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MERGING WITH-PROFITS AND UNIT-LINKED LIFE FUNDS IN A PROPRIETARY COMPANY: ACTUARIAL CONSIDERATIONS BASED ON A CASE STUDY

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ABSTRACT OF THE DISCUSSION

HELD BY THE INSTITUTE OF ACTUARIES

Mr R. M. Paul, F.F.A. (introducing the paper): This paper is principally concerned with the technicalities of merging proprietary funds after a takeover, where the issue is one of equity between different sets of policyholders, and the roles of the Appointed Actuary and the independent actuary are relatively clear. In retrospect, I wish that I had extended the sections exploring their responsibilities, and this I shall do now, in my introduction.

The combined responsibilities of the Appointed Actuary and the independent actuary need to be clearly established in professional guidance, to ensure that with-profits policyholders' rights and interests do not become secondary to the interests of the existing management and, where relevant, the shareholders. In establishing these actuarial responsibilities, we should consider the extent to which the man in the street (i.e. the with-profits policyholder) expects or believes that the actuarial reports are encompassing the policyholders' best interests. I am sure that the expectation is that these reports, in giving their blessing to the proposed scheme, are implicitly suggesting that it is the best scheme available, despite any disclaimers in the report that only the scheme being presented to the court has been considered.

In an article in *The Sunday Times* on 5 May 1996, entitled 'Mutual Policyholders, Rise Up', the comments about the reports by independent actuaries are an insult to the profession. I quote two extracts. "Alternatives will be presented in an impenetrable footnote by an Independent Actuary" (which says little about our communication skills), and "Such arguments find willing listeners among City investment firms and Independent Actuaries who stand to earn massive fees from the demutualisation bonanza." The latter implies that the independent actuary, in order to be appointed, will be biased towards the vested interests of shareholders and mutual company executives. I am confident that this is not the case. If that is our public image, and if we are to maintain or increase our standing, then in demutualisations — and, indeed, in mergers also — this may mean extending our influence into areas where our opinion may not necessarily be welcomed by these vested interests.

If it is proposed to merge the with-profits funds as part of the recent announcement regarding the Royal and the Sun Alliance, then should the option to close not be investigated, as a comparison with any future benefits anticipated from merging? This, I suggest, does not prevent the merger nor interfere in the responsibilities of the board in determining strategy, but simply establishes the minimum compensation to ensure that policyholders' rights are protected and that their interest as, effectively, shareholders in the with-profits fund is recognised.

In demutualisations, in addition to the closed fund option, actuaries should comment on whether other alternatives, rejected by the executive management of the mutual, are more or less advantageous

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to the policyholders. The fact that a bonus or sweetener is to be paid does not obviate their right to a potentially higher payment if justifiable, even if not in the interests of the management. I do not suggest that the alternatives must necessarily be initiated, but simply used to establish a minimum level of compensation for policyholders against which the actual scheme terms can be compared by policyholders when deciding how to vote.

Whatever the legislation might require, our guidance should define the role of the actuaries in a corporate restructure to be broadly as follows, for I maintain that guidance does not need to be, nor should be, restricted if it is in the interests of policyholders. The Appointed Actuary should be required to examine critically, from the policyholders' perspective, all reasonable alternatives, including other offers rejected by the management, as well as the closed option, to ensure that the policyholders are not being excluded from, or entitled to, a more advantageous arrangement. That report would be to the board, and, whether made public or not would be a matter for the company.

The independent actuary should not limit his report to the proposed scheme, as under current guidance, which is too limited in requiring a statement that the report only deals with the actual scheme being presented to the court. He or she should discuss with the Appointed Actuary, if considered appropriate, the alternatives reported to the board, and, in addition, request other investigations that may be considered relevant. The independent report should comment on these alternatives in the manner that I suggested earlier. If alternatives exist, but have not been investigated, then the report should clearly state the reason, and that, although other options may well be better, no comparative comment can be made. I am sure that, in such circumstances, the DTI, if not the policyholders, would have something to say about the lack of information or relevant investigation. Even though other alternatives may be better, the independent actuary may still be able to comment favourably on the actual scheme compared to the status quo, thereby leaving it for the court to decide.

Although this needs much refinement, our responsibilities as actuaries must be to ensure that policyholders' rights are fully protected, even if this does require the board to adapt its strategic objectives accordingly. Definition and consistency in guidance are essential if the statement 'choose your independent actuary with care' is not to have meaning in this field.

Mr A. P. Holtham, F.I.A. (opening the discussion): Commentators have been forecasting a big reduction in the number of United Kingdom life offices over the next ten years or so, and recently there has been another flurry of press comment on this topic. At the start of 1995 there were over 90 companies writing new business (excluding friendly societies), and at least a dozen were acquired, merged or closed to new business in 1995. 1996 looks like being an even more serious year for rationalisation. Willingly or unwillingly, many of us may need to refer to this paper in the future.

In Section 3 the author describes the roles of the various actuaries involved. It has become standard for the Appointed Actuary of the transferring fund to write a report on the proposals, although it is not always clear what its purpose is, or to whom it is addressed. It is certainly not as important as the independent actuary's report, but it receives just as wide a circulation, and I support the author's suggestion that there should be professional guidance on the scope and content of this report. Perhaps the guidance could cover some of the more obvious situations where a conflict of interests might arise, such as the author's example of a single person being Appointed Actuary of both transferee and transferor funds.

On whether the responsibilities of the Appointed Actuary and the independent actuary should be extended in the way that the author has just suggested, I am initially sceptical. I agree that any scheme ought to be justified against the closed fund alternative, but I am not sure how we could define exactly what other alternatives they should consider without either putting themselves into impossible situations or, possibly, misleading policyholders about just how extensive their role is.

In Sections 4-6 the author sets out the background and some of the details of the particular case study. The general point that I would like to draw out is the importance of tax. Achieving tax benefits, or avoiding tax problems, will often play a critical role in deciding the benefits of a particular scheme, and who gets them. However, as the author points out in ¶6.2.5.13, the exact tax treatment will not be known for sure in advance of the scheme being approved. On top of this, the key architects of the scheme will not, generally, be tax experts. Clearly there will be a need for expert tax advice. In

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addition, the Appointed Actuary and the independent actuary may need to consider whether any reliance on such advice should be disclosed in their reports. Given the need to assure policyholders that they are no worse off as a result of the transfer, tax risks should be borne by shareholders, wherever possible.

In Section 9 the author raises the question of controls and protection for policyholders where a fund is restructured internally without recourse to a S49 transfer. I find it rather sinister that someone with the author's experience believes that a gap in the protection may exist (see the end of ¶9.1.9).

The main subject of Section 9 is the calculation of compensation. In ¶9.3.13 the author explains that compensation was calculated in advance of the effective date, and then projected to the end of 1994, based on best estimates of experience. Now, something like this is desirable in practice. No one wants the expense and trouble of recalculating the compensation amount after the effective date, even if such an approach were acceptable to policyholders and the court. Nevertheless, to an outsider it may seem odd for an actuary to make meticulous calculations at one date, and then update them on a relative approximate basis.

The biggest problem arises with investment returns, which can have a significant effect on values. Compensation will be calculated at a certain date, based on asset values and a consistent set of assumptions about future returns, etc. Six months later markets will have moved. Asset values may be much more or much less than expected, and views over future assumptions may also have changed. In general the changes will not be neutral, and recalculating the compensation would give a different answer. Perhaps the compensation should be stable to market fluctuations and it is our methodology that is at fault, but, so long as we use current methods, it is not good enough simply to ignore actual investment returns. If they are ignored, then both the Appointed Actuary and the independent actuary need to consider carefully how this is explained to policyholders and the court, and the exact meanings of the statements that they make in their reports.

