus levels and secondly, the policyholder is only given details of the bonuses which have been declared to date and does not know how much the terminal bonus will be until the policy matures. A recent report of a Working Party of the Institute entitled

“Transparent with-profits - Freedom with Publicity”, which was presented in February 2001, noted:

“The over-arching criticism levelled specifically at with-profits investment (rather than at insurance or investment products in general) is the lack of transparency in its operation, particularly in the information presented to customers, which could conceal unfair treatment of policyholders.”

- 3.4.7 With-profits policies may include guarantees. An example is that the maturity value of a policy will be at least the sum assured and reversionary bonuses. Depending on the terms of the policy and the practice of the insurance company, the cost of these guarantees might fall on the with-profits fund backing the policy or, in the case of a proprietary company, on shareholders’ funds. Alternatively, the expected cost of these guarantees might be included in the premium, with any residual cost (or profit) being charged more generally.

### **3.5 Asset shares**

- 3.5.1 In order to ensure that the total payout to a with-profits policyholder is fair relative to other policyholders, most insurance companies maintain an internal record of the income (being the premiums received and investment return) and outgoings (being expenses, commission, tax and expected cost of claims) relating to each policy. This record is referred to as an ‘asset share’.
- 3.5.2 There is no formal definition of an asset share in any regulations. In most life insurance companies, further additions and deductions are considered appropriate; examples include profits on non-profit business, costs of capital and transfers to shareholders. In particular, some life insurance companies may make some adjustment to a policyholder’s asset share in respect of any guarantees enjoyed by the policyholder over the lifetime of the policy.
- 3.5.3 By comparing the total asset share for a policy at maturity with the basic sum assured and reversionary bonuses declared to date in respect of the policy, the Appointed Actuary is able to calculate the amount of the terminal bonus so that the total paid out equals the total asset share<sup>1</sup>. However, in practice, absolute equality is rarely achieved. The basic calculation of asset share will be the same for all classes of policyholder but the different benefits which are provided by different policies mean that the terminal bonus may differ between the classes of policy. Other factors which mean that absolute equality is rarely achieved include consistency between generations of policyholders and competitive pressures. All these factors taken together form a foundation for assessing PRE.
- 3.5.4 Asset shares may be calculated by crediting each policyholder with the actual investment gain (or loss) achieved by the with-profits fund in each year. This type of asset share is known as an “unsmoothed asset share” and its value will vary with the underlying investments. A bonus policy that paid out unsmoothed asset shares would not normally meet the usual policyholder expectation of a smoothed return.
- 3.5.5 Therefore, life insurance companies often calculate an asset share value that is more stable over time, i.e. a “smoothed asset share”. This allows for a hypothetical, rather than actual, investment return. This hypothetical return will not include every “peak and trough” of the stockmarket and could be calculated, for instance, by using a rolling average of the last 5 years actual returns, or the Appointed Actuary’s estimate of the long-term rate of growth adjusted in the light of actual experience.

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<sup>1</sup> Similar comparisons are carried out when a policy is surrendered.

- 3.5.6 Equitable Life used the term “policy value” to describe smoothed asset share in its bonus notices.

### **3.6 Annuities**

- 3.6.1 In exchange for tax concessions on pension contributions, on maturity (or “vesting”) of a pension policy, Inland Revenue rules require a policyholder to purchase either an annuity or a pension fund withdrawal contract (“**PFW**”)<sup>2</sup>. At its most basic level, an annuity is a contract with an insurance company by which the insurance company agrees to pay a defined amount on a regular basis during the remainder of a person’s lifetime. The annuity may be purchased from the company with which the fund has been accumulated or from another pension provider.
- 3.6.2 There are a variety of different types of annuity and other pension products available on the market. An “immediate” annuity is an annuity which is in payment (i.e. it is being paid to the policyholder). A “deferred” annuity is where the policyholder pays premiums and an annuity is not payable until a number of years later. Most annuities are “level” or increase at a particular rate; some others are with-profits or unit-linked.
- 3.6.3 Each company may offer a different annuity rate (i.e. the level of annuity that is paid for a particular premium). Current annuity rates are based on what an insurance company regards as the expected investment return on a portfolio of medium term fixed interest securities purchased using the proceeds of the policyholder’s pension fund and the anticipated period of payment of the annuity which is dependent on the expected mortality of the policyholder.

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<sup>2</sup> These are described below.

### **3.7 Pension fund withdrawals**

- 3.7.1 Another type of pension product which is relevant to this Report is a PFW (or “income drawdown”). In May 1995, legislation was introduced which allowed a policyholder to draw income directly from a personal pension from age 50 with no compulsion to purchase an annuity until age 75. The idea behind a PFW is that the policyholder defers the purchase of an annuity but, in the meantime, draws an income direct from the pension fund, which remains invested until an annuity is purchased. Equitable Life had already developed a product along these lines and it became the principal provider in this market. By October 2000, it was estimated to have sold approximately 22,000 contracts.
- 3.7.2 One of the perceived advantages of a PFW is that it allows the investor to maintain his funds in equities rather than the fixed interest investments usually backing immediate annuities. Although equity prices are more volatile, it is generally believed that they will outperform fixed interest securities over time. However, a PFW is a complicated product and the charges are considered by some to be high. In addition, opting for a PFW involves two particular risks:
- (a) that, by the time an annuity is purchased, current annuity rates will have decreased; and
  - (b) that the pension fund will be reduced by the withdrawal of an income and may be eroded by poor investment performance.
- 3.7.3 A PFW may only be bought by an investor who has a personal pension plan. An investor with an older pension policy (“section 226 retirement annuity”) may only purchase a PFW if the section 226 retirement annuity is first converted to a personal pension before the PFW is purchased. For those policyholders whose policies contain a GAO, this means that the GAO is lost.

### **3.8 Guaranteed annuities**

- 3.8.1 Some pension contracts contain GAOs. A GAO allows the policyholder, at retirement, to opt to exchange some or all of the amount provided by the pension policy for an annuity at a fixed rate which is set out in the policy. A GAR is the fixed rate at which the cash amount provided by a pension policy is converted to an annuity at the option of the policyholder on retirement.
- 3.8.2 The GARs provided for under Equitable Life’s with-profits policies varied depending on their type as well as the age and sex of the policyholder. Until 1975 the interest rate underlying the guarantee was 4%; after 1975 until 1988 (a period of high inflation) the rate increased to 7%.

### **3.9 Equitable Life’s with-profits GAO policies**

- 3.9.1 Equitable Life issued with-profits policies containing GAR provisions between 1957 and June 1988. No explicit or implicit charge was ever made for the inclusion in the policies of the GARs. The GAR was simply one of the contractual benefits obtained by the payment of the premium by which the policy was effected.
- 3.9.2 In the evidence which was presented in the Court case, Equitable Life provided details of the numbers of with-profits policies containing GAR provisions which it had issued. Ignoring group policies, there were said to be approximately 116,000 with-profits policies containing GAR provisions in issue which were held by

approximately 90,000 persons. Ignoring group policies, Equitable Life stated that there were approximately 300,000 with-profits policies which did not contain provision for GARs in issue which were held by approximately 290,000 persons.

3.9.3 The GARs offered varied considerably between different insurance companies. At one end of the spectrum some options were specific and inflexible, for example, the GAR applied at a specific date and only if the annuity was taken in a specific form. At the other end of the spectrum, the GAR could be taken at a wide range of dates and for any style of annuity. The GARs contained in the policies issued by Equitable Life were among the more flexible - policyholders could retire at any time within the permitted age range of 60 to 75 and receive the same benefits as if they had selected that retirement date at the outset.

