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A REVIEW OF POLICYHOLDERS' REASONABLE EXPECTATIONS

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ABSTRACT OF THE DISCUSSION

HELD BY THE FACULTY OF ACTUARIES

Mr M. Shelley, F.I.A. (introducing the paper)**:** We are all aware that recent judgments by the courts have led to areas where the range of acceptable interpretations of policyholders' reasonable expectations (PRE) by Appointed Actuaries in the past might need to be reassessed. More recently, the discussion papers from the Financial Services Authority (FSA), as part of its review of with-profits business, have raised further issues of fairness, and suggested that each office publishes principles and practices. I understand that the majority of comments received on this are in favour.

Therefore, the time is right for actuaries to have the opportunity to debate how PRE should be interpreted in the future. This is a relatively short paper, presented as a catalyst to enable that debate to happen. It was originally conceived more than a year ago. I thought, at that time, that it was important to bring the papers on PRE on the profession's website up-to-date. However, it became increasingly clear that replacing a few paragraphs in those papers would not be sufficient. The current paper, which was brought together in the last few months, is designed to set the scene and to start the debate by setting out the authors' views on some of the key issues.

While we focus on with-profits business, we hope that the discussion will cover other types of business as well. When the paper was presented to the Institute, some speakers remarked on the strong agreement that there is between the various regulators, and that such agreement was unusual. One area where they were in agreement was that they all disagreed with the use of the term PRE rather than 'treating customers fairly'. Our belief was that the latter will be interpreted as embodying the former, and that, for the purposes of the discussion, it is easier to use the terminology with which actuaries are familiar.

We emphasised, in the discussion at the Institute, that it is for the directors to determine PRE in the context of their own office, and that the Appointed Actuary is only an adviser. In my experience, directors are often confused on this point, and some Appointed Actuaries behave as if the decisions were theirs to make. I believe that the full Board of Directors must remain responsible for meeting PRE, notwithstanding the conflict that this gives them with their role of maximising shareholder value. I am pleased to note that the discussions around introducing a With-Profits Fund Committee now seem to be firmly in that context. I am not persuaded by the suggestion that advising on PRE is so in conflict with a director's role that the Appointed Actuary cannot be a director.

Directors of all companies have conflicts: for example, in balancing the need to maximise

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shareholder value with the need to meet health and safety at work requirements. Indeed, some company directors have further conflicting roles — for example, the directors of water companies have a duty to maximise shareholder value and a duty to maintain water quality. Perhaps, the difference between insurance companies and water companies, and the essence of the difficulty in dealing with with-profits insurance business, is that water quality can be defined relatively easily. Until the Equitable Life and AXA cases, there had been no legal cases which tested the concept of PRE, so the regulators and the actuarial profession had built up an informal framework over the years to define PRE between themselves.

This paper will achieve something if it helps the regulators and the actuarial profession to articulate a common view on the issues of discretion, smoothing, ringfencing and charging for guarantees in a way that company directors can understand. At the Institute discussion there was less disagreement than I expected with the views put forward in the paper on these issues.

Mr M. Willder, F.I.A. (opening the discussion)**:** The concept of PRE was introduced in the Insurance Companies Amendment Act 1973, but, until recently, its meaning had not been interpreted by the courts.

In the past two years we have seen three court judgments which have given at least some interpretation of PRE. The vagueness of PRE has come back to haunt us, with decisions often going against what many actuaries had expected. However, if we are not sufficiently transparent in the way in which we operate, and do not adequately explain to policyholders how with-profits works, then we should not be surprised when the outcome is not what we expected. Given these recent judgments and remaining uncertainties over PRE, this paper is very timely. I thank the authors for summarising the main issues concisely and giving us the basis for what should be a very important discussion on the future of with-profits and PRE.

Section 2 sets out the regulations relevant to with-profits business, as given in the Financial Services and Markets Act 2000 and the profession's guidance notes. Sadly, the Financial Services and Markets Act does not define PRE, and refers only to treating customers fairly. However, in ¶¶2.5.2 and 2.5.3 the authors put forward five widely accepted factors that influence PRE:

— fair treatment of policyholders as a whole versus shareholders;
— fair treatment of different groups of policyholders;
— statements made by the insurer;
— history and past practice of the insurer; and
— general practice within the industry.

