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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

In the current financial climate takeovers of proprietary life companies by other life companies, amalgamations of mutuals and demutualisations have become more and more prevalent. However in respect of takeovers, the process does not end with the purchase, but normally results in the transfer of the long-term business of one of the companies to the other. To optimise synergy and administrative efficiency, there may be a need to reconstruct the amalgamated funds.

The author has been involved as Appointed Actuary and internal project manager in such transfers of business within proprietary companies and has also acted as an independent actuary and as an external project manager for other transfers. One of these transfers involved four companies transacting both with-profits and unit-linked business in which the interests of both policyholders and shareholder had to be protected. He considered this transfer to be of sufficient interest to merit the preparation of a paper discussing the issues which arose. Although the paper is principally based on that transfer as a case study, relevant and related factors arising in other transfers have been included where appropriate, as have references to the role of the actuary before, during and after reconstruction.

In the case study, the scheme of transfer and the associated reconstruction of corporate structure involved merging three separate with-profits funds, merging many unit-linked funds (including unitised with-profits) and, subject to appropriate compensation, rationalisation of the rights to surplus attributable to both with-profits policyholders and shareholder.

KEYWORDS

Transfer of Business; Section 49; Restructuring Life Companies; Merging With-Profits Funds; Rights to Surplus

1. INTRODUCTION

1.1 *Background*

1.1.1 The continuing reduction in the number of life companies in the United Kingdom through takeovers of proprietary companies and amalgamations or demutualisations of mutuals, has been the subject of much detailed analysis. Such analyses have also projected the future outcome if, as expected, this trend continues.

1.1.2 The paper is not concerned with the strategy behind changes of control, but starts at the point where an actively trading proprietary life company has completed the acquisition of another as part of that strategy. Its purpose is to consider the subsequent corporate restructuring, in which the requirements of the shareholder had to be balanced with the rights and benefit expectations of the policyholders to ensure the interests of both were protected.

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1.2 *The Case Study*

1.2.1 The paper is principally concerned with tracing the development and ultimate implementation on 30 December 1994, of a scheme in which the actuarial issues were extensive. It involved not only the transfer of the long-term businesses of three companies to a fourth, but also the simultaneous merger of three with-profits (WP) funds and, in addition, an associated corporate restructure. The restructure required the payment of appropriate compensation for changes to surplus distribution rights in order to maximise synergy and facilitate future administration.

1.2.2 I had previously been Appointed Actuary to one of the companies, but in this scheme my role was that of internal project manager responsible for the control and management of all actuarial, taxation, legal and administrative aspects to ensure ultimate court approval. This encompassed input to, and involvement in, all actuarial and other discussions.

1.2.3 The case study only deals with issues of actuarial interest. It does not consider in any detail the equally important legal and administrative processes which had to be progressed simultaneously, and which also gave rise to many intriguing problems and solutions.

1.2.4 One unusual complication arose well into the project when the Appointed Actuary, having prepared his report, resigned for personal reasons. Consideration was given to a supplementary report from the new Appointed Actuary, but three published actuarial reports were considered likely to be confusing. The format and much of the original report were adopted by the new Appointed Actuary, subject to such amendments as he considered necessary. Fortunately these were relatively few, and the principal conclusions did not alter.

1.2.5 In the case study the four companies are referred to as A, B, C and D, but no prizes are awarded to readers identifying the companies involved! Accordingly, only the figures appearing in the scheme document and actuarial reports are reproduced. The background detail remains confidential to the company concerned.

1.2.6 As a consequence, although much modelling work was produced internally, there are relatively few figures in the paper. However, I believe the underlying arguments provide sufficient background to an understanding of the conclusions. After all, the policyholders were expected to understand the proposals from even less data!

1.2.7 All the issues discussed and either rejected or incorporated during the actuarial process have been included. Many of these deal with subjects which would merit a sessional paper in their own right, e.g. free estate, asset shares, unitised with-profits (UWP), and, accordingly, I have dealt only with the points relevant to the case study. Even so, the end product is much longer than originally anticipated. However, when I remember the numbers of actuaries, lawyers and external advisors involved in, and the number of hours devoted to, the scheme's successful conclusion, perhaps its length is not so surprising.

1.2.8 I trust that the resultant paper not only makes interesting reading, but

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also stimulates discussion by focusing on a process which may become more and more common.

1.3 *Relevant Literature*

1.3.1 Nearly all the relevant actuarial papers concentrate on either the strategy behind the change in control or the assessment of an appraisal or embedded value, either as compensation to the existing shareholder in a proprietary company or to the WP policyholders (and non-profit where the policyholders are losing membership rights) in a demutualisation.

1.3.2 The papers to which I make reference do comment on the common principles involved in protecting policyholders' rights, but mainly in the context of demutualisations where only one company is involved and, thus, only one set of policyholders.