3.9.4 Although GARs were not included in policies sold by Equitable Life after June 1988, policies sold with GARs before that date remain in force. A policyholder can continue to pay recurrent single premiums into these policies and obtain the benefit of the GAR in respect of such premiums<sup>3</sup>.

### 3.10 The emergence of the GAR problem

3.10.1 For many years, current annuity rates exceeded the GARs provided for in Equitable Life's with-profits policies. However, during the 1990s, current annuity rates fell significantly. Two factors are largely responsible for this:

- (a) The yield on government gilts with a 15 year term to maturity fell from nearly 11% at the end of 1990 to just over 4.5%<sup>4</sup> at the end of 1998. These securities reflect the main investments bought by life insurance companies to provide for annuity income payments. As the interest rate dropped, the level of annuity income that life insurance companies can provide reduced accordingly.

Appendix 7 is a graph which shows the yield on 15 year high coupon gilts between 1976 and 1998.

- (b) Over recent decades mortality rates for individuals purchasing annuities have decreased. The life expectancy for a male purchasing a retirement annuity has increased from 14.9 years in 1975 to 17.6 years in 2000<sup>5</sup>. It is now common practice to allow for further improvements in mortality when calculating annuity rates.

Appendix 8 is a chart which shows at 5 year intervals from 1975 to 2000 the life expectancy of a 65 year old male holder of a retirement annuity in the course of payment.

3.10.2 The combination of both these factors has had a significant impact on current annuity rates during the last 10 years. In May 1990 the annuity rate for a male aged 65 was approximately 15%; by June 1999 it had fallen to approximately 9%. In other words, a typical annuity bought by a 65 year old male in mid-1999 bought an income for life of approximately 60% of the income for life that could have been secured by a man of the same age in the spring of 1990.

3.10.3 As a report of the Working Party of the Life Board of the Faculty and Institute in November 1997 (referred to below) noted:

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<sup>3</sup> Following inception of such policies, recurrent single premiums are also known as "top-ups".

<sup>4</sup> Source: Datastream.

<sup>5</sup> Source: Actuarial Mortality Tables, standard in 1975 and 2000 published by Continuous Mortality Investigations Bureau.

“At the time many of the GAO rates were introduced, during the 1960s and 1970s, it was considered appropriate to use a mortality table with no explicit allowance for future improvement ...and what must have seemed a relatively conservative rate of interest.”

- 3.10.4 As current annuity rates fell, the GARs became increasingly valuable. For Equitable Life, the GARs began to exceed its current annuity rates between late October 1993 and mid-May 1994. Between mid-May 1994 and mid-May 1995 the position reversed and Equitable Life’s current annuity rates generally began to exceed the GARs by a small margin. However, since mid-May 1995 the GARs have generally exceeded Equitable Life’s current annuity rates; further, the extent to which they have done so has generally increased over time.
- 3.10.5 Appendix 9 is a graph illustrating the fall in current annuity rates and how the GARs have become increasingly valuable.
- 3.10.6 The emergence of the GAR problem led to the adoption of a variety of different approaches by insurance companies. Some insurance companies had made an implicit charge for the expected cost of the guarantee against the asset share of a policyholder whose policy contained a GAO. The charge was held in a contingency reserve which was contributed towards the actual cost of the guarantees as they emerged. Policyholders with GAOs at insurance companies which had adopted this approach received lower final payouts because the insurance company had made a charge against the policyholder’s asset share. However, these insurance companies applied the GAR to the total payout received by the policyholder.
- 3.10.7 Other life insurance companies did not make a specific charge against the policyholder’s asset share. Some of these insurance companies were able to meet the cost of the guarantees from an “estate” held within their with-profits funds. (It can be argued that the estate has arisen from general deductions from, or under-distributions of the asset shares of, previous policyholders, which makes this approach somewhat similar to the first approach except that the charging is more arbitrary.)
- 3.10.8 Equitable Life had not charged for the GAOs and had not established specific contingency reserves in respect of them. Furthermore, Equitable Life only had a modest estate from which it could meet the cost of the guarantees because of the approach which it had adopted to the distribution of surplus arising in its with-profits fund.

### **3.11 Equitable Life’s approach to distribution of surplus**

- 3.11.1 Since its incorporation and until the House of Lords’ decision in July 2000, the Board of Equitable Life had adopted a policy which it described as “full and fair” distribution of its surplus to with-profits policyholders. The approach was described in a paper entitled “With Profits Without Mystery” which was presented to the Institute in March 1989 by Mr Roy Ranson (then the Deputy General Manager & Appointed Actuary of Equitable Life) and Mr Haddon:

“The essence of the concept is that we regard with-profits policyholders as participating in a “managed fund”. The premiums they pay, after meeting expenses and the cost of life cover and other benefits and options, are invested in the managed fund. The benefits a policyholder ultimately receives will reflect the value of the assets in the fund attributable to his policy, i.e. that policyholder’s asset share.

...

It may be instructive to consider briefly how the concept has developed. In many ways it is the explicit expression of an attitude which has prevailed in the office for many years. Put simply, that is that the business belongs to the current generations of with-profits policyholders. Those policyholders participate in a pooled fund and, when they leave, should take “full value” from the fund. The fund is continually open to new members. In particular, we do not believe in the concept of an “estate” in the sense of a body of assets passed from generation to generation and which belongs to no-one.”

3.11.2 Equitable Life’s practice meant that there was no holding back of profits from one generation of policyholders to the next. This practice had the effect of increasing the returns paid to policyholders and it was a strong selling point for Equitable Life. IFSD told us it was a “source of pride” to Equitable Life which had claimed that it had always sought to pay out the highest possible amounts when policies became claims (whether at maturity, death or surrender).

3.11.3 However, an inevitable consequence of the policy of “full and fair” distribution was that Equitable Life did not build up any substantial free assets (or “estate”) which would be available to meet unexpected demands on its capital resources. The absence of a substantial estate was well known; indeed, it was promoted by Equitable Life as a virtue. It argued that:

“if part of the surplus otherwise available for distribution to policyholders was set aside for future emergencies, this would have been at the expense of policyholders whose policies were in force or maturing when those surpluses arose. In the view of the Board, such an approach would have been inconsistent with full and fair distribution.”

3.11.4 However, Equitable Life’s approach of operating without an estate did attract comment. The discussion at the Institute which took place at the time Mr Ranson and Mr Headdon presented their paper reflected concerns at the absence of an estate. One actuary suggested that one of the advantages of financial strength was that it gave the insurance company freedom of manoeuvre; another suggested that “it was in consideration of the improbable” that insurance companies retained an estate. These comments were reflected by some of the individuals whom we interviewed. For example, GAD told us:

“We knew that it wasn’t a strong office, but it was seeking to distribute the whole of the surplus arising to the existing policyholders. It was also paying out relatively - perhaps not relatively high, but a significant proportion of that surplus in the way of guaranteed bonuses, so it’s very dependent upon there being no investment shocks.”

3.11.5 In our interviews with individuals from IFSD and GAD we asked whether the absence of a large estate affected the way in which Equitable Life was regulated. IFSD told us that it was necessary “to monitor and regulate bearing in mind the fact they have not got one” but there were limited opportunities for the regulator to affect the size of the estate. GAD told us:

“There’s not a lot you can do about it if the company chooses to operate its business in that way; we would keep a close eye on it, and we have expressed the view to the company, over at least ten years, that we weren’t exactly comfortable with the way that they operated, but the company, I suppose, were arrogant in that respect, and felt that they knew best.”

