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Morris Review Of the Actuarial Profession
Room G38
1 Horse Guards Road
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By email attachment.

Dear Sirs

INTERIM ASSESSMENT, December 2004 – AN INDIVIDUAL RESPONSE

The Interim Assessment vindicates my concerns of 1 August 2004 on the impact of actuarial aberrations now exposed to public scrutiny; exuberant application of high equity returns (1.31, 1.32 & 1.40), absence of responsibility for product design (5.46) and compounded by other cultural failings expressed in the Executive Summary.

Whilst the Review is to consider the future Role, I would hope that the Final Report makes reference to the huge losses incurred and to be incurred by policyholders, scheme members and pension beneficiaries, and where considered necessary, to recommend changes in legislation to the Government, so that such disastrous losses cannot recur and financially impair more families.

- Endowment Mortgages £30.0 billion
- The Equitable Life Assurance Society £ 1.5 billion
- Pension Schemes “Under-funding” £93.0 billion

The originating cause of these losses could be considered to begin during a time of self-regulation that did not restrict the proportion of equity loadings in life and pension funds; from 30% in the 1960's to 65% plus during the market booms of the 1980's. In the USA, the world's largest life assurance market, companies are regulated to a 15% limit. The stability and certainty of centuries old with-profit life funds depended greatly upon their gilt, bond and mortgage loadings, but the shift to equities removed that stability.

It is not so much that the increase in the equity loading of the funds is to be decried, but it is the exuberant application of the higher rates used in actuarial procedures without any cautionary duty of care or regulation. It must be questioned whether the relatively short duration of the high equity loadings provides adequate experience to be applied to pension schemes where membership may survive 70 years.

Equity investment is uncertain, and certainly not for pensioners! Regardless of justifications, the figures are damning and self-evident of the failure of a profession.

ENDOWMENT MORTGAGE POLICIES (EMP)

An inquisitive Inquiry, or The Treasury Committee following up on its report, should reconsider the culpability of the insurers. Following the Interim Assessment, the hypothesis for “mis-selling” appears to have created, prematurely, a compensation scheme to protect the insurers from higher liability costs rather than contributing towards policyholder losses, without exclusion. The scale of the losses would suggest that this actuarially designed product was unsuitable for the purpose for which it was sold. Several million pre-1988 policyholders were excluded from the compensation scheme and several million more will lose their right to claim when the insurers impose their time limits. The fact that only 6% of those entitled to claim have done so does not vindicate the industry.

Up until the 1970's, the Endowment Assurance With Profits (EAWP) policy was sold, and fully understood by policyholders, with a single basic sum assured and topped-up with bonuses, in the strictest of terms, at maturity. From the 1970's, lenders, that included some insurers, were prepared to consider future bonuses as security, which led to an actuarially redesigned EAWP, the “low-cost” EMP, *where the non-guaranteed “bonuses” became an integral part of the illustration to match the mortgage offer*, a fact not openly presented. The guaranteed capital repayment content of a 1989 EMP over 25 years was approximately one sixth, even smaller for longer durations, of the amount required to redeem the mortgage.

The Treasury Committee Report clearly presents the financial consequences of this inadequate product, but the real damage will emerge on policies maturing at age 65.

Just a comment, LAUTRO required members to quote using a standard “illustration form” calculated on common rates of interest neutralising competition between members, as was the absence of fund performance data. In the USA (5.46), the use of such forms would have required the prior approval of the Insurance Commissioner's Compliance Department.

THE EQUITABLE LIFE ASSURANCE SOCIETY (ELAS)

“Equity exuberance” (1.31) was the underlying cause for the unsustainable GAR Option, and at one time, 11%pa for a male aged 65, where current rates are significantly lower.

ELAS introduced discretionary bonuses differentiating between policies with and those without the GAR Option. *The purpose was to reduce the final bonus taken by GAR policyholder so that the value of the GAR based annuity was no greater than the value of the annuity had the policy not had the GAR Option.*

A cynic might ask whether this is the only example of the actuarial equivalent of “creative accounting”, namely, “creative actuarialling”? Even today, ELAS argue that this extreme actuarial logic to reduce liabilities to within assets was justified. Lord Penrose reported surprise that it took the relatively small sum of £1.5 billion (a “reserved role” calculation?) to bring down ELAS.

The history and tradition of ELAS, founded in 1762, determined the culture of the actuarial profession and that of its over-seeing Institutes.

THE PENSION FUNDING CRISES

A “double whammy” of calamities.

- The “exuberant” application of high equity earnings.
- Improving longevity.