At the end of ¶9.3.13 the author states that no adjustments were made for actual experience, since scheme approval could not be conditional on later agreement on compensation. There is nothing to stop a scheme making provision for adjustments or additional compensation payments after its effective date, and these could be to policyholders or to shareholders, provided that it specifies the basis sufficiently explicitly. To have a whole raft of future adjustments would be a nuisance, but one or two can be very useful where compensation depends on some factor that is very difficult to predict. In negotiations this might help avoid a deadlock; and in other cases it might avoid an actuary having to set an assumption with little justification. A couple of examples of this at work can be found in the scheme of transfer of Provident Mutual's business to General Accident.

Concerning Section 10 and the merger of with-profits funds, any attempt to merge two funds must be based on a firm understanding of the current position, including ownership of any orphan estate, and how additional shareholder tax is financed. If these facts are in doubt, then, surely, this needs to be sorted out before talk of a merger.

Concerning differences in financial strength, in the case study the author reaches the broad conclusion that the funds being merged were sufficiently similar in financial strength for no policyholder to be disadvantaged, although he does add some reservations in Section 11.2. There is no unique definition of financial strength, and similar conclusions might be reached in many other cases. If compensation had been needed, then this was to take the form of a one-off adjustment to asset shares. I have strong reservations about this approach, which I have trouble summing up, but will try to in the form of two questions:

(1) Can we value the full benefits of financial strength properly without a stochastic approach? If a stochastic approach is needed, then are we really ready to take this on?
(2) How are we going to explain to policyholders and their advisers the implications of giving up security in favour of a boost to asset shares?

Even if we, as actuaries, are satisfied about the fairness of our approach to compensation, we might have enormous difficulty in convincing the policyholders of a very strong fund that an adjustment to their asset shares, whatever they are, is adequate compensation for merging with a weaker fund. I

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would expect the press comment on such a case to be very hostile, even if actuaries might regard some of the comments as misguided.

The implementation of a S49 transfer, especially one that involves significant communication with policyholders, is a major project that needs careful management; it is not enough just to solve all the actuarial and legal technicalities.

Mr P. W. Wright, F.I.A.: In my opinion it was unnecessary to retain anonymity for companies A, B, C and D. I could follow the reasoning set out rather better once I had worked out which the four companies were, and it would have assisted me if this information could have been provided.

I was surprised that shareholders in B and C were receiving compensation for the fact that, henceforth, pensions profit tax would be borne by shareholders. I agree with the author's second thoughts on this. In view of likely representations made to pension policyholders in marketing literature, it would seem clear that this tax must either be paid by shareholders or be met by the free estate. The modest level of the free estate for these companies would suggest that shareholders must bear this cost. The position in the market generally, as stated in ¶11.2.2.4, is that the tax is being charged to the free estate and not to policyholders' asset shares, and hence the comment, in ¶8.3.2, "that it was more common for that tax to be paid by policyholders" is over-simplistic.

I was concerned to read, in ¶8.3.3, that the fact that pensions profit tax was paid by the fund "had probably arisen more by chance than through a specific corporate decision". The Appointed Actuary is required, by GN1, to report to the board on his or her interpretation of policyholders' reasonable expectations. In a proprietary company I would expect this particular issue to be covered in this report, and, indeed, would be surprised if the company's practice was not endorsed in a board minute. Formalisation of the policy has been of even greater importance since January 1995, as a decision has had to be made as to the treatment of this tax in 'own charge' projections.

In Section 10 the author states that the Appointed Actuary of the various companies agreed an investment policy for with-profits business which was justified only by the support potentially available from the building society parent. The ability to rely on such support is not referred to in GN1 or the DTI Prudential Guidance Note 1994/6 on the subject of investment controls. At a discussion on GN1, held a week ago, no-one suggested an amendment to refer to this point. I will not say that the Appointed Actuary is wrong, and I do have some sympathy with his argument, but I think that, in his place, I would seek to have GN1 redrafted.

The author discusses the practicalities of a closed fund option and the closely related subject of free estate considerations in Sections 10.3.6 and 10.3.7, and suggests that the tontine effect will inevitably lead to inequities in the run-off, as a more conservative approach to bonus distribution must be followed in the early stages. This can be used as justification for the principle that all free assets in a proprietary company belong to shareholders, irrespective of their provenance. However, the paper seems to ignore the possibility of making retrospective top-ups to claims paid in the early years. This would not seem to be an administrative impossibility if planned for in advance. There is no justification for a shareholder bonanza, as is implied.

In ¶10.3.7.2 the author suggests that the selection of an independent actuary to look after policyholders' interests in orphan estate discussions is open to abuse. The point is theoretically valid, although it must be remembered that any choice has to be acceptable to the DTI. On balance, I think that it is unfair to highlight the selection of the independent actuary as a particular issue — the same argument could be put forward for the company selecting an Appointed Actuary who, it believes, will be sympathetic to the directors' aspirations, and there are many similar examples of this type of situation in other areas of our professional work.

I was surprised to see, in ¶11.1.4, so explicit a statement that it was the intention of the merged company to charge policyholders' asset shares with the costs of making compensation payments for pensions mis-selling. Whilst it is, in my view, reasonable to charge ICS levies to asset shares, it seems more appropriate for the costs of company misdemeanours to be charged to the free estate or to shareholders.

Previous speakers have suggested looking at a closed fund alternative in a merger of funds. In a proprietary company, the decision to close a fund to new business is one which properly resides with

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the shareholders and their representatives, and hence I can see no justification for expanding GN15 to require a closed fund alternative to be considered in the case of a proprietary company.

Mr D. P. Norris, F.I.A.: The author has presented us with a study of a restructuring that must have been fascinating to work with, and also challenging, in that a number of actuaries faced complex statutory and professional responsibilities. Subjective judgements were called for to deal with some of the issues raised, for which there are no single correct solutions. In the final analysis, the way forward must be a pragmatic one that can be implemented in a cost-effective fashion.

In ¶4.1.6 the author draws an analogy to building society demutualisation. The members of a building society are, in many ways, analogous to with-profits policyholders, in that the benefits they receive, either as borrowers or depositors, are at the discretion of the building society. They all have an interest in surplus, and, therefore, might argue that membership and rights to profits are one and the same.

The case is not necessarily the same for a mutual life company, where it is worth distinguishing two separate issues. For example, non-profit policyholders could be members of a mutual, but those membership rights have little, if any, value. The second issue is the right to share in future surplus, which is clearly limited to with-profits policyholders.

I now consider the calculation of risk discount rates when determining compensation due to either shareholders or policyholders, and, in particular, for unit-linked business that is currently owned by policyholders. In ¶9.3.10 the author suggests that, at least in principle, the issues are the same for both the shareholder and the policyholder. I do not entirely agree, as, for one, the author states, in ¶9.3.11, that tax is different between these two parties, and that itself can affect the choice of risk discount rate. The choice of risk discount rate from the shareholders' perspective may also be driven by issues not actually related directly to the business under consideration. For example, if the parent company is a bank or an overseas owner, the rate of return required on the business may be set independent of the risks involved in writing business in the U.K.