3.11.6 IFSD told us:

“It is sort of self-evident that the less surplus you have got, the more exposed you are to accidents, surprises, or...shocks...I think the question was, was it a reasonable approach for the company to take, or was it so unreasonable that the Regulator should have done something about it? I think our judgement was that it was clearly a factor and, if you like, a risk, but the company were aware of it; the company took a judgement of how much to pay out each year, and that was...a big bonus for the policyholders, the fact that the funds were paid out, the surplus was paid out so fully. Against that has to be set the risk that unexpected shocks would leave them with less fat. But that is a judgement every company has to make. The Equitable were perhaps at one extreme, or near one extreme, in terms of the way that judgement was exercised.”

### **3.12 Equitable Life’s terminal bonus practice**

3.12.1 The emergence of the GAR problem had a particularly significant impact on Equitable Life. IFSD explained part of the reason:

“Equitable had got a lot of these guaranteed annuity contracts, and a lot of the guarantees were quite valuable relative to the guarantees that others in the industry had got. Also, the contracts were very flexible. They allowed people to retire at any date, typically after 60, and to take the benefit of the guarantee, whereas a lot of other companies’ contracts weren’t that flexible: you could only take the guarantee if you retired at either, say, the date you had chosen for your retirement when you took out the policy, or possibly you might have two or three dates, but that was all; if you retired at 65, or 70, or 75, you could take the guarantee, but otherwise you weren’t entitled to it. Because of the flexibility of Equitable’s guarantees, the chance of them being taken up was greater, in their case; whenever you decided that you wanted to retire, you would be eligible for the guarantee. Also the form of the guarantee was reasonably attractive in that, typically, they were monthly or quarterly in advance, whereas other companies were annually in arrears, which was not an attractive form of payment for an annuity.”

3.12.2 When the GARs under Equitable Life’s with-profits policies began to exceed its current annuity rates and in the absence of any contingency reserve or sizeable estate, Equitable Life had to decide which group of policyholders should bear the emerging cost of the guarantees.

3.12.3 The response of the Equitable Life Board was to adopt a “differential terminal bonus practice”. In December 1993 (the first occasion when the GARs exceeded Equitable Life’s current annuity rates) the Board of Equitable Life resolved to allocate to a GAR policyholder a different terminal bonus according to whether the policyholder elected to take:

- (a) an annuity at the GAR pursuant to the terms of the policy; or
- (b) an alternative benefit (such as an annuity at the current rate from Equitable Life or from another provider).

3.12.4 The Board allocated a larger terminal bonus to those GAR policyholders who elected to take an annuity at current rates than the terminal bonus which was allocated to those policyholders who elected to exercise the GAO. The reduction in the terminal bonus which the Board made had the effect of making the total annuity which was available to a GAR policyholder who exercised the GAO identical (in virtually all cases) to the amount available to a policyholder who did not exercise the GAO or a non-GAR policyholder.

3.12.5 Two examples will help to illustrate how this approach operated in practice. For the purposes of these examples, the following assumptions have been made:

- (a) A current annuity rate of £8.30 per annum per £100 of fund;
- (b) A GAR of £10 per annum per £100 of fund; and
- (c) All of the fund is taken in annuity form.

Guaranteed fund (i.e. basic sum assured plus declared reversionary bonuses)	£ 75,000
Terminal bonus	<u>25,000</u>
Total fund	100,000

On current annuity rates the annuity payable would be £100,000 x (8.30/100) = £8,300 per annum.

Equitable Life's approach was to apply the GAR only to the guaranteed fund giving a guaranteed minimum annuity of: £75,000 x (10/100) = £7,500. The terminal bonus allocated to a policyholder opting to take an annuity in GAR form would therefore be reduced from £25,000 to £8,000:

Guaranteed fund	£ 75,000
Terminal bonus	<u>8,000</u>
Total fund	83,000

£83,000 x (10/100) = £8,300 per annum.

3.12.6 There were situations in which the exercise of the GAO would result in the policyholder receiving a higher annuity:

Guaranteed fund (i.e. basic sum assured plus declared reversionary bonuses)	£ 85,000
Terminal bonus	<u>15,000</u>
Total fund	100,000

On current annuity rates, the annuity payable would be £100,000 x (8.30/100) = £8,300 per annum.

However, Equitable Life's approach of applying the GAR only to the guaranteed fund would give a higher annuity of £85,000 x (10/100) = £8,500. In these circumstances, the terminal bonus would be reduced to nil but the GAR policyholder has obtained a higher annuity by exercising the GAO.

3.12.7 The Board considered that it was able to adopt this differential terminal bonus practice under Article 65 of the Articles of Association. That Article provided as follows:

“65(1) The Directors shall, at such intervals as they may deem expedient, but at least once in every three years, cause an investigation to be made into the financial condition of the Society, including a valuation of its assets and liabilities, by the [Appointed Actuary]. Provided that in the valuation of the assets the values thereof be not estimated beyond the market prices (if any) of the same, unless for reasons to be set out in

the Directors' report to the Members upon the results of the valuation. After making such provision as they may think sufficient for such liabilities, and any special or other reserve they may think fit, the Directors shall, at a Special Board Meeting, declare what amount of the surplus (if any) shown by such valuation may, in their opinion, be divided by way of bonus, and *they shall apportion the amount of such declared surplus by way of bonus among the holders of the participating policies on such principles, and by such methods, as they may from time to time determine.* The Directors may pay or apply the bonus so apportioned to each participating policyholder, either by way of reversionary bonus (that is to say, by way of addition to the sum assured when it shall become a claim), cash payment, reduction of premium for the whole of life or any less period, or in any other way they and any participating policyholder may agree.

- (2) The Directors (after obtaining such report or reports from the [Appointed Actuary] as they may in their discretion consider to be necessary or desirable in the circumstances) may, in cases where participating policies become claims in the interval between two valuations, pay such interim or additional or special bonuses as they shall think fit.
- (3) The amount of any bonus which may be declared or paid pursuant to paragraph (1) or paragraph (2) of this Regulation and the amount (if any) to which any participating policyholder may become entitled under any mode of payment or application of any such bonus, shall be matters within the absolute discretion of the Directors, whose decision thereon shall be final and conclusive.” [emphasis added]

3.12.8 It was Equitable Life's belief that this Article conferred an “absolute discretion on the Board as regards whether and to what extent surplus is allocated for the provision of bonuses; and that subject to such discretion being exercised *bona fide* and with a proper appreciation of the relevant facts, the Board is free to divide up surplus as it thinks fit.”

### 3.13 The Court case

3.13.1 The differential terminal bonus practice adopted by Equitable Life led to complaints from a number of its policyholders. The thrust of the complaints was that the Board was renegeing on the contractual obligations under the policies or that it was exercising its discretion improperly. Policyholders with GARs in their contracts argued that Equitable Life had not made its procedures clear at the outset and that their expectation was that the GAR should be applied to the total fund (including the terminal bonus) in order to calculate the guaranteed annuity.

3.13.2 By mid-December 1998 at least 15 complaints had been made to the PIA Ombudsman by individual policyholders about Equitable Life's approach. Equitable Life decided to initiate a Court case rather than allow the cases to proceed before the PIA Ombudsman. IFSD explained the reasons for Equitable Life's decision:

“The problem with the Ombudsman was he was going to decide on individual cases and it was going to be “death by a thousand cuts”. Potentially, the first case the Ombudsman decided, well it could have been very much on the individual circumstances of that case, maybe that policyholder could say the salesman told me this, and it would be very difficult for Equitable to disprove that. If that then

sets precedent for the Ombudsman for future cases. Effectively Equitable would lose the principle potentially without having had a fair hearing on that principle.”