The first whammy commenced during the 1980’s stock market boom. Subsequent statutory valuations with the re-projection of higher interest rate earnings produced “paper” surpluses. The trustees released these surpluses to the employer, not to the employee, as contribution holidays over a period of years; note the Daily Mirror Group under Maxwell. The later re-projection of lower interest rate earnings, partly caused by a repositioning of the investment portfolio, resulted in those same pension funds showing the considerable black holes of today.

The second whammy has been the recently reported improvement, but unanticipated by the actuaries, in life expectancy that has significantly increased the annuity liability of pension funds. “ Reciprocally, it should reduce the death risk cost in life premiums.

PERSONAL VIEW OF “THE ROLE OF THE ACTUARY”

- The “Role of The Actuary” should be considered within the statutory regime within which it operates. The UK Actuary is unique in having such wide discretionary powers in determining the assumptions in the valuation of the life and pension funds. The regulatory regime of each USA Insurance Commissioner is such that they determine the assumptions whilst undertaking their own independent statutory valuation and audit of the insurance firms within their jurisdiction. The over-whelming dominance and depth of authority of UK actuaries greatly exceeds that of its American counterparts; they are not equals in status.
- Actuaries, student and qualified, prevail at all levels of management through to the CEO, and so it is difficult to differentiate between the culture of The Actuarial Profession from that of the organisation in which they are engaged, particularly with the authority ceded by the “reserved role”. It is open to question whether the recent FSA (from CP167) directives will bring about the necessary changes to the culture of The Actuarial Profession presently ensconced in life assurance and pension management and on Boards of Directors. Note the reluctance of Standard Life to reduce its equity loading and the FSA’s repeated criticism of the perceived lethargy with which the firms are handling compensation claims from EMP policyholders. The passive resistance to the Statutory Regulator does not bode well for new regulation.
- In the 1980’s, the actuarial Institutes sought to diversify from their “reserved role” in insurance to others areas of their own self-professed expertise. “Actuary” has become another brand name consultancy and is marketed by The Institutes in the sale of that expertise and in (unwelcome?) competition with other specialists in the financial markets. From the early 18th Century, the original expertise of The Actuary lay in the application of mortality in the calculation of premiums for death risk insurance. Perhaps, the “reserved role” should be restricted to its mortality origins and the Insurance Actuary be separated from the Consultant Actuary with their own separate Institutes?
- Finally, the complacency of the profession to these losses is beyond belief.

PERSONAL OBSERVATIONS

A life fund valuation need not be the sole preserve, within the forum of The Institutes, of a single Actuary, but by a "Valuation Board" comprising all relevant disciplines. For example, life and annuity funds valuations with life expectancy prognoses from medical and research specialists and equity analyses from other professionals of the LSE. The actuarial application (or straight-lining?) of past statistics has been most fallible.

The ABI proudly boast that their members hold funds in the FTSE 100 companies of nearly £1,000 billion, approximately 25% of the FTSE 100 total value. How much of this sum is regulated under the "reserved role" of The Statutory Actuary? Pension fund black holes impact the operation of the stock market and may prejudice mergers and acquisitions as, for example, the £147 million, in Sir Phillip Greens' 2004 failed take-over bid for Marks and Spencer.

As evidenced by Ron Sandler, the EAWP has ceased to exist as the prime savings product of the life assurance industry. The withdrawal of the industry subsidies of MIRAS and of the LAPR percentage, the latter approximated an insurer's charges to the OB and IB life funds, has exposed the structural weakness of the industry in a time of lower equity values and its dependency on the endowment range of policies. Currently, there are nearly thirty life funds that have been closed for new business, Standard Life no longer issue Term Assurance policies and some companies do not quote for endowments. In addition, final salary pension schemes are being closed to new members with the trend to money purchase schemes for annuity purchase at retirement. The EAWP barely exists in the USA market where a "buy term and invest the rest" is a common strategy, but underpinned by whole of life assurance. An American carries seven times the life assurance volume, even with taxed premiums, to that of its UK counterpart.

A life fund includes mortality and capital saving elements, yet the miniscule mortality cost proportion requiring actuarial expertise cedes total and unquestionable authority over the whole of the fund to the "reserved role" of The Statutory Actuary. Sole actuarial discretion for surrender value charges (reported as 18% on EMPs) and fund withdrawal penalties (20% by ELAS) should be subject to FSA scrutiny.

Consequently, should not life assurance portfolios and their regulation be split into their constituent parts?

- Mortality related and annuity funds with reserved actuarial functions regulated by the FSA, but under a regime similar to that exercised by the USA's Insurance Commissioners or by the regulators in Germany.
- Investment only funds without reserved roles and regulated by the FSA.

What does the future hold for "The Role of the Actuary" in the life assurance industry with the loss of the primacy of its products and no longer supported by indirect tax subsidies?

Your patience is appreciated.

Yours faithfully

J K Flowers FCII