In Section 9 the author intimates that a sensitivity test was conducted on cost, and came to the conclusion that this did not have a great deal of effect on the compensation payments. As a point of principle, if you are considering the costs and the benefits from future cost savings, the two need to be treated consistently.

Mr G. K. Aslet, F.I.A.: The author rightly points out that there are no unique solutions in this area. That is one of the fascinations of the subject — blending actuarial science with pragmatic approaches which satisfy all parties, and which are simple enough to administer efficiently, once the merger has been completed. Often the solution finally presented is only one of a range of possible solutions, the merits of each having been hotly debated before the final decision is reached. However, once the decision has been taken it will invariably be presented very positively.

The author comments, on a number of occasions (¶¶10.1.4-8, 10.3.6.3 and 11.2.1.2), on the terms of the two schemes which allowed the UKPI funds to merge with those of Friends Provident. By basing his analysis solely on the published papers, he has, perhaps, missed one of the undercurrents running through management thought at the time — namely the need for any scheme to be approved by the policyholders of both companies.

The operational merger of UKPI with Friends Provident in 1986 was one of the first examples of rationalisation in the insurance industry. It was, in many ways, a shotgun marriage, with all the tensions of such marriages. It was widely perceived as a rescue, a view not shared by a vociferous group of UKPI policyholders who believed, not only that the company should have retained its independence, but that it did not need rescuing. Friends Provident policyholders, on the other hand, did not want to see their assets used to bale out the policyholders of a rival company. Against that background, it was necessary to find a solution which achieved the benefits of merging the companies — to ensure the control that would have been available from day one in a proprietary take-over — but did not inflame passions unduly. A ring-fenced solution was, therefore, proposed in the 1988 S49 transfer.

By 1993 much had been achieved. Freed from the strains of writing new business, the UKPI Fund

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had strengthened. However, the difficulties of running a closed fund were now manifest as real, and not as theoretical, problems. Asset share approaches to determining bonus levels in with-profits fund mergers were better understood. It, therefore, seemed appropriate to complete the process begun five years earlier.

The author has referred to the requirements in GN15 for the independent actuary to comment, in the case of a mutual company, on the effect of the scheme on the proprietary rights of the members of the company, and, in particular, on any change to their ability as members, to secure or prevent further constitutional changes which could affect their expectations as policyholders. The usual change cited to justify this reference is conversion of the fund to a closed fund. This requirement was criticised by Needleman & Westall (1991) and also by Pell (1991), and remains a contentious issue. I add my voice to those who suggest that it should not be needed.

In the present business climate, where there is a widespread expectation that some financially strong companies will seek to demutualise in order to secure their long-term future, the requirement that the independent actuary should consider closing down a company, in order to maximise the benefits for the current generation of policyholders, is a strange one. In many cases the notion would have been an anathema to their founding fathers, who believed that they were setting up abiding companies to meet the needs of successive generations of policyholders, and it encourages the 'something for nothing' mentality. It also has the serious consequence that, by highlighting the immediate benefits of closure — a course the directors would plainly not normally consider — it could discourage some companies from pursuing a course that they believe to be in the long-term interests of their policyholders.

As this issue arises from a consideration of the rights of policyholders as members, it is perhaps worth remarking that independent actuaries who consider the value of membership generally conclude that it is of little or no value. The possibility of sufficient members banding together to force a change of policy is usually considered to be remote. It is all the more strange, therefore, that the issue has been allowed to take on such importance.

Mr J. Goford, F.I.A.: The author gives insight into the decisions actually made in the reconstruction of wholly proprietary companies, and re-emphasises the sharp distinction between them and mutuals. In ¶3.1.5 he writes that, if the directors "are satisfied that the impact on the company is not detrimental to the interests of policyholders, then their allegiance must turn towards the shareholders"; and goes on to say that "the interests of shareholders must prevail". In ¶4.2.1.5 the author explains that the ex-mutual policyholders of company A, now a proprietary company, received distributions from future surplus as if there were no shareholders, by not reducing their asset shares by the actual shareholders' entitlement to surplus. This produces the classic conflict of mutual asset shares within a 90:10 fund

These lines, and more recent experiences on Section 49 transfers, have led me to an analysis of the nature of the rights of the with-profits policyholders from which they may derive their reasonable expectations, and, in particular, their rights in excess of asset shares. Different rights to surplus apply, depending on whether the fund is run as a revolving fund or as an entity fund. If it is run as a revolving fund, then their rights in excess of asset shares only turn into value in the event of the fund closing to new business or winding up. Thus, in a proprietary office, intending and likely to stay open to new business, their reasonable expectations are limited to asset shares with a *de minimis* additional value, if any, for closure rights, winding-up rights, or rights which might be imposed by 'industry practice'. For a proprietary company run as a revolving fund, comparisons with a mutual, and in particular the term quasi mutual, are, therefore, unhelpful.

Would it not be fairer to clarify, for all policyholders, that their proceeds will be derived from asset shares — with added protection from fluctuations provided by the assets comprising the rest of the fund — but that they have no interest in those excess assets? This seems precisely the same mechanism by which the government recently extracted £2bn from the miners' pension scheme. This clarification would also help to resolve the conflict for mutual asset shares within a 90:10 fund.

Paragraph 4.2.1.6 highlights the rationale that injecting an embedded value into an ex-mutual fund provides sufficient additional assets to fund transfers of a ninth of the cost of bonus if the embedded

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value assumptions are met, but what if they are not met? Taking into account the DTI press release issued in 1995, the difference, presumably, falls to shareholders, as they injected the embedded value, even though it is into a 90:10 fund.

My conclusion is that we are moving towards the 90:10 mechanism becoming relevant only in asset shares, and irrelevant at fund level, the fund, then, simply defining the quantum of assets available to support fluctuations.

There has been insufficient analysis on what the author, in ¶10.1.7, refers to as the 'weak position' of the transferor. In a seller's market, insufficient attention is paid to the opportunities for acquiring shareholders to increase the PRE of transferor policyholders from a more realistic analysis of their position. Perhaps too much is being given away to transferor policyholders in such a weak position. A price is a price, and you cannot deny market forces, but more of the price paid may be goodwill than was thought.

Mr N. H. Taylor, F.I.A: I declare an interest, in that I acted as independent actuary in the case before us. Accordingly I read the paper with a certain amount of trepidation. Maybe the author had found something important that I had not considered? He has not, although he has challenged some of the conclusions in Section 11.2, *The Scheme in Retrospect*, and there have been challenges from some earlier contributors to the discussion.

It would be inappropriate for me to respond to these challenges. However, I agree with the author that there are no unique solutions. There was considerable debate amongst the actuaries involved, as well as with me and with the regulatory authorities.

With an increase in merger and demutualisation activity — both achieved by a transfer under the Insurance Companies Act — it might be helpful if I were to make a few general comments regarding the role of the independent actuary, and on some of the practical management issues which arise.

As the author mentioned in his opening remarks, the Insurance Companies Act requires an independent actuary to prepare a report on the scheme in just those terms — nothing more. This applies whether the transfer is large and complicated, or is simply a small block of business going from one company to another as a tidying-up operation.