1.3.3 Protection of policyholders' rights is always of critical importance in a restructure, but the actuarial considerations become more complex if that restructure involves the merger of previously unconnected life funds. This complexity arises as the development histories of the funds being merged will be quite different.

1.3.4 Few papers deal specifically with the actuarial considerations of a corporate restructure of proprietary life companies, where it may be necessary to protect, not only the interests of policyholders, but also the interests of shareholders.

1.3.5 The last such paper was by Hunter & Jones (1986), and even then this topic formed only one of three sections. It considered the interests of the shareholders during the acquisition process, but only those of the policyholders during the merger process. This was understandable, as there was no simultaneous change in surplus rights.

1.3.6 Hunter & Jones provided a very useful paper, but, in my view, in the intervening years there has been sufficient evolution in approach to the protection of policyholders' interests to justify writing this paper.

1.3.7 There are, of course, the actuarial reports, but these deal with specific schemes and comment exclusively on their terms. I have attempted to provide a full insight into all the issues considered during the development of the scheme comprising the case study.

1.4 *Actuarial Complexity — Case Study and Other Schemes*

1.4.1 The degree of actuarial complexity varies greatly from scheme to scheme. The following selection of my own experiences will serve to demonstrate that point.

1.4.2 I was the Appointed Actuary involved in a scheme transferring the businesses of two wholly owned unit-linked (UL) companies into the parent WP company. There was no merging of funds or other operational changes. In such a basic scheme of transfer, the principal actuarial requirement is to ensure that the security of the policyholders in transferor and transferee companies is not adversely affected.

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1.4.3 Provided benefit expectations are not complicated by maturity guarantees, then, if security is protected, it is fairly safe to state generally that benefit expectations will not be adversely affected.

1.4.4 However, the transfer of UL business may become more actuarially complex if there are special problems, such as I encountered when acting as independent actuary in the transfer of business from one friendly society to another. In transfers between friendly societies, the principles are essentially the same, although the governing legislation is different.

1.4.5 Prior to transfer, the transferor had experienced significant problems resulting in reduced policyholder security, and, indeed, even though the business was all UL without maturity guarantees, benefit expectations had already been reduced.

1.4.6 The scheme was constructed to *ring fence* the transferor's business for 5 years after transfer. This was to ensure policyholders' security, and benefit expectations in the transferee were not adversely affected, whilst, at the same time, improving and stabilising security and benefit expectations for the transferring policyholders. The period of 5 years was considered adequate, as the transferor company had been closed to new business for 2 years and the term of the policies, as is standard in a friendly society, was a maximum of 10 years.

1.4.7 The actuarial issues surrounding the transfer were principally related to, and a consequence of, the transferor's problems. There was to be an immediate distribution of surplus on transfer, resulting from the partial release of special sterling reserves held in the transferor, but not considered necessary after transfer.

1.4.8 Prudent sterling reserves would still be required within the ring fence in respect of the transferred liabilities, and had to take into account the transferor's prior problems which could not be resolved immediately. Thus, they had to be set at a level considered sufficient to avoid compromising the security of the transferee policyholders.

1.4.9 On the other hand, these reserves would determine the amount of the initial distribution of surplus to the transferor policyholders. The difficulty in timing arose as delay in distributing such surplus deprived prior policyholders of any share in future surplus distributions, although their maturity payments had been restricted when establishing these additional reserves. Clearly a balance had to be achieved.

1.4.10 It is not my intention, following the comments in ¶1.4.2 on transfers of UL business, to minimise the actuarial input, which remains of paramount importance in protecting policyholders' interests. However, that input increases if the transfer includes special problems, as in the scheme described in ¶¶1.4.4 to 1.4.9, and increases even further where the scheme incorporates the merger of WP funds, as in the case study.

1.5 *Structure of the Paper*

1.5.1 The remainder of this section provides a summary of the following content.

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1.5.2 Section 2 provides a brief background to the relevant legislation, with Section 3 then considering the wider role of the actuary in the light of this legislation, including references to relevant Guidance Notes (GN) issued by the Faculty and the Institute of Actuaries.

1.5.3 Section 4 provides the corporate and structural background to the four companies referred to as A, B, C and D, with Section 5 considering the options for restructuring and rationalisation of the combined entity and the scheme issues.

1.5.4 Section 6 considers the selection of transferee and effective date, which are largely dependent on tax issues.

1.5.5 Section 7 explains the approach adopted in respect of UL business which was complicated by the existence of UWP business. Section 8 explains the approach adopted to rationalise the WP business.

1.5.6 Section 9 deals with the compensation payments between WP policyholders and the shareholder.

1.5.7 Section 10 considers the merger of the WP funds, how the relative strengths were compared and the issue of the ownership/purpose of the free estate in that context.