3.13.3 Equitable Life informed HMT-ID of its decision to initiate the Court case in a letter dated 18 December 1998.

## Part 2

### Solvency of Insurance Companies

#### 3.14 Introduction

- 3.14.1 In Chapter Two we explained that insurance companies were subject to a specific statutory solvency regime which is designed to ensure that insurance companies are able to meet their obligations to policyholders. This section explains how this regime operates including the role the Appointed Actuary plays in it. The background to the debate which took place between HMT-ID and Equitable Life as to how Equitable Life should reserve for GAOs is also explained.

#### 3.15 Statutory solvency requirements

- 3.15.1 The ICA 1982, and the regulations made under it, set out the requirements concerning the solvency of life insurance companies. The two principal provisions in the ICA1982 relating to solvency are sections 32 and 33.
- 3.15.2 Section 32 of the ICA 1982 requires all insurance companies to maintain a margin of solvency of such amount as may be prescribed from time to time by regulations. In effect, this means that insurance companies are required to hold assets which exceed the company's liabilities by a specified amount. This amount, which is known as the "Required Minimum Margin" ("RMM"), must be maintained throughout the year and not just at the year end.
- 3.15.3 In the event that a life insurance company fails to maintain sufficient assets to cover the RMM, section 32 of the ICA 1982 provides that it may be required to submit "a plan for the restoration of a sound financial position" to the FSA. IFSD told us that:
- "for a plan to be acceptable, it would need to provide for cover for the RMM to be restored within a reasonable timescale. The timescale considered reasonable would depend on the circumstances. For example, a longer timescale would typically be allowed to effect a substantial change in investment policy; a shorter period would be allowed for a capital injection from a parent company."
- 3.15.4 Section 33 provides that if the excess of a company's assets over its liabilities falls below the minimum margin of solvency, the insurance company may be required to submit "a short-term financial scheme" to the FSA.
- 3.15.5 The valuation of assets and liabilities for the purposes of calculating the excess of assets over liabilities available to cover the RMM must be in accordance with the applicable valuation regulations. The principal regulations dealing with the valuation of assets and liabilities are the 1994 Regulations.

#### 3.16 Required Minimum Margin

- 3.16.1 The RMM of a company carrying on long-term business is the greater of:
- (a) the Minimum Guaranteed Fund (which, in the case of a mutual life insurance company, is 600,000 euros); and
  - (b) the Required Margin of Solvency ("RMS").

- 3.16.2 The Minimum Guaranteed Fund for all but the smallest and newest companies will be much lower than the RMS. As a result, in the majority of cases (including that of Equitable Life), the RMM equates to the RMS.
- 3.16.3 The rules for determining the RMS of a life insurance company depend upon the classes of long-term business which it carries on.
- 3.16.4 Paragraph (3) of Regulation 22 of the 1994 Regulations requires that, of the assets covering a company's RMM, at least 50% of the Guarantee Fund<sup>6</sup> (or, if greater, 100% of the Minimum Guaranteed Fund) be covered by "explicit assets". Explicit assets are all types of assets other than implicit items (which are described below). For most life insurance companies (including Equitable Life), the Guarantee Fund is equivalent to 1/3rd of the RMS. Consequently, the effect of Regulation 22 is that 1/6th of the RMS (and hence 1/6th of the RMM) must be covered by explicit assets. Such assets are referred to as "explicit available assets" and the 1/6th of the RMM that must be covered by them as the "explicit RMM".
- 3.16.5 The remaining 5/6th of the RMM may be covered by implicit items. These are assets of a long-term fund which are intangible and relate, for example, to future profits, Zillmerising (which is explained below) or hidden reserves resulting from the underestimation of assets or the overestimation of liabilities. In order to include implicit items such as these in the calculation of the margin of solvency, an order under section 68 of the ICA 1982 must first be obtained.

### **3.17 Section 68 Orders**

- 3.17.1 Under section 68 of the ICA 1982 a direction may be made that certain provisions of the ICA 1982 and the regulations made under it, including those relating to the regulatory returns, shall not apply to a company, or shall apply to it with specific modifications. The direction takes the form of an Order. Currently, such Orders may be issued by the HMT on advice from the FSA.
- 3.17.2 Prudential guidance issued by the then prudential regulator, the DTI, states that:
- "Orders in respect of future profits and Zillmerising will be readily available, provided that the relevant requirements set out in this Guidance Note have been satisfied. Orders in respect of hidden reserves will only exceptionally be given."
- 3.17.3 Equitable Life had the benefit of Section 68 Orders in relation to future profits implicit items and to a subordinated loan. These are considered below.

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<sup>6</sup> Regulation 22 of the 1994 Regulations sets out how the Guarantee Fund is to be calculated.

### **3.18 Valuation of explicit assets**

- 3.18.1 Broadly speaking, section 35A of the ICA 1982 requires a UK insurance company to ensure that its liabilities in respect of its insurance contracts are covered by assets of appropriate safety, yield and marketability. The assets must be appropriately diversified and adequately spread so that excessive reliance is not placed on investments of any particular category or description.
- 3.18.2 Assets which fulfil the relevant criteria specified in the regulations are referred to as “admissible assets”.
- 3.18.3 In very general terms, the valuation regulations are designed to arrive at the amount a company could expect to realise from its assets in the short term if it were to cease operations. Part VIII of the 1994 Regulations specifies the basis of valuation to be applied to each category of asset. The main principle behind the valuation regulations is that assets are valued at market value where this is ascertainable. Some types of asset are required to be valued on a more conservative basis than normal accountancy rules permit. For example, investments in, and debts owed by, subsidiaries are valued on the basis that the subsidiary is about to go into liquidation (“break up basis”) and not on a going concern basis, thus eliminating the value of goodwill and other intangible assets.
- 3.18.4 The maximum value of each type of asset that can be taken into the calculation of the value of assets is set as a percentage of the “long-term business amount” which is, approximately, the total policy liabilities excluding unit-linked business. These percentages are set out in Schedule 12 Part II of the 1994 Regulations and vary according to the risk inherent in holding the relevant asset. For example, any value of listed equities of any one company above 2.5% of the long-term business amount is disregarded.
- 3.18.5 Any asset not mentioned in the valuation regulations (for example, gold or commodities) must be excluded from the calculations. In other words, with the exception of cash, the asset is treated as having no value if there is no valuation rule for that particular type of asset.

### **3.19 Implicit items - future profits**

- 3.19.1 EU directives and UK legislation permit a value to be placed on the future profits of an insurance company. This is referred to as a “future profits implicit item”. If such an implicit item is permitted, it represents an intangible asset which can be included in the calculation of assets for the purpose of determining whether the RMM is being covered.
- 3.19.2 GAD explained to us the background to such items:  
  
“The background legislation...stems from the European Directives, particularly the First Life Directive going back to 1979. This says that at the discretion of the supervisory authority, the company may be allowed to count such items against 5/6ths of its margin of solvency, to its future profits calculation. The future profits calculation is then specified in the same Directive as being, in effect, 50% of the average profits earned over the last five years multiplied by the expected duration of the policy in force. The Directive just said that the supervisor could exercise their discretion, and it may be allowed as a solvency margin.”
- 3.19.3 GAD also explained the economic rationale for such items:

“the economic rationale is that in calculating the liabilities, the valuation regulations specify that the Appointed Actuary must make a prudent and conservative assumption about future rates of investment return, and it is then recognised that there is a degree of conservatism or prudence that is built into the system, and it is then permissible that companies may take some of this into account as an item that is available to cover the solvency margin. In effect, what we are saying is that if adverse contingency or experience should arise, then any such losses arising from that adverse experience would be offset against those future profits in the first instance.”