Guidance Note GN15 is currently being reviewed by a small working party. It is mainly a matter of updating rather than making radical changes. The main problem that we, on the working party, are facing is how much the independent actuary should be involved in looking at alternatives. The closed fund option is mentioned in the current GN15 as an example, and the regulatory authorities are keen for it to be considered by the independent actuary. Surely, then, they should also be keen for it to be considered at all times? However, any such consideration impedes the freedom of a mutual office, with a large free estate, to change its corporate status. If it wished to demutualise, they would have to say that it was not necessarily the best option. They, perhaps, should admit now that continuing as an open fund is also not necessarily the best option. The logic of the regulators' approach is that they should certainly tell our largest mutual to close to new business — unlikely, I think!

I rather take the view that all this is the responsibility of the directors, although, as independent actuary, I would want a briefing. I believe that the independent actuary should only be required to report on the scheme, as the Act requires, but I wish to be free to comment on other options as I see fit. Certainly, in a public interest case, I would consider the need to make comments on the alternatives of staying unchanged, accepting a bid, or closing the fund, as well as on the scheme, but only to back up the published views of the directors and the Appointed Actuary, not as the only comment. I do not share the author's views fully, but we are both thinking on similar lines.

The independent actuary requires a lot of information — accounts, DTI returns, Appointed Actuary's board reports, marketing literature, with-profits guides, etc. There is a need to come up to speed very quickly in order to discuss issues with the Appointed Actuary and the other actuaries involved on equal terms.

The independent actuary must consider the security and benefit expectations of all the policyholders, not just those transferring. This may come as a surprise to actuaries in a large office, when a small block of business is being transferred to them, and they believe that the effect is *de minimis.* The independent actuary needs to be so convinced and to say so. Benefit expectations

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include bonus prospects for contracts which participate in profits and the prospects for amendments to charges under investment-linked contracts, where these are allowed.

It is important to discuss ideas with the DTI/GAD early on, and wise to bring in the independent actuary early too. In the case study this happened, and it was not only helpful to me, but also, I believe, to the company, as ideas could be shared to see what I and the DTI/GAD thought. The other important person is the project manager. Someone must be in charge. In the case study it was the author, full time. In other cases it is often the Appointed Actuary, part time. My experience of cases which are not well managed is that costs increase rapidly and timescales get drawn out.

My first reaction to a scheme is to look at what it is trying to achieve. In the case study it was to get a much simplified corporate structure. I try to take a broad view. For instance, if company A takes over company B and then reassures all company B's business, I do not look at it simply as a scheme to change from reassurance to direct writing, but I go back to the original position and look at the overall intentions. The company needs to specify the details of the scheme, having agreed these with the independent actuary, and then let the lawyers get to work.

The court procedures in the Court of Session in Edinburgh, the High Court in London, and the High Court in Dublin have subtle differences. In Ireland, the independent actuary, now, has to be a Fellow Member of the Society of Actuaries in Ireland.

On scheme details, the independent actuary can ensure that certain factors do not get missed. This is particularly important in small cases where no outside advice is being taken. I like to see provision for unit-linked funds to be merged, subdivided or reconstructed. Even if these provisions were not originally contained in the policy documents, it might be possible to insert them as part of the scheme. This gives added flexibility, but makes sure, for instance, that policyholders do not get trapped in a small unit-linked fund which cannot be managed properly. Similarly, it is important that a ring fenced with-profits fund contains provisions to change to, say, a fixed bonus basis when it decreases to an appropriate size or an appropriate number of policies. In the event of any of these changes occurring in the future, I like to see provision that the Appointed Actuary will certify that all is equitable, and the DTI usually wish prior reference to be made to them.

The independent actuary's report is considered to be most important by the courts, and, accordingly, it must be intelligible. Counsel has to present it in court, and the judge must be able to understand it. While the independent actuary must consider all aspects in depth, the advice I have received from solicitors and counsel with experience of these cases is that the formal report should be as succinct as possible.

Commenting on the information given to policyholders, I am appalled at the amount of paper that has been sent to policyholders in some major public cases. It only confuses the majority of policyholders, and is thus a total waste of money. All that the policyholders need to have, by law, are summaries of the scheme and of the independent actuary's report. Those who want to can inspect, or ask for, detailed copies. They can also inspect, or ask for, copies of the accounts and details of any material contracts, all of which are available to the court, and any other court documents, all of which are in the public domain.

In my experience, not many policyholders will ask for additional information, although some IFAs or consulting actuaries will certainly do so. Offices should consider giving them a proper briefing and providing them with appropriate information before a request is received. For policyholders, a hotline staffed by experts seems to provide an ideal solution. The author's company did this in the case study.

I believe that the problem of excess documentation can be laid at the door of the merchant banks advising the parties in major public cases. They are used to issuing a great deal of information, mostly to professional investors and financial journalists, and they fail to understand that the majority of policyholders are not financially sophisticated. My advice, when I am acting as independent actuary, is simply to use the conclusions in my report as the summary. If anyone wants more, then I like them to have my full report. I try to write it such that it is as clear as possible, even if it does, of necessity, contain actuarial jargon.

The author has referred, in ¶2.12 and Section 3.4.2, to the publication of the report by the Appointed Actuary. It is a good idea in the big cases, again preferably telling policyholders the conclusions, and making full copies available on demand. It adds strength to the argument that

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policyholders' interests are being properly protected. In the smaller cases it is only yet more paper to confuse the policyholders and the courts.

The actuaries, accountants and lawyers can agree a scheme and get it sanctioned by the court, but often this is just the beginning. Having spent many years as a line manager in a life office, I find it surprising that, in a merger, the administrative implications take a back seat. I know how difficult it is to administer business all written by one office. It is very difficult, indeed, to administer business coming from a variety of sources.

The role of the independent actuary is a professionally challenging one, particularly in complex cases such as the case study. As well as having to consider the interests of shareholders, if any, it is very satisfying to be involved in looking after the interests of policyholders.

Mr T. W. Hewitson, F.F.A.: The independent actuary has, indeed, an important role, although the DTI/GAD will, of course, wish to take an overview of each case, and may bring specific issues to the independent actuary's attention. Indeed, the DTI would often wish to approve the terms of reference for the independent actuary's report in advance.

One specific issue that may arise is the closed fund option. In practice, the DTI will generally expect the company to consider this option both qualitatively and numerically. The independent actuary would then be asked to review this work and, quite possibly, other schemes that the company may have considered. In this respect, my views are more in line with those of Mr Taylor than those of Mr Aslet. Mr Taylor mentioned that there might be a very strong mutual office which would effectively be asked to close to new business. Rather than close to new business, the company would have the option to consider other possible means of utilising the excess estate, if indeed such an excess exists (which is by no means certain in every case).

There is reference, in ¶9.1.6, to private internal reconstructions. It should not be taken for granted that these are beyond the reach of insurance supervisors. They may well be challenged, and an independent review requested.

Turning now to life office mergers, it should not be assumed that these will be approved automatically by the regulators. In addition to any broader competition considerations, thought needs to be given to the potential effect on areas such as allocation of expenses, investment policy, bonus philosophy and management of the free estate, and, possibly, even quality of service. These issues will need to be considered, even if no Section 49 or Schedule 2C transfer is contemplated in the short term.

Demutualisation is another topical subject in which the attribution of the free estate is a core issue. This should not become available in full to the new shareholder to write future new business on which a 10% share of profits will accrue, unless the existing members receive adequate compensation. In addition, an appropriate mechanism is needed to ensure that the free estate is still available to protect the interests of current members and that it is not all absorbed by future new business strain. Even then, I believe that the free estate would remain in the 90:10 fund, and it would not all belong to shareholders, as Mr Goford implied.

