DAA13

22 December 1999

GOVERNMENT
ACTUARY'S
DEPARTMENT

NEW KING'S BEAM HOUSE
22 UPPER GROUND
LONDON SE1 9RJ

FAX (GTN) +44 (0)20 7211 2650
SWITCHBOARD +44 (0)20 7211 2600
DIRECT (GTN) +44 (0)20 7211 2620
E MAIL chris.daykin@gad.gov.uk

FROM THE
GOVERNMENT ACTUARY
CHRIS DAYKIN
CB Hon DSc MA FIA FSS ASA

Dear Appointed Actuary

RESERVING FOR GUARANTEED ANNUITY OPTIONS

As you will recall, I wrote to you and other Appointed Actuaries on 13January this year regarding the application of the reserving requirements in Part IX of the Insurance Companies Regulations 1994 in respect of contracts containing a guaranteed deferred annuity and a cash or other alternative.

Having now reviewed, at least provisionally, the majority of companies' 1998 annual returns, it is apparent that some aspects of this guidance have been interpreted in a variety of ways. It is clearly important that there should be consistency in the approach taken, and therefore the FSA has concluded that it would be helpful if I were to provide some further clarification on the reserving standards that would normally be expected to be seen in future HMT/FSA returns.

In my view, in determining the reserve for a contract containing a guaranteed annuity it would not generally be prudent to assume that policyholders will choose a benefit form that is of significantly lower nominal value to them than the guaranteed annuity. I indicated previously that I would expect any allowance for the reduction in the liability on the basis of policyholders making such choices to be limited to "a few percentage points" of the reserve. I would like to clarify that I was referring here to the total aggregate allowance that might prudently be made for all other benefit forms (whether cash or other forms of annuity) and that in my view an allowance in excess of 5% would not be considered to represent "a few percentage points".

There may be considered to be a stronger case for making an allowance for policyholders choosing to take a proportion of their benefits in the form of a tax free cash lump sum. However, I would not consider it prudent to assume that more than 20% of policyholders exercised the option to take the maximum cash lump sum permitted under the terms of the contract. In the case of most pension contracts, such an assumption would equate with a 5% reduction in reserve, the maximum aggregate allowance indicated above as likely to be accepted as prudent.

I am also reviewing the level of disclosure made by each company in their 1998 annual returns regarding the assumptions made to determine the level of reserve for contracts containing a guaranteed annuity. For the avoidance of any doubt, we would expect to see full disclosure of the proportions of policyholders assumed to take any available guaranteed annuity, along with the underlying mortality and interest rate assumptions. I should also add in this context that we would expect to see prudent allowance made for future mortality improvement both before and after the assumed retirement date, taking proper account of the recommendations in the latest CMI reports.

Yours sincerely

C D DAYKIN

THE EQUITABLE LIFE ASSURANCE SOCIETY

V

ALAN DAVID HYMAN

High Court, Chancery Division, 9 September 1999

Originating summons – Allocation of final bonuses – Breach of contract – Exercise of discretionary powers – Policyholders' 'reasonable expectations'

Facts

- This was an originating summons seeking declarations on the question of whether the Equitable Life Assurance Society (**the Society**) is entitled, on allocating final bonuses among its with-profits policyholders, to allocate bonuses to one class of policyholders (whose policies included a guaranteed annuity rate, or **GAR**) at a lower rate than the rate at which it awards bonuses to other policyholders (whose policies were without such a GAR provision), and more specifically whether the Society can award reduced bonuses – or no bonuses at all – to policyholders whose policies contain GAR provisions.

- It was contended on behalf of the policyholders that to award lower bonuses to these policyholders than are awarded to others would be in breach of contract and that to do so would be an improper exercise by the Society of its discretionary power to allocate such bonuses.

Law

- In cases such as the present, the Directors should take into account the collective and reasonable expectations, objectively ascertained, of policyholders as a class.

- A reasonable expectation does not become a contractual right.

Held

- There was nothing contractually improper in the allotment of final bonuses on the conditional footing adopted by the Society in the 1994 to 1998 bonus declarations, or in the 1999 bonus declaration.
- The Society's decision to reduce the final bonus of a policyholder who took his benefits in GAR-based annuity form did not deprive the policyholders of part of their asset shares, and therefore was neither irrational nor inconsistent with the object the Society purported to be trying to achieve.
- The 'cost of the contract GAR commitment' is the same as the current value of the GAR-based annuities. The current value of the GAR-based annuity is a measure of the benefits funded by the Society's assets which the policyholder receives. The amount, if any, of the top-up can be calculated accordingly.
- There was no contractual obligation on the Directors to allot the final bonus in such a way as to aim to bring the policyholders guaranteed funds up to the notional asset share. Since there was no contractual obligation to do so and their decision to allot final bonuses on a different basis, a basis that used asset share as the yardstick for the value of benefits taken rather than as a yardstick for the capital sum by reference to which the amount of the annuity taken was calculated, was a decision well within their discretion.
- In such cases as the present one the policyholders' reasonable expectations should play a part in the Directors' decision as to which bonus policy to adopt and that the reasonable expectations which should be taken into account will be the collective reasonable expectations of the policyholders as a class.
- There was no basis on which the manner in which the Directors exercised their discretion can be categorised as irrational. There were no irrelevant factors that they took into account or any relevant factors that they should have taken, but failed to take, into account.

Cases referred to:

- *Edge v Pensions Ombudsman* [1998] PLR 15, [1998] Ch 512
- *Piglowska v Piglowska* [1999] 1 WLR 1360, *The Times*, 25 June 1999
- *Scott v National Trust* [1998] 2 All ER 705

Legislation referred to:

- Insurance Companies Act 1982
- Insurance Companies Amendment Act 1973