1.5.8 Section 11 deals with issues of interest in the scheme document, considers the future financial management of the company, identifies areas of future importance to the Appointed Actuary and makes some comments on the scheme with the benefit of hindsight.

2. Legislation

2.1 For readers not familiar with the legislation covering transfers of long-term business, it is useful to provide a brief summary of its development to the present time.

2.2 Prior to 1870, life assurance business was regulated only by the limitations of the policy conditions and the transferring company's constitution. In 1870, following problems which impacted adversely on policyholders, the Life Assurance Companies Act was implemented, requiring that a transfer of business had to be approved by the court.

2.3 The Life Assurance Companies Act of 1909 introduced the requirement that a report by an independent actuary had to be submitted to the court.

2.4 There was very little change until 1973, when new sections specified that the persons entitled to be heard on the petition to the court were the Secretary of State and any person (including any employee of transferor or transferee) who alleges that he/she would be adversely affected by the scheme.

2.5 These sections subsequently became Sections 49 and 50 of the Insurance Companies Act 1982 (ICA).

2.6 The ICA provisions were amended by the Insurance Companies (Third Insurance Directives) Regulations 1994 (the Regulations) which came into force on 1 July 1994, and the scheme discussed in this paper was approved in accordance with the Regulations.

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2.7 Section 49 (S49) of the ICA was not repealed, but the wording of it and Section 50 were effectively replaced by Part 1 of Schedule 2C of the Act as inserted by the Regulations. It is, therefore, still correct to refer to transfers as in accordance with S49.

2.8 The ICA provisions covered only long-term business carried on in the U.K. The Regulations were intended to meet the needs of the single market in Europe, and were expected to simplify the process of transferring non-U.K. business written throughout that market.

2.9 However, the, presumably unintentional, result has been to introduce considerable additional procedural complexities and expense if there are any policyholders (even just one!) habitually resident in other member states when their individual policies were effected, regardless of whether the policies were effected prior to 1 July 1994, written in English, governed by U.K. Law and the premiums and benefits specified in sterling.

2.10 Such policies would previously have been regarded as part of the U.K. business and transferred under the provisions of the ICA. That procedure still applies under the Regulations to similar policies written on the lives of persons habitually resident outside these member states. The basic actuarial considerations are not affected.

2.11 Statutory Instrument No. 3132 of 1994 has already mitigated the impact, and, at the time of writing, I understand that the provisions are still under review by the Department of Trade and Industry (DTI), with the intention of simplifying procedures relating to member states through additional regulations.

2.12 Although there is no legislative requirement, it has become fairly common in more complex schemes for a report by the Appointed Actuary to be included in the court documentation. Care has to be taken to ensure there is no confusion between the respective roles of the actuaries involved, and this is commented on further in Section 3.4.2.

2.13 The legislation prescribes the procedural requirements which must be followed and which are critical if the scheme is to secure court approval. There is no need to set them out in detail, as their purpose is to ensure policyholders are informed of the proposed scheme and made aware of their rights. For those interested in these procedures, the paper by Pell (1991) is most useful and still relevant, even though it predates the Regulations. For a more recent review there is an article by Evenett (1995), although there have been further developments. Neither is restricted to technical procedures, and each also includes comments on wider issues.

2.14 The S49 procedure is used, in the absence of any alternative legal process, to enable a mutual company to demutualise, but was never really intended for that purpose. S49 was primarily intended to deal with the transfer of long-term businesses between life companies, either where the funds are to continue as separate entities or, as in the case study, where the funds are merged and lose their separate identities.

2.15 In ¶1.4.4 reference is made to different legislation covering transfers of

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business between friendly societies, and this is governed by the Friendly Societies Act 1992, under which the requirement for an independent actuarial report is at the discretion of the Friendly Societies Commission.

3. Role of the Actuaries

3.1 *Pre-Scheme Events*

3.1.1 Before considering the role of the actuaries, it is helpful to consider prior events. C had been a wholly owned subsidiary of a group which wished to sell its share holding, and did so to another wholly owned subsidiary life company. In such a sale the main consideration is the price, and, unlike a demutualisation, there is no need to develop a scheme as an integral part of the sale process. Policyholders have no say in the matter, and do not even need to be informed in advance, for, at the point of sale, they are not affected. When the role of WP policyholders in life company financing is considered, this does not seem reasonable, and this point was made in the discussion on Salmon & Fine (1991). However, that view was not endorsed in the subsequent Working Party Report entitled Life Insurance Company Takeovers (1994).

3.1.2 The board of the vendor does have a duty to act in the best interests of the shareholder, but this is meaningless in a wholly owned subsidiary. However, the shareholder (whilst duty bound to maximise price in the interests of the ultimate shareholders) and the board must have at least a moral responsibility to consider the expectations of policyholders and employees and to extract as much comfort as possible from the purchaser on future intentions. However, no guarantees will be given.