I do not accept the view that a tontine arrangement, as described in ¶10.3.6.6, is consistent with PRE. The actuary should be using his best endeavours to ensure that the surplus is distributed fairly across the different generations of policyholders, thereby avoiding the retrospective type of problem referred to by Mr Wright.

Mr J. A. Jenkins, F.I.A.: Although the compensation payments, discussed in Section 9, were not very large in relation to the total with-profits assets, it was not clear how asset share calculation procedures, described in Section 10.3.8, were amended to cover compensation — not just now, but in the future as well. There is a danger that, when asset shares are being calculated in, say, 20 years' time, by completely different actuarial staff, for policies maturing at that time, the compensation additions may be overlooked. In other words, the compensation might end up being franked against future investment earnings following the reorganisation. The solution to this problem is one of documentation and internal procedures, but I am nervous as to the robustness of these internal procedures, particularly where there are several groups of policyholders involved.

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As the paper clearly shows, tax is often a key driver in the construction of a scheme in one way, as opposed to another. The Appointed Actuary or an independent actuary may be asked to give his blessing to one particular scheme, knowing that, if the expected tax treatment does not materialise, another alternative scheme might, with hindsight, have been better for the policyholders. I know of one scheme where substantial expected tax benefits did not materialise. The risks for the Appointed Actuary or Actuaries and, in particular, for the independent actuary are very significant.

An ever-increasing number of proprietary with-profits offices have a 100% shareholder fund containing the non-profit business in addition to the with-profits 90:10 fund. As the author points out in ¶11.3.2.4, Appointed Actuaries are likely to come under pressure to influence expense apportionments in favour of the 100% shareholders' fund. GN22 is only concerned with PIA projections, which may be a non-issue if the 90:10 fund is closed to new business. Expense apportionments reported in the DTI returns, where there are separate Form 40s, are subject to audit, but even this does not necessarily remove completely the scope for methods slanted in favour of the shareholders. The issue of expense apportionments between 100:0 and 90:10 funds is something which should, in my view, be given further investigation by both the profession and the DTI.

Prompted by the author's opening remarks and comments made by other speakers, I do not believe that benefits, if any, which might arise as a result of closing to new business, form part of PRE. I do not think that any policyholder takes a policy out with the expectation that, at some time in the future, the company might be closed to new business, and he might get something extra. For all the building societies which have demutualised and gone to PLC status, not once has the issue of closure to new business come up. If this does not need to be considered for building societies, why does it have to be considered for life offices? I wonder whether we have a fundamental difference of approach between the DTI, as the regulator of life offices, and the Building Societies' Commission, as the regulator of building societies.

Mr M. R. Kipling, F.I.A.: There are many ways to tackle inequality between groups of with-profits policyholders in a long-term business transfer.

In 1967, the long-term businesses of the Alliance, the London and the Beacon were transferred to a new company specifically constructed to hold them — and to write new business. The main compound bonus series of the Alliance and the London were deemed sufficiently similar for the same bonus rates in future to be applied to them — and also to new business written in the new company. This included the then new-fangled terminal bonus. However, an alignment bonus of £1 10s 0d% for each year in force was added to London policies in the form of a simple reversionary bonus, to compensate for a possibly less generous distribution policy in the future. This approach has the great benefit of simplifying future administration relative to any approach which requires separate bonus series to be maintained. In the case referred to, all companies were considered to be financially strong. In another merger in the same decade, reported by Kitton & Beattie (*J.I.A.*, **92,** 211-252), three funds were also combined into one. However, one was considered financially weaker and was constrained to have bonuses proportionally lower than the other two. This is a situation not unlike that described by the author in ¶10.1.6, although that is expressed in the more modern language of asset shares.

In 1984, the group of companies to which I first referred merged with the Phoenix. No significant transfer of long-term business into or out of the Phoenix fund has ever taken place. However, Phoenix contains within it a segregated with-profits fund, of the type referred to *en passant* by Mr Goford, the operation of which may well be of interest to those planning transfers and considering the closed fund route. The problem of investing for a possibly declining fund is tackled by the segregation being notional rather than real. A formula, enshrined by board minute, dictates how an appropriate proportion of the investments of the company should be allocated to with-profits business, and how that proportion should be 'rebalanced' each year in the light of cash flows and price movements. The tontine effect is avoided by the inwards reassurance of with-profits business from elsewhere in the group, on terms which preserve the reasonable expectations of the original policyholders.

Some of the solutions adopted in the past could be regarded, in retrospect, as providing rather rough justice with regard to PRE. However, when I read a paragraph such as ¶9.5.3, I wonder whether an adequate outcome cannot be achieved with less analysis than is often now expected. In the

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Alliance/London/Beacon case, the independent actuary's report and the combined report of the Appointed Actuaries of the three companies were both three foolscap pages long.

The author raised the subject of the recently announced intended merger involving the companies to which I have been referring. At this stage, no decision has been taken on whether the with-profits funds or any other long-term funds should be merged by Section 49 transfer.

I support Mr Wright in believing that the principles which apply to the merger of with-profits funds of proprietary companies and of mutuals should differ. In the former case, the owners should merely have to demonstrate that the scheme of arrangement leaves both groups of policyholders no worse off than before. In the latter case, as owners, the policyholders should expect independent confirmation that no better arrangement could reasonably have been found. In most cases it may well be that no better arrangement can be found. It would be helpful if this distinction could be conveyed to the press. Mutual policyholders should also be free to do as they wish with the business, irrespective of what the original owners, the founders, may have intended.

In ¶9.1.7 the author points out that Section 49 protection does not apply to internal reconstruction. Rather, policyholders must rely on Section 30 and on proper interpretation of PRE, subject, as Mr Hewitson has mentioned, to DTI supervision. I would not support any changes to legislation or practice in this regard. However, more work is needed to assist actuaries to define PRE in a consistent way, and in ensuring wider dissemination of how it is defined. Additional professional guidance, coupled with an enhanced with-profits guide, would be my preferred solution.

In ¶11.3.3.5 the author refers to the possibility that maturity projections under PIA rules for unit-linked and unitised with-profits business could differ if the 'proportionate' basis is used for the latter. This is true. However, the option of using the lower of the two projections for both types of business is permitted, allowing, at least, a choice between the devil and the deep blue sea!

Mr G. D. Clay, F.I.A.: The author emphasises the care taken to leave future decisions to the Appointed Actuary rather than requiring any subsequent reference back to the courts. He also mentioned the possibility of tontine bonuses. A key consideration in almost everything we do, which we, as actuaries, do not emphasise sufficiently, is that "we do not know what the future will be". Any reconstruction needs to be fair between all parties at the time, but must not fetter the office's future freedom any more than is essential. Setting bonus linkages in concrete, as referred to in ¶10.2.1, in order to ensure fairness, does not seem to me to acknowledge clearly enough that we cannot control the future. More generally, I am concerned that PRE is becoming over-precise and constricting future claim values unduly. This is something we should guard against.

Stochastic modelling can be very helpful, not least in quantifying the relative likelihood of each party doing better or worse under the new structure. That is, in an individual scenario, a group may win or it may lose, but, overall, it must expect no worse than breakeven. There is a tendency to seek to construct transactions under which no group can be worse off whatever the future may bring, thereby giving undue weight to remote contingent interests.

In ¶9.1.2 the author refers to the absence of statutory procedures governing internal restructurings. If there is a possible mischief, it lies in an absence of publicity which can be addressed otherwise than by the introduction of a statutory procedure. Freedom with publicity seems perfectly adequate for any reasonably simple change. The formality of statutory procedures or an independent actuary's report does not seem necessary, unless there are significant complexities or potential conflicts of interest.

