

SUBMISSION TO THE MYNERS INQUIRY

29 August 2004

By D. O. Forfar, MA, FFA, FSS, FIMA, CMath.

1. Introduction

I understand that you are asking for submissions from individual actuaries as part of your remit to look at the governance of mutual life offices. I hope the views below will be helpful.

I was employed by the Scottish Widows Fund and Life Assurance Company for twenty-seven years. I was the Appointed Actuary of the company from 1992-1995.

Details of my experience are on my web-site at <http://uk.geocities.com/doforfar@btopenworld.com/index.html>

During my tenure of this post, the Scottish Widows was a financially very strong mutual life office (i.e. it had a very strong *Estate*- see below for definition of *Estate*), and was usually at the top, or near to the top, of actual results on with-profits endowments.

The Scottish Widows demutualised and was sold to Lloyds TSB and the transaction was completed in 2000.

I am writing in a purely personal capacity. As a matter of courtesy, however, I am sending a copy of this submission to the President of the Faculty of Actuaries.

My concern is the corporate governance of a mutual life office which undergoes a demutualisation and the role of non-executive directors in that demutualisation process. In particular, my concern is with the fate of the *Estate* in any demutualisation. This relates to Q13, Q4, Q5, Q6 and Q7 (quoted below) of your Review.

Q13. (a) What are the forces that drive de-mutualisation?

(b) What are the implications of demutualisation for members and customers?

Q4. In your experience, is the information and advice (including actuarial advice) used by the non-executive directors of life mutuals sufficient – in terms of quality and relevance – to enable them to exercise effective oversight of the executive? In what ways might it be improved? If more information and advice is needed, what are the resource implications? Do similar issues arise for the non-executives of other complex businesses, such as wholesale banking or science-based businesses?

Q5. What is the role of the non-executive director in a complex or technical business? In particular what is their capacity to understand and to challenge the executive over technical aspects of the business?

Q6. What can the owners of a complex or technical business reasonably expect of its non-executive directors? How would you characterise the practical limitations of a non-executive director? What steps might be taken to codify what is reasonable and realistic in this context? Should executives and non-executives have the same legal duties to the company?

Q7. What role should policyholders play in the running of mutual life companies? Are there practical barriers to policyholder participation in UK life mutuals? What action would be needed to allow more effective engagement?

2. Estate

The Penrose Inquiry into Equitable Life emphasised the importance, for a mutual life office, of having a strong *Estate* (within the with-profits fund) which is held in perpetuity for all policyholders both current and future i.e. the *Estate* belongs to no one generation of policyholders.

However, the Equitable Life, despite being founded in 1762, had no *Estate* in July 2000 or even a negative *Estate* and therefore could not bear the unexpected cost to Equitable Life which resulted from the House of Lords judgment. (See Penrose Report, Chapter 6 paras 48,49,56,84 and Tables H.1 and Table H.2 where the Equitable's *Estate* in respect of '*already matured*' policies is put at minus £1.8bn)

The Scottish Widows, when it was a mutual life office, had an *Estate* which was sufficiently large to enable it to bear the cost of the House of Lords judgment (see paragraph 4 below).

(The *Estate* is the 'financial strength' of the with-profits fund and has been built up by prudent management of the life office over 100 years, or more. The *Estate* has been built up slowly and steadily from profits from non-profit business and/or from taking a tiny slice out of the maturity pay-outs of maturing with-profits policies and letting compound interest over 100 years, or more, do the rest.)

The *Estate* is held in perpetuity. By definition, no current policyholder has contributed to the *Estate* as current policyholders have only contributed to their *unsmoothed asset share*.

(*Unsmoothed Asset Shares* are the retrospective accumulation of premiums plus investment return less the expenses of administering the life office and mortality costs. Terminal bonus is based, broadly speaking, on the *smoothed asset share* (smoothed meaning smoothing out the peaks and troughs of investment returns). The *Estate* is thus the spare resources of the with-profits fund and is the value of the assets of the with-profits fund in excess of the *unsmoothed asset shares* of the with-profits policies.)