The authors then discuss the central role played by asset shares in determining PRE. In ¶2.6.4 they make the vital point that the asset share should be charged for the cost of guarantees. I would add that the asset share should also be credited with the charges from other policies if the policyholder is, in effect, underwriting this risk (as was the case for non-guaranteed annuity rate policyholders at Equitable Life). The authors then make another important point, that an asset share, even if fully adjusted for the charges for the cost of capital and guarantees, is only a guideline for payouts. The smoothing of payouts is an important feature of the with-profits product.

Section 3 summarises three recent court decisions that have considered PRE: Equitable Life, AXA and Needler v Taber.

Section 3.1 considers the Equitable Life case. We are not here to discuss how to deal with guaranteed annuity rates. The Faculty has already discussed this during a meeting on 29 November 2001 (Waters, 2002). We are here to discuss how the court's decision affects our future interpretation of PRE. Unlike many people who have written letters to *The Actuary* magazine, I agree with the House of Lords' decision.

The case highlights the importance of statements made by the insurer. The House of Lords considered that these statements would lead the policyholder to believe that the guaranteed annuity rate applied to the full payout, including the terminal bonus. I am sure that the decision would have been different if Equitable Life had informed policyholders, in their

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communications over the term of the policy, and, importantly, before the guarantees actually started to bite, that guarantees would not apply to the terminal bonus.

The second concept highlighted in this case was the past practice of the insurer. Equitable Life had not charged for the guarantee in the past, so the House of Lords would not permit a retrospective charge to be applied now that the guarantee had bitten.

In Section 3.2 the paper considers the AXA case. At the heart of this case was the treatment of the Equity and Law inherited estate. The court, in its judgment, highlighted the importance of the asset share, company literature and past practice in determining payouts. The court judged that the policyholders could not reasonably expect a payout greater than asset share by a distribution of the free estate, although they could expect to benefit from greater investment freedom and smoothing. The proposed restructuring was allowed to go ahead.

This decision caused surprisingly little debate within the actuarial profession compared to the Equitable Life case, yet it appears to break two of our earlier conditions of PRE, namely: treating policyholders fairly compared to shareholders; and treating different groups of policyholders fairly. While I have no doubt that the current policyholders, who voted overwhelmingly in favour of the proposed distribution of the inherited estate, have indeed received more than they can reasonably expect, I worry about two other groups of policyholders: the past and future policyholders. The inherited estate has been built up at the expense of past policyholders. It sounds reasonable to me that they would expect the residual surplus to be passed on to benefit future generations of policyholders, and that shareholders would only benefit through the 90/10 gate in the usual way. I would be interested to know to what extent those here believe that we should take potential future policyholders' expectations into account.

In Section 3.3 the paper considers the less well known case of Needler v Taber. This judgment also stated that a policyholder would not expect a distribution of the inherited estate in the future. Hence, an adviser could not subtract any such windfall payment from the value of compensation for bad advice.

Section 4 discusses where our interpretation of PRE may have to change in the light of recent events. In Section 4.2 the authors consider pooling and ringfencing. They consider the extent to which risks are pooled together over different types of policy and generations, as opposed to ring-fencing certain risks to apply only to a subgroup of policies.

Next, as a related topic, in Section 4.3 they discuss charging for guarantees. These charges are simply the fee that each policy pays to the pool for the risk that it brings. These charges should then be allocated across the pool in relation to the risk underwritten. In the past, I am sure that most policyholders were unaware of what risks they were facing from other policies. For example, the with-profits fund often shared in the risks of the non-profit business. While this business proved profitable, and asset shares were enhanced by these profits, then complaints would not emerge. However, recently policyholders are becoming more aware of these risks. We have seen mis-selling costs and guaranteed annuity rate costs attributed to the with-profits fund.