I am concerned at the actuarial tendency to refer to protecting policyholders' rights or interests as though these two concepts are synonymous. The author recognises, in ¶1.3.4, that shareholder interests merit protection, i.e. that there are shareholders' reasonable expectations as well as policyholders' reasonable expectations. We should all make an effort to refer to the need to balance the interests of all affected parties, thus including shareholders and the different categories of policyholders, which may include future policyholders.

We should also recognise the directors' responsibilities, as emphasised by concepts of sound and prudent management, and not implicitly assume that the directors are only concerned with the shareholders' interests.

At a more personal level, I wish to take up the author's comments on directors of subsidiaries who

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are employees of the parent. I have found myself in this role in many subsidiaries over the last decade and more, but the one relevant to this discussion was my first directorship. It was of an overseas listed subsidiary with a 70% shareholding by the listed parent. I had been an employee for 10 years, was a director, had, until recently, been joint Appointed Actuary, and remained a shareholder. Significant stockmarket activity led to a takeover situation. I was in London; all this was happening overseas. There was no doubt in my mind, with no guidance from my employer, that my primary duty was to all shareholders collectively, and that, as a director, I had responsibilities, which I would now characterise as falling within sound and prudent management, to all policyholders and, in a different sense, to the employees and agents. I was comfortable with the proposals, but had I found it appropriate to formulate and express cogent arguments in favour of an alternative to the action favoured by my employer, I have no doubt that they would have been considered carefully. If, ultimately, I had felt compelled to resign as a director, then I feel sure that the resultant publicity would have been substantial. The fact that both parent and subsidiary were, and are, listed may have been significant.

Is the status of the parent — listed or otherwise — perhaps the key determinant of the effectiveness of publicity? The financial press is much more interested in listed companies than — apart from the last year or two — mutuals. Is there, perhaps, a corporate governance deficit in a mutually owned parent when potential conflicts of interest need to be addressed? If so, then I suggest that that is the area where the independent actuary may have a key role.

Mr D. G. R. Ferguson, F.I.A.: In ¶2.2 the author talks about the 1870 Act, which was introduced following problems which impacted adversely on policyholders. At that time about 20 companies a year were going out of business, and there was great concern in the actuarial profession that so many important jobs for actuaries were disappearing. The current debate on the future of the actuarial profession has something in common with this.

Many of the disappearing companies were technically insolvent. Some of the receiving companies were attracted by the positive cash flow in these companies, and thought that that might help their own finances. Things grew to the point where two such companies, the Albert and the European, went bankrupt with substantial deficits. It was felt that there should be some control over the liabilities in relation to the assets of these companies, that should not just be looking at cash flow, and, indeed, that there should be legislation that protected the receiving company from taking over business which was manifestly insolvent. That is what led to the 1870 Act.

In ¶3.1.5 the author states that it is not clear whether the directors' prime responsibility is to the company or to the shareholder. It is very important that the board of directors should take legal advice, and be quite clear as to what their duties are. In two apparently similar situations you will not always get the same legal advice, but legal advice should be taken to avoid the lack of clarity to which the author refers.

As a profession, we should reinforce the perception, which I believe is widely held, that, because a significant number of actuaries are involved in these cases, looking at all the angles, we can ensure a result that is fair and just to all the parties involved. Our reputation should be recognised and reinforced, and we should react to the type of adverse publicity referred to by the author in his opening remarks. In that connection, I agree with him that both the Appointed Actuary and the independent actuary ought to look at, and have regard to, all reasonable alternatives which could be available at the time to the companies concerned. They should look at those reasonable alternatives as a matter of principle, but, when it comes to formal professional duties and signing off on reports, I think that GN15 is right in restricting attention to the specific case that is before them. In an increasingly litigious world, it would be most unfortunate if the actuaries who have to sign off in these cases had a statutory obligation to look at all possible alternatives that are available.

Mr R. E. Snelson, F.I.A.: Mr Ferguson has said that, in the final analysis, the independent actuary's report should consider only the present and the proposed scheme. If equal prominence is given in the official papers to two alternatives, you can be fairly sure that the one that is not chosen will develop

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some sort of head of steam from another direction, and actually threaten to scupper the whole exercise.

Mr Norris made a comparison between building societies and insurance companies. Membership is a matter of legal fact, defined in the Articles of Association of the company concerned. For most building societies, membership is restricted to investors, and only a sub-set of those. Building societies used to have deposit accounts and share accounts, and it was only the share account holders who were nominally members. Any benefits that mortgage holders get are just their luck, and are not theirs as of right.

For mutual life companies, there is a definite distinction between members and policyholders, and between members who have voting rights and members who do not. There have been cases of mutual companies with substantial amounts in group policies, where the group policyholders are excluded by the definition in the Articles of Association from membership and membership rights.

When mutuals go into unit-linked business, the new business strain is financed by the with-profits policyholders. As unit-linked business grows, a big gearing effect may be created. There is at least one company where that has been a material fact in what has transpired.

In ¶8.3.2 the author mentioned that tax on transfer to shareholders might be paid by the shareholders or by the policyholders, but that it was more common for the tax to be paid by the policyholders. When this first became an issue for proprietary companies, they started from a position where, *de facto*, tax was paid by the policyholders. Some have taken tax considerations into account in their philosophy for determining the participation of profits, but have had to manage the transition from where they once were to where they are now, to avoid a hiatus in the transfer to profit and loss.

In ¶8.3.1 the author states that if there is a 32% corporate tax rate, then on a pension fund the extra tax liability would be 32/68 of the transfer of pension surplus. If the liability is paid entirely by the policyholders and you have a 90:10 fund, then the 32/68 actually translates into about 86:14. Similarly for the figures given for a life policy: 7/51 of the transfer of surplus will become something like 88% or 89%. This is not obvious from the author's figures. A mixed fund would be somewhere in between the two.

Mr P. H. Grace, F.F.A.: It is only reasonable to expect independent actuaries to comment on three scenarios: the scheme being put to the members; a closed fund; and the status quo. Any requirement to comment on other alternatives is, I think, a non-starter. At the point when the independent actuary first becomes involved there could be a number of alternatives under consideration. They should all be evaluated by the company. In the case of my own office, some three years ago, the actual scheme that went to the policyholders, for tax reasons, was completely different from those that were on the table when the independent actuary was first appointed. If he had been asked to comment on all the alternatives, they would have been quite irrelevant and misleading.

Several speakers have referred to 'carpet bagging' in one form or another. I note from press comments that one mutual office has changed its members' rights recently. That is, perhaps, unfortunate, in that it might have raised the expectations of existing policyholders.

Mr P. J. Nowell, F.I.A.: Mr Taylor suggested that the largest of our mutuals would be forced to close to new business if it considered the closed fund option. I have been reflecting on that. If it can continue to write new business on a basis that adds to the amount inherited from the past, then that seems to be a sensible use of that money, and it should continue in business in the same way as any other organisation. Turned round the other way, one of the ways in which your disclosed expenses can be reduced is by saying that you are going to draw on the estate on a permanent basis. If an organisation has got to a situation where the only way in which it can stay in business is, effectively, to give a negative rate of return on its working capital, then that is the time at which it is right for the management of that organisation to say that it is not in anybody's interests to continue.