The *Estate* can amount, in a financially strong with-profits office, to several billion pounds, perhaps 20-40% of *unsmoothed asset shares*.

The *Estate* is needed for smoothing maturity payouts in order that with-profits policyholders are not '*hostages to fortune*' as to the level of the stock-market on the day when their policies mature i.e. peaks and troughs of the investment return are smoothed out.

As the Penrose Report points out, any smoothing upwards of maturity pay-outs in the with-profits fund (i.e. to a level above the *unsmoothed asset share*) cannot be done fairly if smoothing upwards can only be done by having to take money out of the *unsmoothed asset shares* of other with-profits policies. Such a practice involves "*having to rob Peter to pay Paul*". This means "*having to rob Peter's unsmoothed asset share in order to pay Paul's smoothed asset*". A life office with no *Estate* is then accused of 'over-bonusing' the with-profits fund and running it as a Ponzi scheme (as has happened in the case of Equitable Life). If a life office gets the smoothing wrong then Peter suffers unfairly.

This means that a strong *Estate*, held in perpetuity within the with-profits fund, even in a proprietary office (and nothing to do with shareholders) is necessary for with-profits policyholders to be treated fairly in compliance with Financial Services Authority Principle No. 9 ('*treating customers fairly*').

The *Estate* in the with-profits fund is also needed for:-

- (1) meeting any policy guarantees including guaranteed annuity rates,
- (2) meeting any options in a policy,
- (3) giving support to the ongoing operation of the with-profits fund,
- (4) enabling the office to have investment freedom without relying on shareholders money (money in the non-profit fund, apart from that required to cover non-profit policyholder liabilities, is part of shareholder value),
- (5) funding policies, like Sandler products, which have a payback period longer than shareholders are willing to fund,
- (6) meeting any mis-selling costs (to the extent that these are not all borne by the shareholder).

An *Estate* can enable all these things to be done without damaging the reasonable expectations of policyholders and without any recourse to shareholder value.

(Shareholder value is the sum of *two amounts*. The *first amount* is the value of the non-profit fund in excess of the value of liabilities for policyholders holding non-profit policies. The shareholder effectively owns the non-profit fund in excess of policyholder liabilities in this fund. The shareholder derives 100% of the profit from the non-profit fund. The shareholder can remove the part of the non-profit fund in excess of policyholder non-profit liabilities. The *second amount* is the value of the shareholder fund. The shareholder also normally receives a share of the profits in the with-profits fund - usually equal to the value of one-ninth of future bonuses on conventional with-profits policies.)

In my view, a board (of a life office) which allowed more than about 10% of the *Estate* to be sold to the new shareholders (e.g. in a demutualisation of a mutual or, as in the AXA case of a proprietary life office, by a re-attribution of the *Estate*) has done considerable damage to the corporate governance of both mutual and proprietary life offices.

In my view, the Regulator should have said that it is illogical, on the one hand, to have a Ministerial Statement of 24 February 1995 stating that:-

“A life office may make distributions from surplus in the long-term fund as shown by the statutory annual actuarial valuation. It is common practice to make distributions to policyholders and shareholders in the proportion 90-10. In assessing policyholders’ reasonable expectations, the Department would expect this ratio to be used as the basis of attribution [of the Estate] between policyholders and shareholders, unless there was clear evidence, based on a company’s circumstances, statements or practice, that a different proportion was appropriate in respect of the surplus arising from some particular part of the business.”

And, on the other hand, to allow 100% of the *Available Estate* (see below for definition of *Available Estate*) of a mutual life office to be sold by the current generation of policyholders to the new shareholder(s) in a demutualisation.

To me, the logical deduction from the Ministerial Statement is that, in a demutualisation, the current generation of with-profits policyholders cannot benefit from selling off 100% of the *Available Estate* as the *Estate* was previously held in perpetuity for all generations, current and future, of policyholder (see view of Mr. A. Shedden, FFA below). If 100% of the *Available Estate* is sold to shareholders then, when all those with-profits policies in-force at the time of demutualisation had gone off the books, the life office would be denuded of its *Estate*.