I believe that we should remember that the policyholders have bought what they consider to be investments with lower risks than unit-linked policies. We should pool risks whenever this reduces overall risk for the policyholders — for example sharing mortality risk across the fund, or investment risks across generations via smoothing. We need to be careful that each policyholder is charged for the risk that he or she brings to the fund. However, policyholders should not be exposed to additional risks which increase the volatility of their payouts, e.g. non-life insurance or banking, and these should be borne by shareholders.

If a group of policyholders is underwriting more risk than it brings to the fund, then this needs to be clearly communicated to the policyholders. They should receive an appropriate risk premium in the good years to compensate for potential losses when the risk bites.

The authors next consider (in Section 4.4) the exercise of discretion. The ability to apply discretion has been very important in the past. It allows with-profits offices to deal flexibly with unexpected events and to improve procedures through time as new techniques become available, for example through increased computing power. However, the application of discretion conflicts with the transparency that the industry is being urged to show.

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The authors discuss the extent to which we can use discretion if an unexpected event occurs. I believe that, in these circumstances, we see the benefit of a large free estate, so that current policyholders' expectations are not substantially eroded. The orphan assets are not so orphaned as some would have us believe. They build up when the unexpected does not happen, but, from time to time, they will be needed when the inevitable surprise comes along.

The next topic (Section 4.5) was smoothing, which the authors say: "lies at the heart of with-profits business". It was suggested in Clay *et al.* (2001) that insurers should make public the value of a smoothing account. There is a danger that insurers with negative smoothing accounts will not attract or retain business. Again, we see a conflict between having flexibility and transparency. It will be interesting to see how people reconcile these differences in this discussion.

I am a big fan of the with-profits concept. I am sure that, over the next few years, a number of important changes will be made to improve both this product and policyholders' understanding of it.

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Mr R. M. Paul, F.F.A.: I comment on when PRE is determined. In the paper reference is made to actuaries needing to change their perception of PRE in the light of the court cases to which reference is made. However, I would like to raise the timing of when PRE is established for an individual policyholder or a group of policyholders — whether it is established at point of sale or if it develops throughout the term.

I shall not comment on the rights or wrongs of the legal judgment in the Needler v Taber case, but the developments since then, under which the FSA has sought to interpret that judgment and to take it into account in compensation calculations. Following the judgment, the FSA naturally deliberated, and, having first placed an embargo on all cases affected by it, that is any case where there was a need to remove the value of any bonus resulting from demutualisation, it has produced a consultation paper CP126.

CP126 first states that Needler v Taber was about windfall benefits flowing from a demutualisation event, but goes on to state that there may be other corporate events which could give rise to windfall benefits. Accordingly, it proposes that firms should conclude that a windfall benefit arises where:

— there has been a demutualisation, distribution or reattribution of the inherited estate, or other extraordinary event in a life office; and

— the event gave rise to 'relevant benefits'.

Thus, the FSA proposes that firms should identify as 'relevant benefits' those benefits that fall outside of what is required to fulfil PRE at the point of sale. I repeat 'at the point of sale'. The FSA considers that the following should be treated as 'relevant benefits':

— free shares or cash on a demutualisation; and

— additional bonuses and policy enhancements given by way of an incentive to approve a reattribution or distribution of an inherited estate.

In its response, the ABI has queried the principles on which the FSA has based its proposals. Reference is made to the Needler v Taber judgment, identifying two propositions:

(1) The relevant question is whether the negligence which caused the loss (that is the mis-selling) also caused the profit (that is the windfall), in the sense that the windfall was part of a continuous transaction of which the mis-selling was the inception.

(2) The question is a matter of fact.

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It concluded that the Needler v Taber case was decided on grounds of causation, but the FSA has approached the issue on the basis of foreseeability. Thus, the FSA is proposing that the corporate event which gave rise to the windfall should depend on whether the benefits fell outside what is required to fulfil PRE at 'the point of sale'.

The ABI maintains that PRE is not fully determined at 'point of sale', but continues to be determined throughout the period for which the policy is held, and changes over this period.

It would be interesting to know whether the authors would define PRE as able to be fully determined at the point of sale or needing ongoing determination which results in its adaptation over the term of a policy.