3.1.3 With regard to the board's responsibilities to policyholders and employees, it is worth questioning how much influence it can exert if the shareholder is determined to sell. In the case study, representatives of the shareholder were directors of C and had to balance these responsibilities with the interests of their employer. Through them, the shareholder effectively determined to whom the company would be sold, with the other directors often advised of certain events after decisions in principle had been taken.

3.1.4 This is not intended to imply that the other directors did not approve of the purchaser of C or, indeed, related decisions which ultimately they had to ratify, but their involvement was much less dynamic than in a company with a wider ownership base. If they had not approved, then their only course of action would have been to resign, but I wonder if this would have had any impact other than bad publicity for the shareholder.

3.1.5 In any event, it is not clear whether the directors' prime responsibility is to the company (including employees and policyholders) or to the shareholder. There must be some balance, and if they are satisfied that the impact on the company is not detrimental to the interests of policyholders, then their allegiance must turn towards the shareholders. To what extent this balance of interest extends to employees remains a dilemma for the directors, but the interests of the shareholders must prevail.

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3.1.6 This uncertainty regarding the responsibilities of the directors in a takeover of a proprietary life company is referred to by Needleman & Westall (1991), although the Working Party Report implied that the directors' duty was to act in the best interests of the shareholder. Thus the role of the DTI, as referred to in ¶3.1.8, is paramount in respect of policyholders, but the security of employees is very much in the hands of the new owner.

3.1.7 It is interesting to note that, in 1986, Hunter & Jones placed great importance on the retention of employees. Today the feelings of insecurity among employees have increased dramatically, for it is now quite common for a large percentage of staff to be made redundant, either on a voluntary or compulsory basis, in an attempt to reduce unit costs as one of the objectives of the takeover. In this respect actuaries are not 'immunised'!

3.1.8 Apart from the board, there are other protections, for the sale cannot proceed without the agreement of the DTI. This will involve private discussions on, and implicit approval of, the new shareholder's future business plans, with primary emphasis on policyholders' interests, including that in the free estate. Plans to restructure the enlarged entity, involving the transfer of long-term business from one life company to another after purchase, can only be progressed in accordance with the S49 process.

3.1.9 It is probable that the members of the new board of the acquired company will comprise either the same members as the main board of the purchaser or a sub-set of them. This will also apply to existing subsidiary life companies.

3.1.10 Once the sale process has been concluded, the scheme can be progressed, and, theoretically, the order of events will be as follows:

— boards of the transferor and transferee companies will propose a scheme of transfer, having considered and rejected any alternative schemes;
— the Appointed Actuaries will be asked to prepare reports to respective boards;
— the solicitors will prepare a scheme document;
— the independent actuary will prepare a report;
— policyholders will be circulated and notice served on the DTI; and
— application will be made to the court for approval.

3.1.11 In practice, apart from the statutory processes, development will be in much less clearly defined stages, with the involvement of the independent actuary and DTI recommended at a very early stage to minimise the possibility of objections later.

3.2 *Appointed Actuary*

3.2.1 *Sale process*

3.2.1.1 Prior to sale, the Appointed Actuary of the vendor, although having no statutory duties, will play an active role in advising the shareholder and the board on matters affecting policyholders' reasonable expectations (PRE). During

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the sale of C, I was also involved in the provision of information and advice to the consulting actuaries advising the shareholder, actuarial negotiations with the purchaser's consulting actuaries and Appointed Actuary and discussions with the DTI and Government Actuary's Department (GAD).

3.2.1.2 The Appointed Actuary is placed in an invidious position. Professional responsibilities to policyholders are paramount, whilst there are executive responsibilities to the board and shareholder, but in the near future the actuary will have a new employer and will be mindful of that impending relationship! In certain circumstances the shareholder of a wholly-owned subsidiary may put pressure on the Appointed Actuary, who must resist if the action suggested might impair PRE.

3.2.2 *Scheme process*

3.2.2.1 Returning to the theoretical order of events, in practice, as happened in the case study, the main board will endorse the general principle that they wish the transfer to be progressed. The Appointed Actuary, in his executive capacity, will then determine the technical principles of the restructure and the associated terms of the scheme for the main board's approval. Any other relevant alternatives must also be considered.

3.2.2.2 For ease of reference, it is assumed, from this point onward, that there is only one Appointed Actuary to both transferor and transferee. In my opinion, this can give rise to a potential conflict of interest, which is considered further in Section 3.3.

3.2.2.3 Once the principles are approved by the main board, the solicitors, in conjunction with the Appointed Actuary, will convert the proposals into a legal document. This, together with the finalised report from the Appointed Actuary on the scheme's terms, must be given formal approval prior to the transfer procedure proper being initiated. In practice, the internal process may have already started with board knowledge, but before such formal approval.