The one exception to this might be where the transaction of with-profits business is to cease in the future but even then the smoothing of maturity payouts on current policies, which is part of the reasonable expectations of the current generation of with-profits policyholders, would be damaged by selling the *Available Estate*.

In my view, the Regulator has insufficiently appreciated the importance of holding a strong *Estate*, in perpetuity, within the with-profits fund. In the AXA life office case (involving a proprietary life office) a strong *Estate* was sold to shareholder(s) for a fraction of its face value. The Regulator permitted this.

Furthermore, a demutualised life office may be very reluctant to write any further with-profits business as they have no internal strength (*Available Estate*) in the with-profits fund and the shareholder may not be prepared to use their external strength (the former *Available Estate* now sold to shareholder) for smoothing, guarantees, options etc. There is a great difference between the internal financial strength of a with-profits fund and strength external to the with-profits fund because the external strength is owned by the shareholders and forms part of shareholder value. Further the external strength, in contrast to internal strength (the *Estate*), will not be willingly used for the benefit of policyholders because of the dangers of doing so (these dangers are described below in Section 5 below).

It destroys the internal financial strength of the with-profits fund if, in a demutualisation, the *Available Estate* now becomes part of shareholder value and therefore there is no longer any *Available Estate* held in perpetuity within the with-profits fund.

(The *Available Estate* means the *Estate* after earmarking some of the *Estate* to protect transferred policyholders so that their asset share is calculated as if they were still in a mutual life office (i.e. they are protected even although they have to transfer one-ninth of the value of future bonuses to shareholders). It also allows for some of the *Estate* to be earmarked for policies with guaranteed annuity rates following the Law Lords judgment. With-profits policyholders transferred from a mutual company to a plc company need to transfer one-ninth of the value of future bonuses to shareholders.)

3. The Estate of the Prudential Insurance Company

The Prudential Insurance life office has an un-attributed *Estate* (un-attributed between policyholders and shareholders) of some £5bn within the with-profits fund which if they divide approximately 90/10 (policyholders/shareholders) will still leave an *Estate* of £4.5bn within the with-profits fund. Many commentators are saying that a demutualised life office, now with no *Estate* in perpetuity to speak of within the with-profits fund, is unable to compete in the IFA marketplace.

4. Views at the Faculty and Institute meetings to discuss the paper ‘With-Profits without Mystery’

At separate meetings of the Faculty of Actuaries (held on 19 February 1990) and the Institute of Actuaries (on 20 March 1989) to discuss the paper ‘*With-Profits without Mystery*’ clear doubts were expressed (within the normal standards of professional etiquette) that it was possible to run a with-profits fund fairly without an *Estate*. (see discussion on the above paper in *Transactions of the Faculty of Actuaries*, **42**, pp139-186 and *Journal of the Institute of Actuaries*, **116**, pp301-345.).

Mr. A. Shedden, one of the most respected figures in the U.K. life industry a former President of the Faculty of Actuaries, then the Appointed Actuary of Standard Life (a major with-profits office) said:-

“Most actuaries today are still likely to subscribe to the entity theory of mutual company operations under which the Estate is deemed to belong to no-one”

i.e. Mr. Shedden was indicating that most actuaries subscribed to the theory that you needed a strong *Estate* within the with-profits fund which is held for policyholders in perpetuity and belongs to no one generation of policyholders.

Mr. M. Ross, then the Appointed Actuary of Scottish Widows (another major with-profits office) said:-

“Free Assets (i.e. an Estate) are likely to be required over and above the unconsolidated terminal bonus element”.

Mr. P. Kilgour, Appointed Actuary of Scottish Life (another life office with a large portfolio of with-profits business), said:-

“this excess (by which he meant the Estate) being a dowry which is passed on by each generation of policyholders to the next ... The existence of this dowry adds extra security....”

