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DAA 11

The Appointed Actuary
All companies authorised by the Treasury
to carry on long-term business

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Dear Appointed Actuary

RESERVING FOR GUARANTEED ANNUITY OPTIONS

Further to Martin Roberts' letter of 18 December regarding the costs of guaranteed annuity options in the context of policyholders' reasonable expectations, he has agreed that it would be helpful if I were to provide some guidance to Appointed Actuaries of companies on the advice I have given him on the application of the existing reserving requirements in respect of contracts containing a guaranteed annuity.

2. I consider that Part IX of the Insurance Companies Regulations 1994 (ICR 1994) requires a life office to calculate its liabilities (and hence to reserve) on the basis of all the benefits offered under the contract. Regulation 64 of the Regulations requires long-term liabilities to be determined "on actuarial principles", and to "make proper provision for all liabilities on prudent assumptions". Regulation 64(2) makes clear that the determination must "take account of all prospective liabilities as determined by the policy conditions".

3. Contracts providing for a guaranteed annuity typically take two main forms - either:

- a contract to provide an annuity with an option to secure a cash fund; or
- a contract to provide a cash fund with the option to convert the benefits into an annuity at a guaranteed rate.

4. I would expect the reserving requirements to be very similar (if not identical) irrespective of whether the guaranteed annuity is the principal benefit under the contract or only an option. This is on the basis that in substance a policyholder will be entitled to the same choice of benefits irrespective of which is the principal benefit and which is the option.

5. In my view it is clear that, where a contract provides for a guaranteed level of annuity, then the effect of Part IX of the ICR 1994 is to require the company to reserve fully for its liabilities to provide annuity benefits to the value guaranteed under the contract. In addition it will be necessary to reserve fully in respect of any facility for policyholders to select an alternative form of benefits.

6. In assessing the extent of these liabilities, the company will need to make a prudent assessment of the extent to which any options are likely to be exercised. In this context I consider that, where the cost of meeting the guaranteed annuity benefits at maturity is significantly greater than the value of any alternative benefits, prudence will require the company to reserve for the contract at a level close to the full value of the guaranteed annuity. In general it would not in my view be prudent to assume that policyholders will choose a benefit form that is of significantly lower nominal value to them, although some limited allowance (of a few percentage points of the reserve) could in some cases be made for a reduction in the liability on the grounds of the additional flexibility or other perceived advantages to policyholders of any alternative benefits.

7. Where the levels of terminal bonus are to be adjusted with the aim of bringing the value of the guaranteed annuity option closer to the value of the alternative benefits, there might at first sight appear to be some room for argument that it was not necessary to reserve on the assumption that almost all policyholders will take the guaranteed annuity benefit. However, it needs to be remembered that, although the benefits formally "guaranteed" under the alternative form of benefit may be lower than those under the guaranteed annuity option, the company's discretion in setting the value of terminal bonus applied to the alternative benefit is limited as a result of the existence of the guaranteed annuity. It is likely that close to 100% of policyholders will exercise the annuity guarantee unless the company maintains terminal bonus at a level which ensures that the value to the policyholder of the alternative benefit is at least equal to the value of the guaranteed annuity. Accordingly, this constraint will need to be reflected in the valuation assumptions made about either the proportion of policyholders opting for the alternative benefit or the value of that alternative benefit. Consequently any reduction in the reserves held by the insurer by more than a few percentage points below the full value of the guaranteed annuity for this reason would require very careful justification by the actuary.

8. I am aware that many policyholders have in the past exercised their right to take up to 25% of the benefits of their pension policy in the form of a tax free lump sum. However, I would not consider it prudent to use past experience alone in this regard as a basis for reducing the percentage of benefits assumed to be taken in guaranteed annuity form. In my view there is a significant risk that there may be a marked change in policyholder practice if policyholders and their advisers view annuity guarantees as valuable and something that should be utilised to the full. For instance, there is the possibility that in future individuals with more than one pension policy will seek to maximise their benefits by exercising in full any guaranteed annuity option and only taking cash from those policies that do not carry a guarantee. In addition any further increase in the value of the annuity benefits relative to cash has the potential to lead to a significantly greater take up of annuity guarantees. As a result I would only consider it prudent to make significant allowance for a proportion

of available policy proceeds to be taken as cash, to the extent that policyholders are obliged to take some of the benefits as cash. Where policyholders are not obliged to take some of the benefits in cash, then the principles described in the above two paragraphs of this letter would apply.

9. In addition to holding mathematical reserves to cover their liabilities for annuity guarantees, companies will need to assess the extent to which a resilience reserve is required. I would expect companies to apply the recommended resilience tests and other general advice in my letter (DAA6) of 30 September 1993 (as amended slightly in my letter of 24 November 1998 - DAA10) in determining the need for a resilience reserve. The need to hold substantial mathematical reserves to cover guaranteed annuity options would not in my view be a sound argument for reducing the stringency of the resilience test applied.

10. The level of reserves established for guaranteed annuity options is likely to be one of the features of companies' 1998 annual returns which FSA and GAD will want to review particularly closely. It should be remembered that Schedule 4 of the Insurance Companies (Accounts and Statements) Regulations 1996 requires the actuary's report in the annual returns to include detailed information about the contracts written.

11. In particular, paragraphs 4(1) and 5(1) of the Schedule require the provision of a description of the benefits of the contracts written, including any material options. I would expect such a description to provide an indication of the form of any annuity guarantee offered. In addition, in accordance with paragraph 6(1)(h), actuaries should provide a description of the way in which reserves for any annuity guarantees and options have been determined (including an indication of the interest rate and mortality assumptions used). I would also expect that, in accordance with Instruction 9 to forms 51-54, categories of contracts containing annuity guarantees would be shown separately in those forms.

12. The annual returns should include sufficient information for the FSA and GAD to make an assessment of the extent of the guarantees offered, the reserving basis adopted by the company and hence the scope for guaranteed annuity options to impact on the financial position of the company.

13. The above is my considered view and is without prejudice to any decision of the courts which may affect it.

Yours sincerely

C D Daykin
Government Actuary