3.2.2.4 At this stage, as the transferor and transferee are still separate corporate entities, approval must be given by both boards, even if comprising the same directors.

3.2.3 *Professional guidance*

3.2.3.1 Neither GN1 nor GN8 refers specifically to the Appointed Actuary's responsibilities in a demutualisation, where a proprietary company is being sold or where the long-term businesses of one or more companies are being transferred. GN23 was issued as a result of the Working Party Report, which concluded no changes to existing guidance were necessary. It refers only, in passing, to the need for an Appointed Actuary who is also a director to consider carefully whether these two roles conflict, but is mainly concerned with the responsibility of actuaries under the Takeover Code.

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3.2.3.2 However, GN1 does state that it is incumbent on the Appointed Actuary to ensure that the long-term business is operated on sound financial lines and with regard to PRE. This must translate into a duty to report to the board on the terms of a sale or of a proposed scheme (including comments on any alternative schemes) with regard to the impact on PRE.

3.2.3.3 These reports are confidential to the board, but remain a professional duty, even though the Appointed Actuary may have been closely involved as an executive or director in developing and recommending the actuarial provisions. Such a potential conflict of interest is quite common, but usually avoided in practice, by the actuary remembering his alternate responsibility when acting in each capacity.

3.2.3.4 With specific reference to a proposed S49 transfer, there is no legal requirement for a report from the Appointed Actuary, but, as GN1 implies responsibilities, it would be helpful if the Appointed Actuary's role was recognised and referred to in an appropriate GN. As referred to earlier, the Appointed Actuary will undoubtedly be involved in discussions with the independent actuary, the DTI and GAD, and this will include provision and analysis of any actuarial information required by the independent actuary. I suggest guidance should also comment on the wider issues referred to in ¶3.2.3.1.

3.2.4 *Legislative duties*

3.2.4.1 There is a specific requirement under S87 of the Friendly Societies Act 1992 that the transferee will furnish the Friendly Societies Commission with a report by the appropriate actuary (either the Appointed Actuary or, if there is none, an actuary appointed to perform the required function), as to whether it will, immediately after the proposed transfer, possess the statutory margin of solvency.

3.2.4.2 Since 1 July 1994 there has been a requirement in the S49 process precluding court approval unless the DTI, as the relevant authority, has certified that the transferee possesses the necessary margin of solvency after taking the proposed transfer into account.

3.2.4.3 In practice, the DTI will require the Appointed Actuary to provide a solvency report or statement similar to that required by statute for friendly societies. As solvency is being assessed at a future date and cannot be guaranteed, it is essential to incorporate appropriate wording to allow for unforeseen changes not within the company's control.

3.2.4.4 An appropriate wording might be "*provided external factors such as interest rates and asset values vary only within presently anticipated bounds, then the transferee will possess the necessary margin of solvency after the proposed transfer of the long-term business fund (LTBF) of the transferor*".

3.3 *Conflict of Interest*

3.3.1 GN1 states that, if, temporarily in a special situation, a material conflict

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of interest should arise, or would seem to arise, the Appointed Actuary, before making a report, should first ask the company to obtain a report from an actuary who has no conflict of interest.

3.3.2 It is quite possible that one actuary will be acting as Appointed Actuary to both transferee and transferor, and this raises the possibility of a material conflict of interest in a proposed merger, particularly of WP funds.

3.3.3 Where both transferee and transferor have been part of the same group for some time, there may be no conflict, as the Appointed Actuary will have been involved in issues requiring the interests of policyholders in each company to be protected through balanced recommendations. An example would be the allocation of expenses between the companies.

3.3.4 However, where the transfer process starts at an early date after a recent acquisition, the Appointed Actuary will only very recently have assumed responsibility for both transferee and transferor, and I believe that such a material conflict of interest may arise.

3.3.5 This is not implying that the Appointed Actuary will act in an unprofessional manner. Actuarial science does not normally produce a single solution. For example, the value of a company suggested by the same actuary will be at different ends of an acceptable range, depending on whether the actuary is advising the vendor or purchaser.

3.3.6 It may be that, in the circumstances set out in ¶3.3.4, the Appointed Actuary will inadvertently recommend a scheme which leans more towards one company than to the other, albeit not quite as far as an actuary responsible for only one fund might lean!

3.3.7 Placed in that situation, the Appointed Actuary should consider very carefully if there may be a material conflict of interest, and, if in doubt, should only report in respect of policyholders in the company for whom he has been Appointed Actuary longest. Another actuary, preferably the previous Appointed Actuary, should be commissioned to prepare an appropriate report in respect of the other policyholders.