Mr C. G. Thomson, F.F.A.: I need to declare several interests in this topic. I speak as a former Chairman of the Life Board at the time when the position statement was prepared and issued, and as the Faculty Member of the Working Party on PRE which produced the report between 1990 and 1992.

My other interest: I will not comment on Equitable Life for obvious reasons, other than to say that I remain deeply unconvinced (despite the comments of a number of learned Counsel) that that judgment should be allowed to apply widely to other companies. It is disappointing that those who could have made a difference, i.e. the FSA, the Treasury and the Government, have said so little publicly. The consequence is that a number of companies have now made changes which, at least arguably, conflict with PRE as we used to understand it, to the disadvantage of other policyholders. The concept of 'fair' on which we all believe PRE is based, now means quite different things to different observers.

I agree with almost everything that the authors write, but I am not sure that the position which they describe is sustainable. The fairness envisaged in ¶2.5.3 is still possible, provided that you have told the necessary groups of policyholders that they are in different bonus series. What used to be commonplace, effectively putting it right after the event because the result was fair, will not pass the legal test.

I now mention some of the inconsistencies which the profession needs to contemplate. I am not clear how they can be resolved, since those with the power to do so remain extremely reluctant to get involved.

There is a problem with ¶4.3.4 and ¶¶4.4.4 to 4.4.6. Most of us would approve of what is suggested, but this does not sit well with ¶¶4.2.2 and 4.2.3. The reason is that one is detail and allows hypothecation of sub-funds, and the other looks at principles and suggests that investment return is broadly based across the entire fund. If we want freedom to set fair bonuses by differentiating between different groups of policyholders, then we must take far greater care than before with PRE. This point was not missed in 1998 and 1999 — ¶18 of Appendix 1 and the final substantial paragraph of the letter in Appendix 2 both draw attention to it. If we wish to retain the right to hypothecate assets into sub-funds that have different bonus rates, but do not have separate legal personae, we need to be crystal clear that what we propose conforms to PRE, particularly the expectations created in the policyholder literature. Silence is no longer a defence — the literature needs to spell it out.

I also have some concern about the comments in Section 4.5 about smoothing and the suggested rules in ¶4.5.4. Smoothing works well when dealing with a 25-year endowment policy paid by monthly premiums with a fixed maturity date. Progressive 'improvements' in the with-profits policy — allowing single premiums, flexible premiums, shorter terms and flexible retirement dates — all potentially damage the ability to smooth and to reduce 'fairness', both for those who are given an option against the fund and for the other policyholders. Arithmetic rules can be a useful guide, they should never be a requirement.

It is a modern shibboleth that increased transparency in with-profits contracts is desirable. If it constrains transfers from policyholders to shareholders it may be beneficial, but in all other areas it is proving to have perverse effects. The suggestions in ¶4.6.4 are not wise. In this area our profession seems interested only in appeasement, and does not seem to have thought the issues through. Those who see themselves as modernisers are, in fact, doing a pretty good

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demolition job. I urge the authors and the profession generally to reflect on this. It is almost certainly too late to save with-profits business, but at least it should be allowed to die with dignity, because the essential ingredient of trust is no longer fashionable. I believe that that is why with-profits business is doomed, rather than because it fails to measure up as the unit-linked contract that it never was supposed to be.

Mr J. S. R. Stocks, F.F.A.: I want to point out my lack of comfort with the points made in ¶4.2.7: "...we believe that the various legal rulings and opinions should not limit the ability of the office to share experience across groups..."; and in ¶4.3.4: "Notwithstanding recent court judgments on ring fencing, it is normal practice to charge the cost of guarantees to policies able to benefit..."

I reiterate what Mr Thomson has just said: "Who is defining what the expectations are?" I think that these will be determined by court decisions, but also by how the high-level principles in the FSA rule book — Principle 6, 'unfairness', and Principle 8, 'conflicts of interest' — will be applied. These areas are still open to interpretation, and hence my lack of comfort with the two statements. I am afraid that it is not necessarily the actuarial profession which is going to be the arbiter; I think that it is going to be the legal profession.