It could not have been clearer that actuaries with a wealth of experience of running with-profits funds were saying you needed an *Estate* within the with-profits fund. But it was up to the DTI to take this on board. It does not seem to have done so. The DTI did not intervene to prevent the Equitable continuing to transact business with a negative *Estate*. (see Penrose Report, Chapter 6 paras 48, 49, 56, 84 and Tables H.1 and Table H.2 where the Equitable's *Estate* in respect of 'already matured' policies is put at minus £1.8bn.).

It is being asked whether the DTI, despite its legal duty to monitor PRE, realised that Equitable were operating with a negative *Estate*.

The Scottish Widows needed to release some 40% of its *Estate* to comply with the Law Lords judgment. The strength of Scottish Widows was that they had an *Estate* of about £4bn so, even after the 40% release (worth about £1.5bn), they still had £2.5bn left in the *Estate*. The Scottish Widows could withstand the Law Lords judgment even although they may not have agreed with it. In contrast, the Equitable had a negative *Estate* in July 2000 and so immediately were rendered insolvent by the Law Lords judgment.

5. Shareholders and the with-profits fund

It is becoming clear that the shareholder is not prepared to use their value (if the former *Available Estate* is sold to shareholders and becomes part, in a demutualisation, of the non-profit fund belonging to shareholders) for smoothing policy pay-outs, policyholder guarantees, or policyholder options because the dangers of doing so are:-

- (1) the shareholder is not willing to pay money from the non-profit or shareholder fund to the with-profits fund because the shareholder can only take one-ninth of future bonuses out of the with-profits fund. In contrast, the surplus in the non-profit fund (the part not needed to cover non-profit policyholder liabilities) belongs 100% to the shareholder,
- (2) if the shareholder makes a loan to the with-profits fund from the non-profit fund the shareholder may never get the loan back,
- (3) it will damage the share price at a time when markets are falling but that, paradoxically, is the time smoothing of pay-outs is most needed,
- (4) the shareholder may wish to remove part of the non-profit fund (the former *Estate*) from the life office.

6. Non-executive directors

In the demutualisation process, the non-executive directors may be unaware of the importance of an *Estate*.

Your Review asks in Q4(a) whether:-

Q4.(a) In your experience, is the information and advice (including actuarial advice) used by the non-executive directors of life mutuals sufficient – in terms of quality and relevance – to enable them to exercise effective oversight of the executive?

For the reasons given above, my answer to Q4(a) is no.

Your Review asks in Q5(b)

Q5.(b) In particular what is their capacity to understand and to challenge the executive over technical aspects of the business?

For the reasons given above, my answer to Q5(b) is that the capacity of non-executive directors to understand and to challenge the executive over technical aspects of the business is poor.

7. The policyholders and customers

Your Review asks the question Q7.:-

Q7. What role should policyholders play in the running of mutual life companies? Are there practical barriers to policyholder participation in UK life mutuals? What action would be needed to allow more effective engagement?

In my view the policyholders, who own the mutual life office, should play a larger role in the corporate governance of that life office, particularly when it comes to two crucial matters.

(1) *Policyholder reasonable expectations (PRE) (FSA Principle No. 9 'treating customers fairly')*,

It was my experience as an appointed actuary, on the occasion of advising the board on the interpretation of policyholders' reasonable expectations (PRE) or treating customers fairly, that it would have been useful to have a small group of responsible policyholders where these matters could have been discussed – otherwise the appointed actuary (or with-profits actuary as proposed) is only putting forward his views, albeit honed in the light of his contact with other actuaries at professional meetings. It would be useful and helpful to have discussed these matters in advance with a representative group of policyholders. Then it would have been more powerful to say to the board, particularly to the non-executive directors, *"I have discussed PRE with a representative group of policyholders and they agree with my interpretation of PRE."*

(2) Where a *demutualisation* is proposed,

The with-profits policyholders current at the time of demutualisation (and the non-executive directors) might never be informed that the internal financial strength of with-profits fund would be destroyed if all the *Available Estate* were to be sold to the new shareholder. They may never realise that it damages the expectations of current with-profits policyholders who wish to top up their benefits as policyholders (current at the time of a demutualisation) reasonably expect any smoothing, guarantees and options to be met without damaging their reasonable expectations or those of other policyholders or damaging shareholder value. Indeed they may not realise that the demutualisation cash or share windfall paid to them may have to be paid for, at least in part, by a cut in the terminal bonus on their actual maturity payouts.