- 3.19.4 Regulation 24 of the 1994 Regulations sets out the requirements in relation to future profits implicit items. In order to obtain a Section 68 Order in respect of a future profits implicit item, the Appointed Actuary must certify that the amount applied for is less than the present value of the profits actually anticipated to arise in the future on the in-force business. The Appointed Actuary is not required in the application to state the assumptions he has used in this prospective calculation, or the results of this calculation. However, the 1984 DTI Guidance Note on Implicit Items (which is still current) states that the Appointed Actuary should use “cautious assumptions in regard to the future experience, in many respects similar to those required for the minimum basis for calculating mathematical reserves”.
- 3.19.5 Since 1994 Equitable Life has applied for on an annual basis, and been granted, a Section 68 Order permitting a proportion of future profits to be included as an implicit item in the calculation of its solvency margin. The table in Appendix 10 provides details of these applications and orders.

### **3.20 Implicit items - Zillmerising**

- 3.20.1 A number of life insurance companies reduce the calculated reserves for liabilities by an adjustment referred to as a “Zillmer adjustment”. The Zillmer adjustment allows for the uneven incidence of expenses incurred by a life insurance company writing new business and effectively spreads the acquisition costs of writing the policy over the lifetime of the policy in proportion to the premiums receivable. Consequently, Zillmer adjustments are only applied to regular premium policies and not to single premium (or recurrent single premium) policies.
- 3.20.2 If a life insurance company does not explicitly reduce its liabilities in this way, it is possible that it could apply for a Section 68 Order to allow this reduction as an implicit item.

### **3.21 Valuation of liabilities**

- 3.21.1 The overriding principles for valuing the amount of the liabilities are set out in Regulation 64 of the 1994 Regulations. Paragraph (1) of Regulation 64 requires:
- “The determination of the amount of long-term liabilities..... shall be made on actuarial principles which have due regard to the reasonable expectations of policyholders and shall make proper provision for all liabilities on prudent assumptions that shall include appropriate margins for adverse deviation of the relevant factors.”
- 3.21.2 Paragraphs (2) and (3) of Regulation 64 require that:
- “(2) The determination shall take account of all prospective liabilities as determined by the policy conditions for each existing contract, taking credit for premiums payable after the valuation date.

- (3) Without prejudice to the generality of paragraph (1) above, the amount of the long-term liabilities shall be determined in compliance with each of the regulations 65 to 75 below and shall take into account, inter alia, the following factors:
- (a) all guaranteed benefits, including guaranteed surrender values;
  - (b) vested, declared or allotted bonuses to which policyholders are already either collectively or individually contractually entitled;
  - (c) all options available to the policyholder under the terms of the contract;
  - (d) expenses, including commissions;
  - (e) any rights under contracts of reinsurance in respect of long-term business; and
  - (f) discretionary charges and deductions, in so far as they do not exceed the reasonable expectations of policyholders.”<sup>7</sup>

### **3.22 Valuation of liabilities - The Appointed Actuary’s obligations**

- 3.22.1 The “actuarial principles” referred to in Regulation 64 are set out in two Guidance Notes prepared by the Faculty and Institute, GN1 and GN8. As set out in Chapter 2, both GN1 and GN8 are designated as “practice standard” which means that they are, in effect, mandatory for Appointed Actuaries. The Appointed Actuary is required to certify whether he has fully complied with them in his certificate to the FSA as part of the regulatory returns.
- 3.22.2 GN1 deals with general matters. It states:
- “It is incumbent upon all Appointed Actuaries to ensure, so far as is within their authority, that the long-term business of the company is operated on sound financial lines and with regard to its policyholders’ reasonable expectations.”<sup>8</sup>
- 3.22.3 GN1 sets out in paragraph 4.1 the broad duties of the Appointed Actuary. The Guidance Note goes on to set out the extent of the Appointed Actuary’s responsibility and the duties of the Appointed Actuary. Paragraph 8.1 states:
- “The Appointed Actuary is required as part of the Appointed Actuary’s statutory duties to report to the Supervisory Authority in a prescribed form on actuarial investigations carried out under section 18 of the ICA 1982. It is the Appointed Actuary’s professional duty first to report in writing to the directors on the results and implications of any such investigation, whether or not an allocation of profits is involved. In the Section 18 Report to the Supervisory Authority, the Appointed Actuary should use best endeavours to ensure the financial results are presented in a way that demonstrates the true underlying position of the company and that these results are not distorted by any undisclosed valuation methods or assumptions.”
- 3.22.4 GN8, which is supplementary to GN1, draws the attention of the Appointed Actuary to certain aspects of Regulations 64 to 75 and their implications for the manner in which the valuation is carried out. In particular, it states that:

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<sup>7</sup> This sub-paragraph was added by the 2000 Regulations.

<sup>8</sup> Paragraph 1.1.

“Regulation 64 is paramount. The Appointed Actuary must use prudent bases determined according to actuarial principles, and which have regard to the professional considerations set out in GN1...”

3.22.5 Paragraphs 65 to 75 of the 1994 Regulations impose further requirements in relation to determining the liabilities. In particular, Regulation 72 requires provision to be made for options as follows:

- “(1) Provision shall be made on prudent assumptions to cover any increase in liabilities caused by policyholders exercising options under their contracts.
- (2) Where a contract includes an option whereby the policyholder could secure a guaranteed cash payment within twelve months following the valuation date, the provision for that option shall be such as to ensure that the value placed on the contract is not less than the amount required to provide for the payments that would have to be made if the option were exercised.”

It was the interpretation of Regulation 72 which was at the heart of the debate on reserving which took place between HMT-ID (later IFSD) and Equitable Life.

3.22.6 The effect of the 1994 Regulations and the professional obligations imposed on the Appointed Actuary is to require all life insurance companies to reserve on “prudent assumptions” for all guaranteed benefits and options exercisable by the policyholder which could secure guaranteed benefits. Prudent assumptions are a matter of actuarial judgement and are not defined in the legislation.

### **3.23 Reserving**

3.23.1 In broad terms, the reserves for life insurance policies are calculated as the expected value of any future contractual benefits to the policyholder discounted to the valuation date, offset against the expected value of that part of any future premiums which are required to provide the basic benefit, again discounted to the valuation date. Any premiums not required (on the valuation basis) to provide the basic benefit, together with the actual investment return in excess of that expected (on the valuation basis) is available to fund future expenses and provide future bonuses.

3.23.2 The expected values of the future benefits and premiums are assessed taking into account the likelihood of the policyholder dying or surviving over the duration of the policy. In calculating the reserves, it is generally assumed that policies will not lapse unless this increases the liability.

3.23.3 The rate of interest used to discount the expected values has a maximum value less than the interest earned on the assets. This ensures that the valuation basis remains prudent.

3.23.4 Future benefits to policyholders which are given at the discretion of the insurance company do not need to be explicitly reserved for, provided that policyholders would not reasonably expect that some level of discretionary benefit would be paid if the prudent valuation assumptions occur in practice.

3.23.5 In particular, the 1994 Regulations require that reversionary bonuses which have already been declared are reserved for, as these are contractual benefits, but future reversionary bonuses and terminal bonuses do not generally require explicit additional reserves.