I now return to how we determine reasonable expectations and how we deal with charging for guarantees. If it is set out clearly in communications to policyholders that they will be charged for guarantees, for example by way of a different bonus series from those without guarantees, then expectations are set upfront. The discretion subsequently exercised by the directors must be limited by what policyholders have been told. The post-event rationale of how we allocate bonuses and apply ring fencing is difficult to accept. We, as actuaries, may understand the reasons for this as we should understand the issues, but I think that there is evidence from the courts, and I know from speaking to non-actuaries that others do not see the issues in the same way. If you have not been charged for guarantees explicitly, then what rights does a company have for retrospectively charging for guarantees by selectively reducing bonuses?

Bonuses have to be seen to be set fairly, and to be seen to be so by a reasonable person, and, ultimately, by the courts. I am frightened that many of the issues here are going to continue for quite a period of time, until we have seen more cases resolved. There is obviously a question about the costs of raising class actions through the courts, and hence some decisions by companies may not be challenged. However, I do not think that it is beyond belief that there will be challenges in the future, where people seem to be effectively paying through the back door for policy guarantees that were given at inception.

My other point concerns the whole issue of who pays for company and management costs, such as mis-selling costs. Is it right for people to enter into a with-profits fund as new entrants without being made aware of such potential issues, but what company would declare that it has potential hidden problems that may result in future costs to policyholders? Are we absolutely certain that we have fully disclosed all such issues in our actuarial statements? Is the Appointed Actuary fully aware of all the risks? It is quite a challenge to examine where we are now, so that we do not land with another series of difficulties that are likely to damage the profession in the future.

Dr D. J. P. Hare, F.F.A.: I hope that Mr Thomson is not right in saying that with-profits is doomed, and should be allowed to die gracefully. Perhaps with-profits, as we knew it in the past, will need to change to suit a new view of society where people question whether society exists, and where individualism overrides the concept of cross-generational smoothing. Then with-profits struggles to deliver what it used to do.

I hope that some of the ideas of corporate governance that have come out of Issues Paper 5 from the FSA with-profits review may help to go some way to bridging the gap of trust to which a previous speaker has rightly drawn attention.

Given that background and my hope that with-profits can survive, it is worth pointing out that with-profits means different things to different people. That was something that we tried to

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say in the Fair Value Working Party Report (2002). One of the difficulties that we found there was that, if you are trying to cost the guarantees implicit in a block of with-profits business, how do you do it without introducing formulae into the process, since once you introduce formulae, have you not then breached the discretion that is an essential part of with-profits? We posed that question, and I, for one, am still looking forward to hearing answers. Maybe Project 2005 will come up with some.

I now make specific points in response to some comments that have been made. It is often said that other business profits should be underwritten by shareholders rather than by policyholders. I have to take issue with that, given that my employer is a mutual company. Mutuals are not necessarily bad entities. At the sessional meeting in February 2002 we discussed corporate governance and its diversity, or lack of it, in the provision of financial services (Guijarro & Hare, 2002). We should be careful before we say that it is inappropriate for a life office to have other business activities as well as with-profits and still remain mutual. This model still can work, and work very acceptably, with the appropriate benefits to policyholders, but, of course, it needs the appropriate controls and risk management of what businesses are entered into on behalf of the policyholders in the companies.

The other point, that estates have been built up by previous generations of policyholders, may be true in some companies, but may be true only in part, if at all, in others. Some of the mutuals that were plcs before they became mutuals could have had large estates at the time of mutualisation, which they may still possess today.

On the question of when PRE is determined, we should remember that, if we had been speaking about fairness we would not have needed to discuss this point. My reading of Disclosure Paper 7 from the FSA in 2001, on treating customers fairly, is that treating customers fairly is far bigger than PRE. Broadly speaking, PRE involves doing what you hinted that you would do at the time of writing the policy, or in literature going forward; whereas treating customers fairly is to do what, with the benefit of hindsight, policyholders think was in the spirit of the agreement that they entered into with you. That is a much bigger concept, and potentially a much more expensive concept, but one that would certainly resolve some of the issues with PRE that we have raised already. I would like to see the paper broadened into what fairness means going forward.