3.3.8 The initial response may be to suggest that this is the reason why the legislation requires a report from an independent actuary, who should be aware of all the arguments and issues leading to the scheme approved by the boards. However, as stated earlier, there is a potential range of solutions, and the duty of the independent actuary is to comment on the terms of the scheme, not potential variations.

3.3.9 In addition, the independent actuary is very dependent on the Appointed Actuary for information about, and analyses of, the financial figures. Although entitled to place reliance on the latter's professional responsibility not to mislead by withholding, concealing or misrepresenting the relevant information, the former remains responsible, under GN15, for the extent of any investigation or verification of that information. The independent actuary cannot incorporate any disclaimers to the conclusions of the report, although reference can be made to the source of the information and with whom discussions took place.

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3.3.10 It is interesting to note that Section 87 of the Friendly Societies Act not only gives the appropriate actuary specific right of access to information and explanations thereof, but also makes it a criminal offence for any officer knowingly or recklessly to provide misleading or false information. Section 88 contains the same provisions applicable to officers providing information to the independent actuary, and the appropriate actuary, being an officer, must comply.

3.3.11 There are no similar provisions in the ICA, and I find it difficult to understand why one Act deems such provisions necessary and the other does not. Presumably some form of retribution would still apply if the independent actuary appointed under the ICA was deliberately misled. Certainly, in respect of an Appointed Actuary or, indeed, any actuary, it would be regarded as unprofessional conduct of a serious nature and dealt with accordingly.

3.3.12 Assuming there are no such misdemeanours, the independent actuary's report will ensure that the scheme does not unduly favour one set of policyholders. However, the result may vary from that which might emerge if advised by two actuaries. If they differ in their conclusions, then the independent actuary will be in the position of an arbiter, and a more balanced result should emerge.

3.3.13 By way of example, in the scheme referred to in ¶¶1.4.4 to 1.4.9 there were two Appointed Actuaries. There was no difference of principle, but one was concerned that the interests of policyholders in the transferee were protected, whilst the other was concerned that the surplus distributed to policyholders in the transferor was maximised. The force of both arguments could be appreciated, and it would have been justifiable to accept either view and still state that policyholders' interests were not adversely affected.

3.3.14 The above general comments are not intended as a criticism of the terms of the scheme in the case study, which were proposed by the Appointed Actuary in an entirely professional manner, having concluded that there was no conflict of interest for, as project manager, I was available as the previous Appointed Actuary.

3.4 *Independent Actuary*

3.4.1 *Requirements*

3.4.1.1 As stated in ¶¶2.3 and 2.15, there is a statutory requirement for a report from an independent actuary, without discretion for insurance companies, but with discretion for friendly societies.

3.4.1.2 GN15 deals exclusively with the independent actuary's responsibilities under S49. It is currently being rewritten, and the requirement for friendly societies will no doubt be addressed, although, as the general principles and requirements are similar, any amendment will presumably simply identify the references.

3.4.1.3 Needleman & Westall (1991) and Pell (1991) criticise GN15 in respect of the professional responsibility under it for the independent actuary to consider and comment on the *closed fund* option and compensation for

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membership rights in a demutualisation. Although the current version post-dates these criticisms, the comments still appear to be valid. In a transfer of proprietary funds only the former is relevant, and this is discussed later.

3.4.1.4 Under S49 the independent actuary is reporting to the court, but GN15 recommends early and on-going discussions with the DTI, which are generally very helpful. However, it is interesting to ponder the position if the independent actuary disagreed with the DTI and produced a report with which the DTI disagreed!

3.4.1.5 It is sensible to involve the independent actuary at an early stage, to ensure that his/her views are taken into account, but it would be pointless to describe the role in the development of the scheme further, in view of the existence of GN15.

3.4.2 *Confusion of reports*

3.4.2.1 At this point, it is relevant to comment on the potential confusion if two actuarial reports are made public and submitted to the court as part of the documentation.

3.4.2.2 In ¶2.12 reference is made to the relatively common practice of the report by the Appointed Actuary being submitted as part of the documentation, but only for more complex schemes. This is sensible, since in straightforward schemes, involving only the transfer of UL business for example, the reports could well look very similar.

3.4.2.3 In more complex schemes the same issues may be approached quite differently, with the Appointed Actuary's report including more background detail on the companies, their development prior to the transfer, future objectives and, certainly, further views on the effect on policyholders. It should provide additional comfort to both the court and policyholders.

3.4.2.4 If made public, then it is important that the respective roles of the Appointed and independent actuaries are made clear to policyholders. In the case study, both reports were submitted as part of the court documentation.

3.4.2.5 Whether made public or not, the representatives of the DTI and the GAD will wish to discuss the matter with the Appointed Actuary as well as with the independent actuary.

4. Corporate and Structural Background

4.1 *Further Background to the Case Study*

4.1.1 In ¶1.1.2 it was stated that the paper would start at the point where the acquisition was completed and, with reference to ¶¶3.3.10 and 3.3.11, by spending some time on earlier issues and digressions, I am concerned that this statement has not deliberately misled the reader!