### **3.24 Resilience reserves**

- 3.24.1 A number of different assumptions are made when calculating the value of liabilities of a life insurance company. These include economic assumptions (for example, about future investment returns) and demographic assumptions (for example, about future mortality). However, if the value of the assets change, the value of the liabilities will generally not change by the same amount. The result might be that after a change in asset values, the assets may be insufficient to cover the policy liabilities.
- 3.24.2 To protect against this risk, the 1994 Regulations require the company to demonstrate that it would have sufficient assets to meet the value of liabilities, even if there were to be a significant change in investment conditions. This is known as the resilience test. Its purpose is to ensure that the company would remain solvent without relying on its free assets if a change in financial conditions were to occur. The reserves which are required to satisfy the resilience test are known as the resilience reserves.
- 3.24.3 Regulation 75 provides:
- “The determination of the amount of long-term liabilities shall take into account the nature and term of the assets representing those liabilities and the value placed upon them and shall include prudent provision against the effects of possible future changes in the value of the assets on:
- (a) the ability of the company to meet its obligations arising under contracts for long-term business as they arise; and
  - (b) the adequacy of the assets to meet the liabilities as determined in accordance with regulations 65 to 74...”
- 3.24.4 The main professional guidance is set out in GN 8. Paragraph 3.9.2 of GN8 states:
- “Regulation 75 gives no indication of the range of possible future changes in the value of the assets which is to be allowed for. In determining an appropriate range, the Appointed Actuary must use professional judgement as an experienced financial practitioner. The essential point is that if changes, for example in market yield or currency values, would result in a change in the aggregate liability that is not matched by a change in the market value of the corresponding assets, then Regulation 75 requires the Appointed Actuary to consider what provision is required as a contingency margin, having regard to the consequences should the provision prove to be insufficient. In particular the Appointed Actuary needs to exercise special care with regard to any investments presenting novel or unorthodox features, derivatives (whether assets or liabilities) and any contracts containing substantial options.”
- 3.24.5 GAD, as part of its responsibility to review the regulatory returns, developed internal working guidelines as to the changes in market yields and equity prices which it might be considered prudent to take into account. The Government Actuary publishes these internal guidelines as “Dear Appointed Actuary” letters which are the *de facto* standard for testing the resilience of the reserving basis. It is relevant to note that these are guidelines and are not mandatory.
- 3.24.6 In a letter in September 1993 the Government Actuary stated:
- “For with-profits offices, we consider that the valuation should be tested for three different scenarios. Our benchmark at the present time would be:

- (1) a reduction in fixed-interest yields by 20% combined with a fall in value of equities of 10%;
- (2) a reduction in fixed-interest yields by 10% combined with a fall in equity values of 25%; and
- (3) a rise in fixed-interest yields of 3% combined with a fall in equity values of 25%.”

3.24.7 These scenarios were used until November 1998 when GAD wrote to Appointed Actuaries setting out a more complex version of the second scenario which allowed a modification of the test if the FTSE Index fell below 4500. Tests (1) and (3) remained unaltered.

3.24.8 Test (2) was changed again in September 1999. The test comprised a combination of:

- (a) a 10% fall in fixed interest yields; and
- (b) a fall in the value of equities of the greater of:
  - (i) 25%, subject to the fall being restricted to such as would not produce a P/E ratio on the FTSE Actuaries All Share Index lower than 75% of the inverse of the long-term gilt yield<sup>9</sup> before the assumed fall in paragraph (a); and
  - (ii) 10%.

3.24.9 On 15 May 2000 the Government Actuary wrote again to Appointed Actuaries. He noted that the recent revisions to the 1994 Regulations had made two of the three scenario tests unnecessarily severe and he therefore considered that revisions to the resilience tests were appropriate in the then current conditions<sup>10</sup>. In particular, the second scenario became a combination of:

- (a) a fall in the value of equities of the greater of:
  - (i) 25%, subject to the fall being restricted to such as would not produce a P/E ratio on the FTSE Actuaries All Share Index lower than 75% of the inverse of the long-term gilt yield before the assumed fall in paragraph (b); and
  - (ii) 10%;
- (b) for fixed interest securities:
  - (i) a fall in the yields on risk free securities of less than 5 years outstanding term to redemption and on short term deposits to the level which is calculated under Regulation 69(9) of the 1994 Regulations for future investments (or remain constant if already at or below this level);
  - (ii) the yields on risk free securities of at least 15 years duration remaining constant;

<sup>9</sup> As defined in Regulation 69(9).

<sup>10</sup> The letter foreshadowed the provisions of the Insurance Companies (Amendment) Regulations 2000 which were to come into effect on 29 May 2000.

- (iii) a fall in the yields on risk free securities of more than 5 but less than 15 years outstanding term to redemption to levels obtained by interpolating between the figures given by (i) above and the 15 year gilt index yield (or remain constant if already at or below this level);

(c) a fall in property values of 20%; and

(d) a rise in the real yields on indexed gilts of 10% (for example, from 2% to 2.2.%)

3.24.10 Where the nature and terms of assets and liabilities are well matched, then changes in investment conditions, as described in the above resilience tests, may require little additional reserves. However, when assets and liabilities are not well matched or the liabilities include onerous options or guarantees, then the resilience test may require significant reserves.

3.24.11 The test described in the letter of 15 May 2000 had a significant effect on the resilience reserves required by Equitable Life. On 11 August 2000, the Appointed Actuary estimated that this would reduce net explicit assets by some £600million.

### **3.25 Subordinated loan**

3.25.1 Equitable Life used a subordinated loan and, for the years ended 1998 and 1999, reinsurance to strengthen the financial position which was reported in its regulatory returns.

3.25.2 Under the 1994 Regulations, funds raised from the issue of loan capital do not count toward the RMM because the value of the money received would be offset by a corresponding liability to repay the loan with interest. However, the 1994 Regulations provide that subordinated capital may be counted if the obligation to repay the loan is subordinated to the rights of policyholders and a Section 68 Order is obtained.

3.25.3 If granted, the Section 68 Order, in effect, varies the terms of the 1994 Regulations to provide that the liability to repay the value of the loan capital may be excluded from the calculation of the company's liabilities up to (in the case of Equitable Life) 50% of the RMM.

3.25.4 In August 1997 Equitable Life entered into a £346million subordinated loan with a specially created subsidiary which had floated corresponding bonds on the market.

### **3.26 The interaction of asset shares and statutory reserving**

3.26.1 As noted above, the unsmoothed asset share for a with-profits policy is internal management information which is used to monitor the accumulated "value" of a policy. The total of all the asset shares for each policy compared with the tangible and intangible assets available is a measure of the ability of the insurance company to meet PRE.

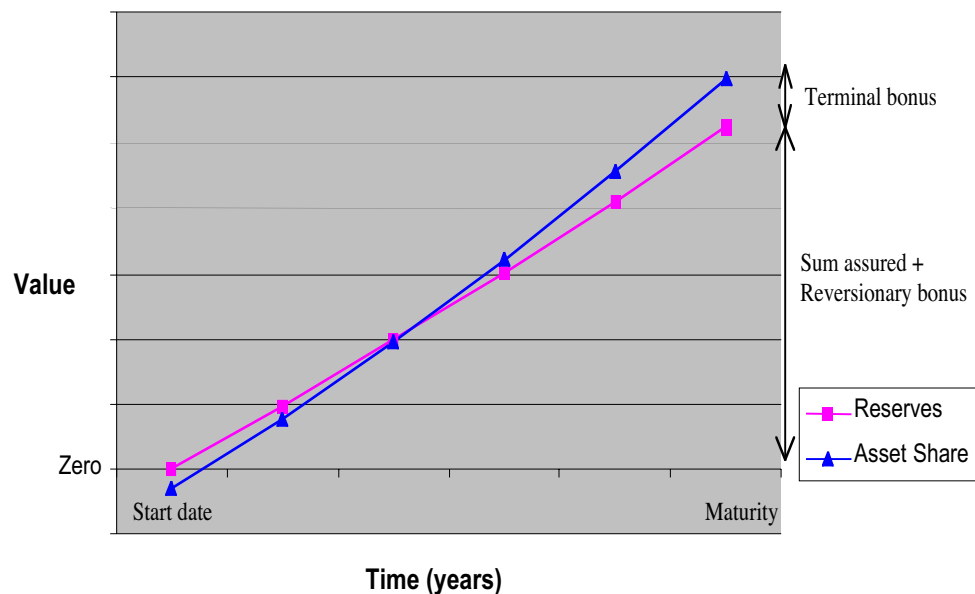
3.26.2 Once the policy reaches maturity, the Appointed Actuary must decide whether an appropriate claim value is simply the asset share (generally with the investment return smoothed in some way) or something more or less than the asset share so that the payout meets PRE. One aspect of meeting PRE entails the maturity value being consistent with previous maturity values on similar policies, taking into account contractual commitments and reflecting relevant marketing literature.