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Mr C. W. F. Low, F.F.A.: I shall attempt to broaden the discussion on the generic words 'with-profits'. If I remember rightly from the history books when I was a student, with-profits business was originally non-profit business, but, because of the uncertainty over mortality rates, such prudent assumptions had been made that excessive profits were made, and, as a result, gratuitous additions to the sum assured were made.

Naturally, we have been talking in this discussion about with-profits on endowments and whole of life life business. A question was asked: "Is there PRE for future policyholders?" I think that there is PRE for future policyholders. I agree with Dr Hare and disagree with Mr Thomson that with-profits business will continue to be sold, although not necessarily in the same format that we have had in the past.

I now consider two areas where there is a degree of uncertainty. The first is long-term care costs. There are not enough statistics to know how to cost long-term care products accurately, and, undoubtedly, with the changing definitions in society, it will be an ever-changing product. The second is insurance against excessively long longevity for annuities. We do not know what effect genetics is going to have on prolonging life. It is very difficult to price other than very conservatively for long-term annuities. These are areas for possible with-profits business, going

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back to the fundamentals: price conservatively, group in a pool, sell and educate to accept the concept of pooling. There is the challenge. Then distribute profits, if they are available.

We should not restrict ourselves to the sort of technical discussion that we are quite rightly having about how the FSA might look at the current generation of with-profits. I hope that we will remember the roots of with-profits business, and think of how that can be applied to future products.

The President (Mr T. D. Kingston, F.F.A.): The last two speakers have broadened the topic considerably. I encourage you to think that the concept of PRE does not just apply to with-profits business or even just to life business, but, as Mr Low has pointed out, to a broad range of businesses. For example, how might it apply to pensions business in particular, as people switch from defined benefit schemes to defined contribution schemes, and what might be involved in that particular aspect?

Mr J. Hastings, F.F.A.: It is interesting to consider the rationale for with-profits given in ¶2.1.2, where it states that it gives: "policyholders the benefit of investment in a broad range of types of asset whilst protecting them from the full volatility of such investment." Reducing volatility is a very attractive objective for one of the options within the fund range. From that perspective, I would like to hope with Dr Hare and against Mr Thomson that with-profits is not a dying breed. It offers a very attractive savings vehicle that will have continuing validity in the United Kingdom. Indeed, I have even heard it suggested that it may be a potential asset for pension schemes to use for FRS 17 purposes, because of its lower volatility. I am not quite sure who is going to bear the risk of that volatility, but that is, perhaps, another subject.

Life insurance provides a long-term savings mechanism. One of the problems that I have with PRE comes down to past performance statistics. Past performance, particularly with regard to with-profits contracts, causes me quite a lot of concern. I was brought up at a time before animals such as unitised with-profits had been invented. I think back to a time when there was considerable profit from surrenders and from non-profit business, and these are sources of profits that do not now exist. Yet, offices rely upon bonus records which were built when those sources delivered considerable profits which are no longer available. It is difficult to explain PRE if you start by being disingenuous about investment prospects.

I was intrigued when the authors explained that they thought that the House of Lords judgment regarding the Equitable Life differed in important respects from the widely held actuarial interpretation of PRE. I consider this from the point of view of being offered an option and the sense that, if I value the liabilities underlying the contract, then I expect the value of the annuity option to be priced into the asset share calculation.

Reading further, the authors consider whether, retrospectively, with a degree of hindsight, we should price in the cost of that option premium as an element of the premium being paid, or, if these are insufficient, then it should form some debt against the existing asset share of the contract. It might be reasonable for an element of the premium to be considered in that way, but I think that, when you get into a situation where you have a naked option which is uncovered, and you feel that there is a responsibility on the management of the office to have covered that option in some way, then the cost of that option should be covered by the shareholders, or, for a mutual company, by the implicit shareholders, who would be all of the with-profits policyholders. I think that that is one way in which we could reconcile the House of Lords' judgment with an actuary's definition of PRE.

