

HM Treasury
Insurance Directorate



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The Managing Director
All companies authorised by the Treasury
to carry on long-term business

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Dear Managing Director

**GUARANTEED ANNUITY OPTION COSTS AND POLICYHOLDERS'
REASONABLE EXPECTATIONS**

As you will know the Government Actuary's Department undertook a survey of life offices' exposure to guaranteed annuity options (GAOs) earlier this year. The results of that survey indicated that the exposure to GAOs was relatively widespread within the industry and had the potential to have a significant financial impact on a number of companies. The nature of the guarantees offered by companies varied widely, but one issue that needed to be addressed by all companies was how the concept of policyholders' reasonable expectations (PRE) should be interpreted in the context of GAOs. The purpose of this letter is to provide some guidance to companies on the Treasury's interpretation of PRE in these circumstances.

As a starting point, we take the view that policyholders entitled to some form of annuity guarantee or option on guaranteed annuity terms could reasonably be expected to pay some premium, or charge, towards the cost of their option or guarantee.

Charging for the cost of providing a guarantee or annuity option

For linked contracts, any charge would have to be included within the normal explicit charges levied under the terms of the contract, and these charges could clearly only be raised to cover the costs of guarantees to the extent that this was permitted under the contract. Any cost arising to the office in respect of meeting the guarantees over and above the accumulated charges, would therefore have to be covered by the insurer from other available resources.

In the case of participating policies, any charge could be deemed to be met out of each premium received (or the investment return to be credited by way of bonus), and hence would impact on the assessment of bonuses, including in particular any terminal bonus that would normally be payable to the policyholders. Generally we consider that it would be appropriate for the level of the charge deemed to be payable by participating policyholders for their guarantee (or annuity option) to reflect the perceived value of that guarantee (or option) over the duration of the contract. This could be achieved in some cases through some reduction in the terminal bonus that would be payable if there were no such guarantee (or option) attached to the policy. However the selected treatment by each office would need to depend on the wording of the contract involved and how it had been presented to policyholders.

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Under the majority of participating policies which have been written it appears that any guarantee or annuity option is applicable to at least the guaranteed initial benefit under the policy and any attaching declared bonuses. As a consequence of this, we would expect that for most companies the present guaranteed cash benefits (including declared bonuses) would be converted, as a contractual minimum, to the annuity on the guaranteed terms. However as indicated above, it would appear possible, depending on the particular circumstances relating to the contract, that any terminal bonus added at maturity may be somewhat lower than for contracts without such options or guarantees, and that this terminal bonus could in some cases be applied at current annuity rates.

Apportionment of costs of GAOs not recovered under the relevant contract

In the case of both participating and non-participating contracts any residual cost for the insurer in respect of annuity options and guarantees will need to be recovered from available resources within the long term fund or from shareholder funds.

Where the long-term fund is to be used, we would in the first instance expect to see the cost met out of any 'estate' held by the company. However, where the cost is significant relative to the estate available, then an insurer may wish to consider adjusting the future bonus allocations for some or all of its participating policyholders, or making a transfer to the long term fund from the shareholders' fund.

The appropriateness of any such adjustments to bonus allocations for participating policyholders would need to be assessed by each office in the context of the reasonable expectations of all their policyholders. This assessment will be influenced by their policy documents and any representation made through marketing literature, bonus statements or elsewhere.

The above is the Treasury's considered view, and is without prejudice to any decision of the courts which may affect it.

Please supply a copy of this letter to your Appointed Actuary.

Yours sincerely

Martin Roberts
Director, Insurance