8. Conclusion

In my view, in the demutualisation of a mutual life office, around 90% of the *Available Estate* needs to be held in perpetuity within the with-profits fund for the benefit of all generations of policyholder, including future generations.

If this is not done, demutualisation destroys the internal financial strength of the with-profits fund which may be the prime reason why the mutual life office was so highly regarded in the first place.

To me, it also breaches corporate law for the directors of a mutual life office to sell off (to the new shareholder) more than about 10% of the *Available Estate* in any demutualisation arrangement as:-

- (1) it breaches the spirit, if not the law, of the Ministerial Statement on attribution of *Estates*,
- (2) an *Estate* is needed to write with-profits business in compliance with the FSA Principle No. 9 of *'treating customers fairly'*. It is future policyholders whose interests are paramount as they need the *Estate* and the *Estate* (while its value may have gone up and down as a percentage of the with-profits fund) has always been there, in perpetuity, for future policyholders,
- (3) it damages the interests of the life office as a going concern,
- (4) it damages the expectations of current with-profits policyholders who wish to top up their benefits as they would reasonably expect smoothing, guarantees and options to be met without damaging their reasonable expectations or shareholder value,

(5) it damages the expectations of future with-profits policyholders, as they would reasonably expect smoothing, guarantees and options to be met without damaging their reasonable expectations or shareholder value,

(6) with-profits policyholders, current at the time of demutualisation, may never have been informed that the financial strength of their with-profits fund was being damaged.

9. Demutualisation

If the result of the way a demutualisation is done, is that it ruins the mutual life office then it may be felt by your Review that the role of the independent actuary (to any demutualisation) and his duty to protect on-going and future policyholders should be examined by your Review.

If a demutualisation must take place, the way it should be done, in my view, is as follows:-

The amount of money paid by the new shareholder to policyholders should represent:-

- (a) the value of goodwill (meaning the value of the flow of shareholder profits arising from future new business),
- (b) the value of shareholder profits from the transferred policies (meaning one-ninth of the value of future bonuses from conventional with-profits policies transferred to the new plc company but see (c)) and,
- (c) only around 10% (not 100%) of the value of the *Available Estate* (meaning the *Estate* as a mutual insurance company available after deducting one-ninth of the value of future bonuses from transferred conventional with-profits policies in order to protect existing policyholder payouts, see (b) above, and after the cost of guaranteed annuities following the House of Lords judgment).

10. Recommendations

I recommend that any corporate governance of a mutual life office should require that:-

1. the non-executive directors should challenge the executive over whether there is any need for a financially strong office to demutualise or whether a demutualisation will damage the financial strength of the with-profits fund and future prospects of life office,
2. the board, particularly the non-executive directors, should be informed of the size of the *Estate* in relation to the size of the with-profits fund,
3. the fate of the *Estate* (the internal financial strength) under any demutualisation arrangement should be specifically addressed by the board, particularly the non-executive directors, of a mutual life office,
4. the with-profits actuary of the company should emphasise to his board that a strong *Estate* is needed in perpetuity for with-profits business to be viable, whether you have shareholders or not,
5. with-profits actuaries should be required to advise their boards, particularly non-executive directors, that shareholders are only willing to use their value (i.e. the shareholders fund and the part non-profit fund in excess of policyholder liabilities) in extreme circumstances as it is external to the with-profits fund and any use for policyholders damages shareholder value,
6. the board, particularly the non-executive directors, in any demutualisation, should take account into account the spirit, if not the law, of the Ministerial Statement,
7. the fate of the *Estate* under any demutualisation arrangement and any weakening of the mutual life office's internal financial strength, should be specifically addressed by the independent actuary (to the demutualisation) taking into account the spirit, if not the law, of the Ministerial statement,
8. the fate of the *Estate* under any demutualisation arrangement should be specifically addressed by the Regulator taking into account the spirit, if not the law, of the Ministerial statement.