3.26.3 Further, the claim value is made up of the sum assured, previously declared reversionary bonuses and a terminal bonus declared at the maturity date. A major

part of the Appointed Actuary's role, in managing the finances of a with-profits policy, is deciding how much of the asset share the company should recognise from time to time by way of guaranteed reversionary bonus.

- 3.26.4 In setting the reversionary bonuses, the Appointed Actuary will have regard to the statutory valuation. The reversionary bonus affects the statutory valuation in two ways. Firstly, there must be enough surplus assets, assessed on the prudent statutory basis, to be able to finance the cost of the reversionary bonus. Secondly, once a reversionary bonus has been declared, it becomes a guaranteed benefit and hence must be provided for. This, in turn, limits the investment freedom of the insurance company because prudence requires that the higher the proportion of benefits that are guaranteed, the more that assets should be invested in lower risk investments, such as Government stocks.
- 3.26.5 Terminal bonuses are not guaranteed, but there must be sufficient surplus available to pay them.
- 3.26.6 Against these pressures to keep bonuses (particularly guaranteed reversionary bonuses) low, there are obvious commercial pressures from policyholders and intermediaries to make payments (and guarantees) as high as possible.
- 3.26.7 In balancing the pressures between financial prudence and the need to be competitive, the Appointed Actuary uses the unsmoothed asset share as a benchmark from which he can depart, but not by too much and not for too long.
- 3.26.8 The relative amounts of the asset share and statutory valuation reserves over the life of a policy are set out in the diagram below:

**Asset Shares versus Statutory Reserves**



3.26.9 As can be seen from the diagram, the unadjusted asset share is less than the statutory reserves at the outset of the policy, principally because of the high level of acquisition costs, which the unadjusted asset share recognises (but the statutory valuation does not). At this stage of a policy's life, it is a net absorber of capital. Later, the asset share exceeds the statutory reserves, with the result that the policy is effectively providing capital to the insurance company. The capital base of the insurance company, and hence its investment freedom, depends heavily on the amount of the excess of the capital provided by 'older' policies over the capital absorbed by the 'newer' policies.

### 3.27 Reinsurance

3.27.1 Reinsurance is the process by which a life insurance company transfers part of its risk under a contract to another life insurance company (which may be a professional reinsurance company). Reinsurance is a powerful portfolio management tool that enables insurance companies to accept large or unusual risks and reduce the effect of variations in claims experience from year to year.

3.27.2 Certain types of reinsurance also have financial objectives over and above simple transfer of risk. For example, some financial reinsurance can be used to improve the disclosed statutory solvency position of an insurance company, by obtaining reinsurance from a reinsurer located overseas, and not subject to the same requirements as a UK regulated insurance company. In interview, GAD referred to this as "regulatory arbitrage" and told us:

"We have always expressed our discomfort with these types of regulatory arbitrage arrangements and suggested to the companies that, if possible, the regulator may well seek to limit the benefits that can be derived from these arrangements. It is unsatisfactory, to the extent that the liability is going down a black hole, because you are taking it off one company's books and somebody else is taking up a liability but not making any provision for it."

3.27.3 This type of financial reinsurance takes account of the value of future surpluses that are expected to emerge from a portfolio of business. Possible forms of financial reinsurance include:

- (a) The insurance company receives a payment from the reinsurer in advance of the emergence of future surplus, in exchange for the reinsurer being granted the right to a proportion of that surplus when it emerges;
- (b) The reinsurer agrees to pay the cost of future claims, in exchange for the right to repayment from any surplus emerging after the claim is made under the reinsurance treaty. The insurance company is thereby able to reduce reserves without any substantial premium being paid to the reinsurer.

3.27.4 In both cases, it is key that the repayment to the reinsurer is subordinate to the rights of policyholders. It is usual for some premium to be paid to the reinsurer for the agreement and this premium will reflect the reinsurer's assessment of the risks that future surpluses may not emerge.

3.27.5 As described in Chapter 4, Equitable Life entered into a reinsurance agreement with Irish European Reinsurance Company Limited ("IERC"). This agreement fell into the second category described above. The risk premium paid at the outset of the agreement was £400,000 payable in two instalments, one of £150,000 payable on commencement and one of £250,000 on 1 April 1999. IERC agreed to pay for the

additional costs of GAOs should they be exercised on more than 25% of the value of funds retiring in any one year. If this occurred, IERC would be liable to pay Equitable Life an amount which equalled the additional cost of providing an annuity at the GAR, over the cost of an annuity at current annuity rates. However, IERC would then have “call” on the surplus emerging after the date of the claim on the reinsurance.

3.27.6 The agreement also provided that IERC would recover, in instalments, any sums it had paid to Equitable Life. The size of the instalments was limited so that payment would not make Equitable Life insolvent.

3.27.7 GAD explained to us the purpose of the agreement:

“The purpose of the treaty was to enable Equitable Life to reserve on a basis which was more akin to their view as to what a prudent reserving basis should be, because they felt that it required quite a significant change in the practice of policyholders for the take-up rate to get anywhere near 25%, which was the level which they felt was prudent. They negotiated with the reinsurer that the reinsurer should take the commercial risk that the take-up rate might exceed 25%, which the reinsurer was happy to do because it wasn’t under the control of the UK supervisory regime. If it was a UK-regulated reinsurer, we would require the reinsurer to set up the balance of the liability under the 75% that it was taking.”

3.27.8 The agreement was conditional on there being no change to Equitable Life’s terminal bonus practice; in the event, Equitable Life was able to renegotiate the reinsurance agreement following the House of Lords’ judgment. In the new agreement, the take-up assumption was increased to 60% which Equitable Life believed to be a prudent estimate of the additional take-up rate following the judgment.

### **3.28 Reserving for annuity guarantees**

3.28.1 As annuity rates declined during the 1990s the actuarial profession began to appreciate the consequent increase in the value of GARs. A report of the Working Party of the Life Board of the Faculty and Institute, which was published in November 1997, identified a number of possible approaches to reserving for GAOs in relation to with-profits business. Three possible approaches were set out “for consideration”:

- (a) “Allow for guarantees in the same way as for unit-linked business by setting aside additional reserves related to prudent estimates of cost over and above existing, unadjusted with-profits reserves;
- (b) Recognise the cost of guarantees as effectively increasing the guaranteed sum assured on some prudent basis. Net premium reserves are then recalculated on this basis;
- (c) Review whether and to what extent the guarantee will be covered by terminal bonus adjustments. Providing that terminal bonus adjustments will be used and are sufficient to cover guarantees in all circumstances, there is an argument for not reserving for such guarantees - no explicit provision is made for terminal bonuses and hence the provision for guarantees is simply part of this implicit provision subject to the existence of appropriate terminal bonus margins.”

3.28.2 None of these approaches was considered entirely satisfactory. The first approach was described as the “most prudent” so would have an adverse effect on the solvency margin and would therefore be unattractive to a company using it in isolation. The second approach was arbitrary in its effect. The report stated that the third approach,

which was the approach which Equitable Life adopted up to and including the 1997 year end valuation, “could be viewed as being unsound because no explicit provision is made for an explicit guarantee”. The report concluded that because of low interest rates and improving life expectancy, companies would need to work out how to reserve for guarantees.