Mr P. H. Grace, F.F.A. (closing the discussion)**:** I suspect that the catalyst for the paper was the court judgments to which the authors refer, but believe that, even without those judgments, the Sandler review and the FSA's current work on with-profits would have triggered a review of PRE by the profession. The outcome of these reviews will affect the basis under which with-profits business is marketed and managed in the future. Furthermore, they might also impinge on how discretion can be used by product providers in other areas as well.

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As stated in the opening sentence of the paper, the concept was included in the Insurance Companies Amendment Act 1973, but the term had, in fact, appeared in a paper by R. S. Skerman some seven years earlier (Skerman, 1966). The Financial Services and Markets Act 2000 (FSMA) has included the term 'treating customers fairly' — the authors suggested that they believed this term would be interpreted as embodying PRE.

In interpreting PRE, actuaries have, in fact, erred towards 'treating policyholders fairly', and accordingly, in the light of the FSMA, we now need to develop our approach to issues, in particular those involving discretion — smoothing, use of the estate, etc.

I recall a discussion, before I retired from full-time employment, which I had with a colleague who was a lawyer. We were discussing a particular issue, and I expressed a view that, having regard to PRE, we should go down a particular route. The lawyer took a different view, and went as far as to say that, in his opinion: "Actuaries' interpretation of PRE was incorrect — we should stick to the contractual obligations." I think that his views might have been different if the test had been one of 'treating customers fairly'.

Mr Paul questioned whether PRE was established at the outset of a policy and remained unchanged, or could it change? I believe the latter. As techniques develop, so should PRE. For example, asset shares were unheard of when many policies now maturing were effected, but they are now referred to quite freely. Also, consider probably the most common measure of PRE — the guide used by many offices that payouts from year to year could not vary by more than 10%. To cater for the effects of moving from a high inflation era to a low one, payouts have had to be brought down more quickly than would have been possible under the 10% rule.

In introducing the paper, Mr Shelley expressed the hope that we might discuss PRE with regard not only to with-profits business. However, the term is, by the nature of its wording, relatively narrow — except for those working in the general insurance area, other actuaries do not encounter 'policyholders'. I think that reference should have been to 'treating customers fairly'. That would, in turn, have encompassed the work of all actuaries, including those in wider fields. However, both Mr Low and the President responded to this invitation; Mr Low referred to PRE in the case of health insurance business, and the President raised the subject of the application of the concept to pensions business.

It was about five years ago when the profession discussed the inclusion or otherwise of a reference to 'public interest' in the Professional Conduct Standards (PCS). There were strong views on both sides. I think that it would have been more difficult for those opposed to a reference to 'public interest', to resist 'treating customers fairly', or perhaps 'treating people fairly', which, I suspect, many of us had in mind. I accept that any test of that concept would be so subjective that it would be difficult to write it into the PCS, and I should add that it would be most unpopular amongst the group of those who have spent a lot of time in the last two years reviewing the wording of the PCS.

Several speakers, including the opener and Mr Stocks, have referred to the need for good communication. For some time now the profession has required students to take a paper on communication, and it is seen as a stumbling block. It is not surprising — we have been bad at communicating. This was one of the themes adopted by the current President of the Institute in his Address almost two years ago, and to which he has referred on a number of occasions. As a result, we have become more conscious that we have not been good at communicating.

Mr Thomson thought that with-profits was 'dead'; but both Dr Hare and Mr Low thought that this was not the case, although the business would develop. Personally, I subscribe to the latter view. With-profits has changed a lot in my working lifetime, and I expect that it will continue to develop. With-profits business could not exist without actuaries. The public do not understand how with-profits business is managed. Only recently we have tried to deal with this lack of understanding. The problem is not restricted just to with-profits, but also to other areas where discretion plays a part.

The FSA inherited from its predecessors a series of point of sale and immediate post sale documents, including one on key features. Whilst these have contained useful information, I

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would be surprised if more than a small proportion of the recipients have both read and understood the documents. Furthermore, currently the regulators do not ask offices to explain, in the documents that must be issued to policyholders, how with-profits works: what guarantees are entailed; where and how discretion can be applied; how smoothing works. Only the with-profits guide gives any information; and that does not have to cover all aspects nor does it have to be sent to new with-profits policyholders — it only has to be available on request. It is for offices, not their actuaries, to decide what information is given voluntarily to policyholders, but we could encourage the dissemination of more useful information. In this way we could educate future policyholders on their PRE.