4.1.2 The project began in early 1994 with a target effective date of the year end, and involved four life companies authorised under the ICA. The first step was to prepare a report outlining the perceived corporate objectives and the

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administrative and technical processes which had to be followed to achieve them through the scheme. This paper is concerned only with the technical actuarial issues, but first a little further background and a short digression!

4.1.3 The ultimate holding company was a building society, which, in 1989, had perceived an advantage in moving beyond the control of distribution of life products to the control of the manufacturing process through the demutualisation of a mutual life company (Company A).

4.1.4 Since then much discussion has taken place, and papers have been written about the objectives of banks and building societies extending their interests in this way, either by purchase or by establishing their own authorised life companies.

4.1.5 The only recent innovation to this process of rationalisation of financial services has been the hostile takeover of smaller building societies (such as Abbey National's offer for National and Provincial). The smaller society has been forced to recommend to its members that, in exchange for a significant cash payment, membership rights should be surrendered, allowing the society to relinquish its mutual status to facilitate the takeover. The method of distributing the society's equivalent of a *free estate* has been closer to a payment per member rather than in direct proportion to the member's financial interest.

4.1.6 Perhaps there is an analogy in the value of these rights and those of members in a life company demutualisation. Current opinion is divided on whether compensation, and if so how much, should be made for loss of rights to members holding non-profit and WP policies, or whether only WP policyholders should be compensated for changes in surplus distribution rights.

4.1.7 There is possibly another analogy to be made with mutual life companies. In a mutual with a substantial free estate, what will be the reaction of the board if a similar hostile bid is made public, and it contains an offer of substantial compensation for loss of membership rights? Alternatively, if the directors voluntarily recommend demutualisation, can the company simply be floated on the market, which will protect the interests of the existing management, or must the board accept, or even actively seek, a takeover bid, if the compensation to members might be improved? If the independent actuary has to comment on whether the closed fund option would be better, then surely that obligation must extend to the alternative of a takeover.

4.1.8 Now the case study proper!

4.2 *Company A*

4.2.1 *1989 scheme and distributable surplus*

4.2.1.1 A was the original mutual which had become a wholly owned subsidiary of the building society in 1989. The demutualisation had been effected through a S49 transfer, and A was probably the first to do so. Burdon (1991) describes, not only the process involved in, but the arguments leading to, a demutualisation.

4.2.1.2 The new owner had to compensate existing WP policyholders.

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Compensation was in two parts, the first for the agreed embedded value of the shareholder's rights to future surplus and the second for goodwill. The latter payment was a negotiated compromise, as A was in a weak bargaining position and the building society was reluctant to pay for a potential profit stream from future new business generated as a result of the scheme. It was, therefore, a payment primarily for acquiring an established company, and was only distributed to WP policyholders. There was no compensation for loss of membership rights.

4.2.1.3 Both amounts were paid into the LTBF, the first being retained as additional assets to meet future liabilities, with the second distributed immediately as a *sweetener* to the WP policyholders in the form of a special bonus.

4.2.1.4 The new shareholder became entitled to 10% of the future distributable surplus and was responsible for payment of any additional tax generated as a result of future transfers. How this additional tax liability arises is explained in the context of C in Section 8.3. The scheme limited the entitlement to a maximum of 10%.

4.2.1.5 As the fund was not closed to new business, it was necessary to differentiate between existing and future WP policyholders, as only the former were entitled to compensation. This was to be effected through the operation of asset shares, which are not reduced in respect of existing policyholders to allow for the shareholder's entitlement to surplus. Thus, the amount of future surplus distributed to existing policyholders is the same as it would have been if there had been no shareholder.

4.2.1.6 The transfer of surplus to the shareholder in respect of existing WP policyholders is funded from the first part of the compensation payment referred to in ¶4.2.1.2. Theoretically, if all the embedded value assumptions are met exactly in practice, the rationale is that there will be sufficient additional assets available over the remaining term of the policies to fund a transfer to the shareholder equal to 10% of that distributed to existing policyholders. In the meantime, all policyholders benefit from the availability of additional assets through their impact on asset allocation policy.

4.2.1.7 There was also a deposit administration fund called the 'Assured Growth Fund', which was similar to a UWP contract. The scheme made no change to the rights of policyholders in that fund, and accordingly no compensation was required on demutualisation.

4.2.2 *Structure and business*

4.2.2.1 A's LTBF incorporated both traditional WP and non-profit business, plus individual and pooled UL pension business. Profits and losses from the UL business accrued to the WP policyholders, and thus the shareholder was only exposed to these through the right to 10% of distributable surplus.