3.28.3 GAD explained some of the background to us in the context of a letter written by a senior actuary, Professor David Wilkie, to an actuarial publication:

“He [David Wilkie] wrote a letter saying that actuaries are using a stupid assumption, or a stupid approach to valuing these sort of options. He was suggesting they should use stochastic methods. The problem is that, whilst interest rates are high and well above the strike price of the option, you don’t set up any provision. Even though you do a resilience test, the resilience test might not cause you to set up a provision. But, as interest rates come down, you start to expose the option and you start to need a provision. Unfortunately, in this particular case, interest rates sort-of collapsed in 1997, end of 1997, and fell from 6.5% at the end of 1996, I think it was, or even 7%, and ended up being of the order of 4.5%. So really, quite a dramatic fall, and it suddenly exposed these options on the basis, the way in which actuaries reserve for these sorts of options...Actuaries generally probably were caught out by this. Most offices don’t have the facility to do stochastic modelling and stochastic approaches to reserving.”<sup>11</sup>

### **3.29 Equitable Life’s approach to reserving for GAOs**

3.29.1 Prior to the decision of the House of Lords in July 2000, Equitable Life established reserves for GAR policies in reliance on its terminal bonus practice. Equitable Life took the view that there was only a very remote chance that this practice might be overturned and it did not therefore set up a reserve against this contingency.

3.29.2 In assessing the reserves required for GAOs in the context of Equitable Life’s terminal bonus practice, Equitable Life’s Appointed Actuary sought to rely on Regulation 72(1) of the 1994 Regulations (which is referred to above). Equitable Life maintained that, as a first step, a prudent assessment should be made of the proportion of retiring policyholders that would exercise the GAO based on a comparison of the income that would be available if the policyholder chose to exercise the GAO with the income that would be available if the policyholder elected to take an annuity at current annuity rates. In a letter from Equitable Life to GAD dated 30 October 1998, the Appointed Actuary wrote:

“All retirement cases are checked to determine whether, if a conventional non-profit annuity is required, the guaranteed annuity rate will produce a higher level of income. Currently that is so in around 30% of cases and clients are advised accordingly, even if their intention is known to be to take some other form of annuity. Interestingly, to date no such clients have actually chosen to take advantage of the guaranteed annuity rate - all have preferred a more modern form of annuity.”

3.29.3 Nevertheless, the Appointed Actuary felt it was prudent to establish reserves on the assumption that 30% of the vesting policyholders would exercise the GAO, based on this experience, and that the remainder would not.

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<sup>11</sup> Appendix 7 contains a graph showing the levels of 15 year high coupon gilt yields from 1976 to 1998.

- 3.29.4 Having made this assumption, Equitable Life valued the two groups of policyholders on different bases. For those exercising the GAO, Equitable Life made provision for the full value of the GAR, applied to the guaranteed value of the fund expected; for the others, it made provision merely for the guaranteed value of the fund without terminal bonus. In line with general reserving practice, Equitable Life did not reserve for terminal bonus as terminal bonus was not guaranteed. The result of applying this approach at previous valuation dates was that the additional reserves required for the GAOs were small in the overall context of Equitable Life's funds, and therefore were regarded as immaterial.
- 3.29.5 HMT-ID and, after 1 January 1999, IFSD, advised by GAD, took a different view. Their view was that the policyholder's decision not to exercise the GAO was based on there being sufficient terminal bonus to outweigh the value of the guarantee. This being the case, the terminal bonus was not "discretionary" and reserves should be established at least up to a level sufficient to cover the GAO.
- 3.29.6 Equitable Life's response was that this was tantamount to setting the proportion of vesting policyholders taking GARs to 100%, which was, in its view, excessively prudent. The regulator accepted that this was tantamount to a 100% proportion, but that this was the logical consequence of assuming that terminal bonus could fall to zero. This was because if the open market cash fund used in the initial comparison fell below the value of the GAR, the proportion of policyholders accepting the GAR would rise to 100%. The regulator also relied on Regulation 64(3)(c) of the 1994 Regulations (which requires all options available to the policyholder under the terms of his contract to be taken into account when determining the liabilities).
- 3.29.7 The subsequent debate, which is described in further detail in Chapter 4, was then conducted in terms of the appropriate proportion of policyholders accepting the GAR option, with Equitable Life eventually accepting that the proportion accepting GARs should be increased significantly. In the 1998 regulatory returns, Equitable Life adopted a proportion of between 70% and 82.5% depending on policy class. GAD subsequently pushed for the proportion to be increased to 95% or greater<sup>12</sup>.

### **3.30 January 1999 guidance on reserving for GAOs**

- 3.30.1 In early January 1999 the FSA prepared draft guidance to be sent out by the Government Actuary to all Appointed Actuaries of companies authorised to carry out long-term insurance business relating to reserving requirements for GAOs. The guidance was considered and commented upon by GCD.
- 3.30.2 The guidance asked Appointed Actuaries to reserve for GAOs on prudent assumptions. The guidance noted that it would not be prudent to assume that policyholders would choose to take a benefit of significantly lower nominal value than the guaranteed annuity. However, some limited allowance, of "a few percentage points" of the reserve could be allowed for the possibility that some policyholders might prefer to take their benefit in some other form, such as the perceived flexibility of a different type of pension arrangement.
- 3.30.3 IFSD explained the background to the inclusion of the reference to "a few percentage points" in the letter:

"The question was, were we going to put a number on it?, and it may well have started off originally as being 5%, and –but, I suppose, as with all good things, there would be a spread of actuarial opinion about how much flexibility you

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<sup>12</sup> See 3.31 below and Appendix 3.

should allow, and I suppose that, rather than settle on a number, in the end, as I say, I think it was the Government Actuary's suggestion that we go for "a few percentage points of the reserve". I suppose people felt that you have got to have – there was even a question about do you leave it at the point of saying that you have to be very close to the full value of the guaranteed annuity, very close to 100%; what does that mean?, and in the end, yes, it was thought that we needed to clarify in some way what "very close to" meant. Certainly, I suppose that everybody could agree that "very close to" meant a few percentage points."

- 3.30.4 The guidance was sent out under cover of a letter dated 13 January 1999 to managing directors of companies authorised to carry out long-term insurance business. The covering letter asked the managing directors to consider whether their 1997 regulatory returns had been prepared in a way which was consistent with the guidance, and that if not (and if, as a consequence, they would have shown a materially different financial position if they had been so prepared), they were asked to submit their 1998 regulatory returns by 31 March 1999 (three months early).
- 3.30.5 A copy of the January 1999 guidance on reserving for GAOs is in Appendix 2.

### **3.31 December 1999 guidance on reserving for GAOs**

- 3.31.1 In the 1998 year end regulatory returns, a small number of companies had interpreted the words “within a few percentage points” of 100% in the January 1999 guidance to mean a range of percentage points that went as low as 70%.
- 3.31.2 In mid-December 1999 GAD prepared amended guidance in relation to reserving for GAOs which, among other matters, referred to the meaning of “a few percentage points”. The guidance was reviewed by IFSD and GCD. The guidance was issued on 22 December 1999 by way of a letter to managing directors of all life insurance companies enclosing a guidance letter from the Government Actuary. The reference to “a few percentage points” was clarified to mean the total aggregate allowance that might prudently be made for all other benefit forms (whether cash or other forms of annuity) and that an allowance in excess of 5% would not be considered to represent “a few percentage points”. The letter also reported that the Government Actuary was reviewing the level of disclosure of the assumptions made in the regulatory returns. On the same day, the guidance was sent separately by GAD to Appointed Actuaries of insurance companies authorised to write long-term business.
- 3.31.3 A copy of the December 1999 guidance on reserving for GAOs is in Appendix 3.