One of the recent Issue Papers published by the FSA concerned the governance of with-profits funds. It floats the idea of an independent 'with-profits committee', possibly as a sub-committee of the board, to represent the interests of the policyholders in the management of the with-profits business. This concept has been put in place for some funds following demutualisation, and those committees are very conscious of the issues raised by PRE. If the FSA's ideas proceed, 'treating customers fairly' will be at the forefront of the minds of those committees.

One aspect which those committees need to address, if customers are to be treated fairly, is the tontine effect arising from the run off of a closed fund, especially if reserves have been required against potential claims for guaranteed annuity options.

The FSA paper poses a number of questions, including one as to the format in which such a committee should report. Clearly, there should be a formal statement in the accounts or returns to the effect that such a committee exists, and outlining the functions that it has carried out, but would it not also be sensible if it produced an easy to read, attractively presented report on its activities that could be issued to policyholders together with annual bonus notices? The cost of producing such a report would be reasonable; but, more importantly, it could be used to help educate policyholders as to how the with-profits business is run. It could explain asset shares; how smoothing has operated — perhaps warning policyholders that an upturn in the market may not mean an upturn in payouts. It could explain how guarantees have worked. It could explain any transfers from the estate, etc.

I believe that this paper is just the beginning of a new project for the profession, and I look forward to its development.

Reference

Skerman, R.S. (1966). A solvency standard for life assurance business. *J.I.A.* **92**, 75-84.

Mr M. Arnold, F.I.A. (replying)**:** As Mr Shelley explained at the beginning, we very much wrote this paper as a catalyst for a debate for taking the concept of PRE or 'treating customers fairly' forward. This discussion, although briefer than the one that was held by the Institute, will be an important contribution to that.

Clearly, our work is not complete. It cannot be complete. Even if with-profits is dead — and I, for one, hope that that is not the case, and believe that it will not be the case — there are still £350 billion of assets of current with-profits funds that have a considerable lifetime left, which will require PRE or fairness. From my perspective, the two are synonymous and go hand-in-hand. These existing funds will continue to require actuarial management. PRE will need to be better defined and better disclosed and explained to policyholders.

It was quite clear from the contribution to the debate at the Institute from the regulators — and I believe that a Member of Parliament, the Chairman of the Treasury Select Committee, was there — that they are quite clearly looking to somebody to provide a better description of PRE or 'treating customers fairly'. If the actuarial profession does not take the lead in doing that, then somebody will do it for us. If we want more legal interpretation on PRE, then the way that we will get it is by us sitting back and doing nothing and waiting for someone else to define the concept or to describe how PRE or fairness should be interpreted in the future. I am sure that no one at this discussion would want it to be that way.

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I cannot believe that it is not possible to describe the principles on which discretion is exercised by boards of with-profits funds or life companies, or however the governance regime eventually settles down. It must be possible for them to be able to describe the principles on which they would exercise that discretion in a way that demonstrates fairness and demonstrates the reasonable treatment of policyholders without losing the necessary flexibility and freedom on which with-profits business is so dependent. It is not adequate to say that it is too difficult or that it is beyond the wit of us to do it in a way that the ordinary person could understand. I just do not accept that.

The work is not complete. This is the beginning of the debate, as the closer implied. We volunteered ourselves to take the matter further, and I am sure that we will be doing that.

The President (Mr T. D. Kingston, F.F.A.): On your behalf, I thank particularly the authors, Mr Shelley, Mr Arnold and Mr Needleman, for starting this debate. One of the things that the President of the Institute and I have been very keen on over the past couple of years has been to open up discussions on topics which do not always have very easy answers, but which are of very widespread interest. This topic extends beyond with-profits, where it is particularly important, to the broad area of 'treating customers fairly', as well as giving policyholders their reasonable expectations. Thank you very much indeed.

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