Therefore, I draw a strong distinction between a mutual which is selling policies which are contributing, and can be sustained; and the organisation which is just destroying capital for no good purpose.

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Mr C. E. Barton, F.I.A.: With regard to the point made by Mr Snelson about building societies, my impression is that, in most cases, if not all, borrowers are members. In a demutualisation, it is necessary for the members to vote and agree separately; a 50% majority of borrowers and a 75% majority of savers are both required.

Mr Aslet said that the founding fathers of a mutual office would not be at all happy about closure. I accept that, but I suggest that they would be even less happy about demutualisation. If there appears to be an advantage to participating policyholders in closure, then this is a sign that there has not been proper management, in that insufficient surplus has been distributed to past policyholders. With proper management there would be no inherited estate.

If a mutual office is not being managed economically, the founding fathers would rather see the fund merged with, or taken over by, another mutual office, than for it to demutualise.

Mr P. R. Simmons, F.I.A.: What is a closed fund? Can a closed fund be temporarily closed, or does it have to be permanently closed? When I read the description of some of the unit-linked funds in the case study that were closed, I wondered whether they could be re-opened to business in the future, and whether that might have had some impact on the decisions made.

In ¶11.3.4 the author said that there was nothing in the documentation about the way that the balance between reversionary and terminal bonuses would be managed in the future. I found that quite strange, given that one of the principles of the scheme, as described in Section 5.3, was that there would be a common pool of assets for all with-profits funds. The assets were dealt with explicitly, but there was nothing equivalent for the liabilities.

Mr P. N. S. Clark, F.I.A. (closing the discussion): One of the subjects raised in the discussion was the payment of tax on transfer, particularly for pensions business, and whether the tax should be paid by shareholders or policyholders. It is important that people and offices do know what they are doing and are quite clear on who is paying the tax notionally, implicitly, explicitly or otherwise.

The questions of tax advice, bad tax advice or future tax changes, were also mentioned. In that context, I agree with Mr Clay's comments, although they were not made in reference to tax. One is looking for the best estimate at a point in time rather than having to keep going back at some later stage and changing it. What goes for tax advice also goes for legal advice, and the need to make sure that one is on ground that is as firm as possible.

As a profession, we need to get the links and the balance between the independent actuary and the Appointed Actuary right. I agree with Mr Ferguson that we then need to make sure that the proper image of the profession is given to the outside world. I was interested, when listening to Mr Hewitson, that the DTI is heavily involved in approving the terms of reference for the report of the independent actuary, and, indeed, the DTI and the regulators were mentioned on a number of occasions.

Two speakers mentioned stochastic work. I agree with the importance of using stochastic techniques where appropriate, but it lays upon us a firm responsibility to be able to explain our work so that people really understand what we are saying and what we mean by it.

The question of the estate, or the lack of estate, was spoken about on a number of occasions. Mr Goford suggested that, in many with-profits funds, the with-profits policyholders have no interests over and above the asset share, without saying what should happen to any assets that were there over and above the asset share. Mr Jenkins rightly suggested that we need to be clear what we mean by asset shares, not only now, but so that our successors, in 20 years' time, can understand and follow their documentation.

Mr Clay suggested that the policyholders' reasonable expectations could be becoming over precise; and, going back before the days of asset shares, Mr Kipling spoke about the rough justice displayed in an earlier reconstruction. There is a danger that, in over-prescriptive policyholders' reasonable expectations, the basic with-profits concept might be lost.

Mr Clay also introduced the subject of shareholders' reasonable expectations and the need to keep a balance between shareholders and policyholders. In my experience, boards of directors are more than capable of looking after shareholders' reasonable expectations. It is, therefore, right and proper

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that this profession spends the majority of its time looking very carefully at policyholders' reasonable expectations.

I was not at all attracted by Mr Wright's suggestion that there might be a retrospective adjustment to past claims. Mr Taylor rightly suggested that we look at the administrative issues arising from mergers, and such similar. Despite Mr Wright's optimism, coping with retrospective adjustments to past claims, though theoretically possible, would, in practice, be an administrative nightmare, considering the length of time for which such a closed fund could go on.

Several speakers wanted the independent actuary to be very alive to the closed fund option. The DTI were very keen to press an investigation into the closed fund option. We need to be clear where this is leading. Taking it to its logical conclusion, should all on-going funds consider the closed fund option every year? Should the actuary be looking at this in his financial condition report? Mr Barton suggested that excess estates are a bad thing, and clearly must be dealt with.

A subject which came up on a number of occasions was professionalism. In ¶3.3.5 the author writes that "actuarial science does not normally produce a single solution". Of course it does not. If it did, we would be technicians. We are not technicians, but are members of a profession. Professionalism is concerned with the three themes of relevance, competence and integrity. With regard to relevance, Mr Taylor stressed that the judge must be able to understand the independent actuary's report. He also commented on the large weight of paper that accompanies many of these reports. I wish to put in a plea for actuarial reports to be relevant and comprehensible. I like the idea of Mr Kipling's three foolscap pages.

On the subject of competence, anybody doubting the value of CPD need only read this paper. Actuaries cannot afford to be out of date. The paper makes it clear that the profession and the world round about it are changing.

Paragraph 9.1.6 refers to a situation that is dependent on the integrity of the Appointed Actuary. The significant role of the Appointed Actuary is referred to many times. Mr Jenkins mentioned the split of expenses between 90:10 funds and shareholder funds. There are many other issues that came up in the paper and in the debate where the integrity of the Appointed Actuary is paramount. The opener wanted more guidance in some of these areas, as did the author.

Integrity is not achieved just by following or issuing guidance notes. Integrity has to be a personal matter, and if this profession is to have a future we have to have actuaries of integrity; we need to consider how the profession can best encourage that. Guidance notes may encourage it, but, at the end of the day, it is a personal matter, and we need to support one another. We need to challenge one another, both within our various organisations, where it may be easier without breaching confidentiality, but also on a wider basis.

There is great strength in our current approach, but it depends on integrity, competence and relevance.

The President (Mr C. D. Daykin, C.B., F.I.A.): Apart from covering many detailed technical issues in relation to the subject, the author has focused on the role of the profession and of the independent actuary, to which the closer has alluded.

In cases of corporate restructuring, the Appointed Actuary clearly has a key part to play in ensuring that the interests of both the policyholders and the shareholders are fully taken into account, both in drawing up possible schemes and in being satisfied that the scheme that is brought forward is satisfactory.

The legislation clearly sees a particular role for the independent actuary in relation to the courts, and the courts will expect that individual to give particular attention to the interests of the policyholders. I suppose that the legislation reflects a view that the shareholders will have their interests fully taken into account by plenty of people, and that it is the policyholders who need to be supported through a special report by the independent actuary.

This should not detract from the role of the Appointed Actuary in taking all interests into account; nor should it force the Appointed Actuary into the position of looking primarily at the interests of the shareholders, because that would be a travesty of the role as it has been developed. The profession will clearly need to give some thought as to whether there is need for any specific guidance to

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Appointed Actuaries in these cases, as some have suggested. I agree with the closer that the principal issue here is the professional integrity of the Appointed Actuary, rather than a need for additional detailed guidance.

The discussion this evening has also focused on the question of policyholders' reasonable expectations. This has highlighted the split which clearly exists within the profession between those who believe that it can be defined by asset shares and those who see it as going beyond that.

Although this paper was originally written for, and presented to, the Faculty, the Institute Sessional Meetings Committee clearly thought that it was a paper of great quality, which would be highly appropriate for this meeting. That has been amply evidenced by the very good discussion that we have had this evening, stimulated by the wide range of professional and technical issues raised in the paper. For this our thanks are principally due to the author.

Mr R. M. Paul, F.F.A. (replying): The closer has covered much of the discussion in his remarks. I endorse his comments about professionalism. Professionalism is not fully covered in the guidance notes, for it includes the question of integrity .

Much of the discussion related to points of principle, and the responsibilities of the Appointed Actuary and the independent actuary. It is difficult to provide detailed guidance in all potential situations, but I think that more general guidance would be of assistance.

On the question of the shareholder's reasonable expectations, I do not think that the shareholder needs much protection. My ex-shareholder had no doubt what his objectives were when he was selling the company, and he achieved them. There were many problems for me as the Appointed Actuary, and pressure on me to agree to suggestions that, perhaps, were not entirely in the interests of policyholders. These had to be, and were, resisted.

At the discussion at the Faculty it was suggested that the protection needed for the Appointed Actuary was a three-year contract which became effective the moment a professional issue arose, and the Appointed Actuary had to present a most unwelcome report to the board. In such circumstances, the pressures can be extreme.

Mr Hewitson mentioned the DTI, who will comment on any restructure. If they do not agree with what the independent actuary and the Appointed Actuary have approved or accepted, they will object. It seems fairly sensible that the view of the DTI, whether right or wrong, should be made known at the outset. Hence the reason for early discussions.

I am concerned as to the role of the independent actuary if the report is restricted to commenting on the actual terms of the scheme presented to the court, and not on associated issues. I referred, in the paper, to the difficulty of including complex issues in the scheme presented to the court, because that would implicitly expect the court's approval, and it may not be prepared to do so. In the case study, the legal opinion was not to expect the judge to approve the compensation amounts, as intended, in the first version of the scheme. However, if every associated issue is excluded, so that only the basic transfer of business is included, is this really different from the status quo? I am not sure how meaningful or valuable the independent actuary's report is if restricted to that point alone.

There was a wide difference of opinion on the responsibilities of the actuaries. In nearly every case the integrity of the company is beyond doubt, but there must be situations where that may not be the case. Thus, the need for actuaries to comment as Appointed Actuary and independent actuary, as opposed to the executives, is very important.

Mr Jenkins referred to the allocation of expenses. When I was writing the paper, I was surprised to discover that there is no specific guidance on this issue. GN22 covers it only in general terms, when dealing with a different subject. Development of guidance would require much thought to ensure that there is no potential for a bias towards the shareholder. When presenting expense allocations to the board as an executive, there will be considerable pressure to skew the result in favour of the shareholders, particularly where business is poor and losses have arisen.

The point made by Mr Snelson about the impact of shareholder tax was also made at the Faculty discussion. The extra shareholders' tax is quite a small amount, but I believe that the principle remains important.

The first time that I came across a possible merger was in 1964, when I worked for the Caledonian

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Insurance Company, which still exists in Ireland. At that time the company had recently been taken over by a company then known as the Guardian. There was some debate, in which I was not involved, about the two companies not being able to merge because of differences in relative strength. The view, at that time, was that there was no technique to merge them on an equitable basis.

It was interesting to hear the comments about the respective roles of the Appointed Actuary and the independent actuary in a demutualisation. Clearly, the views expressed this evening mirror the views expressed in the GN15 Committee, and hence the reason that we have taken so long to progress with its redrafting. We must make a decision, define the roles, and set that down as our proposal. The problem, at the moment, is that there are directly opposing views. Some actuaries suggest restricting comments to the scheme proposed; others wish to go further and consider alternatives. Whatever the answer is, it needs to be debated within the profession and an approach agreed to ensure consistency. I do not propose that the independent actuary should produce reams of paper commenting, in detail, on the terms of all alternative schemes. I intend it as a final check for it would be marvellous if the actuary could state, "I have looked at various alternatives, and this is the best one available."

With reference to the closed fund option, I am not necessarily suggesting that funds actually close, but that the option should be used as a minimum reference point in deciding appropriate compensation.

I can see no objection to temporary closed funds. A fund can close, and, if the financial position recovers, there is nothing to stop it re-opening, for it need only be a temporary measure. However, it may be very difficult in practice, because, in the interim, all the sales staff may have been dismissed and many connections lost. Alternatively there is nothing to stop a fund being closed if it is in financial difficulties, but continuing to write simplified business with less strain.

WRITTEN CONTRIBUTION

The author subsequently wrote: I am pleased to realise that there were only a few issues on which I considered a further comment necessary. I do not believe that it is appropriate to counter-argue all of the points raised during the discussion.

Mr Holtham referred to the approach under which compensation was agreed on an estimate at a future date, and questioned the logic. Whilst I appreciate his concerns, the principal objective was to obtain shareholder agreement, as potentially open-ended compensation would not have been acceptable to them. I accept that compensation could be varied after approval, and that this would be acceptable to the court, but, unfortunately, in the case study it was not acceptable to the shareholder!

Mr Wright referred to the possibility of retrospective top ups to claims paid in the early years after the closing of a fund, but I agree with later speakers, who suggested that this might well be somewhat complex to operate.

Mr Norris referred to the choice of risk discount rate varying between shareholder and policyholders. I agree that selection is probably not always as straightforward as implied in the paper, with the selection of an appropriate rate possibly varying according to the precise circumstances concerned.

Mr Goford made interesting observations on the rights of policyholders and shareholders in proprietary companies to the assets in excess of aggregate asset shares. Clearly this is an important issue, particularly in the current climate, where the ownership of these 'Orphan Estates' is being hotly debated. He expresses one opinion, but I am certain that others, such as Mr Hewitson, will, equally vociferously, express an alternative to his suggested ownership rights, but that issue will be subject to further debate in the Institute in June 1996.

Mr Taylor referred to the problems associated with considering the closed fund option, and, indeed, others made similar remarks, particularly in relation to large financially sound mutuals. However, I would reiterate the comments which I have made that measurement of the benefits to policyholders of closing could simply be used as a guide to the minimum level of compensation to which they were entitled, rather than actually requiring the fund to close. This ignores the possibility of considering a

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'wind-up', where even greater compensation might be granted, but I do not consider that it would be in the interests of the company or, indeed, of all of the policyholders to adopt such an approach.

Mr Jenkins expressed concern that compensation payments, which were not very large in relation to the total with-profits assets, were to be dealt with through calculation of future asset shares. I can certainly share his concern, but, at the time, the opinion was expressed that the Appointed Actuary, initially, and any future Appointed Actuary would be bound by the general requirements to protect PRE, and I might suggest that ignoring such an issue could be considered as contrary to the Appointed Actuary's professionalism. It is, therefore, up to the actuary to ensure that appropriate internal procedures are set up for future reference. On the other hand, Mr Clay referred to the approach in drafting the scheme to ensure that future decisions were left to the Appointed Actuary, but this flexibility was not intended to incorporate changes in principle to those decisions set down in the scheme.

Mr Wright referred to the use of letters instead of the full names of the companies. This was originally intended to ensure no breach of confidentiality, but as in the final paper all disclosed figures were public, in retrospect this proved to be unnecessary. To assist those readers who may have difficulty of identification: A was Britannia Life Limited; B was Britannia Life Assurance Limited (formerly Crusader) and C was Britannia Life Association of Scotland Limited (formerly Life Association of Scotland Limited).

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