4.2.2.2 A transacted life assurance, general annuity, pensions and permanent health business in the U.K. only. All new pension business transacted by the group was written in A.

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4.2.2.3 B, C and D were all subsidiaries of A, the first two being assets of the shareholder's fund and the last an asset of the policyholders' fund.

4.2.2.4 There were two non-life subsidiaries, Company A Investment Managers Ltd and Company A Unit Managers Ltd. The former was owned 70% by the policyholders' fund with 30% owned by the shareholder's fund. The latter was owned 54.9% by the policyholders' fund, 37.5% by the shareholder's fund and 7.6% by the investment management company.

4.2.2.5 The investment management company had contracts with each of the life companies to manage their investment funds. These were its principal clients, although there were some third party contracts.

4.3 *Company B*

4.3.1 *Distributable surplus*

4.3.1.1 B had been purchased by A in 1991 as an asset of its shareholder's fund, and comprised two sets of WP policyholders entitled to different percentages of distributable surplus.

4.3.1.2 With reference to the main class of WP policyholders, the shareholder was receiving 10% of the distributable surplus and WP policyholders 90%. The latter had historically paid all tax arising from the operation of the LTBF other than from those sub funds where the shareholder had a 100% interest. The memorandum and articles of B did not limit the percentage which the shareholder could appropriate.

4.3.1.3 In addition, the 'Growth Pension Fund' was a small separately operated, WP sub fund, within which the profit to the shareholder was calculated using a fixed formula dependent on the total assets in the fund and the level of surrenders during the year, rather than being based on the surplus produced. This had resulted in less than 10% of the surplus being paid to the shareholder, but payments had increased in recent years from 4.17% in 1988 to 5.59% in 1993, and were expected to continue to increase. The policyholders paid the additional tax.

4.3.2 *Structure and business*

4.3.2.1 B's LTBF incorporated both traditional WP and non-profit business and UL business, including UWP. The shareholder was entitled to 100% of the profits from the UL business and, as a consequence, was fully responsible for any losses. This arrangement required the Appointed Actuary to recommend an equitable apportionment of expenses between the two long-term sub funds.

4.3.2.2 B transacted life assurance, general annuity, pensions and permanent health business, both in the U.K. and overseas. Following the launch of a new range of UL and UWP life assurance contracts, all new business of this type was written in B.

4.3.2.3 As the transferee (see Section 6), it was important that B was authorised to write all classes of long-term business, as defined in Schedule 1 of the ICA, and which had been written by A, C and D.

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4.3.2.4 B also operated two other funds, long-term accident and capital redemption, from which the shareholder was entitled to 100% of the profits and, as a consequence, was fully responsible for any losses. As B was the transferee, the scheme had no effect on these funds, and no further reference will be made to them.

4.4 *Company C*

4.4.1 *Distributable surplus*

4.4.1.1 C had been purchased by A on 8 October 1993 as an asset of its shareholder's fund, and was governed by its own Act of Parliament dated 1964.

4.4.1.2 The Act permitted the shareholder to appropriate up to 10% of the distributable surplus. Historically the shareholder had restricted the appropriation to only 7%, leaving the balance of 93% to be distributed to the WP policyholders.

4.4.2 *1993 scheme*

4.4.2.1 C had owned two UL life assurance subsidiaries, one writing standard UL contracts and the other writing pooled pension fund business. As with A, profits and losses from these businesses accrued to the WP policyholders, and thus the shareholder was only exposed to these through the right to distributable surplus.

4.4.2.2 Prior to the takeover, a scheme was approved and their long-term businesses were transferred to C on 1 January 1994.

4.4.2.3 Profits and losses continued to accrue to the WP policyholders.

4.4.3 *Financial strength*

4.4.3.1 C had been regarded as financially weak, principally due to losses in procuring new business, for, like many companies in the present financial climate, the volume was not sufficient to cover the costs of distribution. Immediately prior to the takeover, the original shareholder had been supporting C through capital injections, not only into the shareholder's fund to provide additional capital to cover solvency, but also into the policyholder's fund to insulate the WP policyholders from these losses. In the takeover, the price paid took into account the value of the former as net assets, but only 7% of the latter through the embedded value of the shareholder's right to future profit.

4.4.3.2 This support ceased on takeover, but the new shareholder had agreed to purchase from the WP policyholders the UL business excluding the pooled pension fund business. Accordingly, in early 1994 a compensation payment of £18.3m, partially financed from a financial re-assurance arrangement, was paid into the WP fund with an immediate impact on solvency from an asset that was previously inadmissible for regulatory purposes. The WP and UL structure had, therefore, become the same as that in B. As previous Appointed Actuary in C, I was asked to submit a letter to the board confirming that the price paid was reasonable. This letter was also copied to the DTI. This approach avoided any potential conflict of interest, as discussed in Section 3.3, in the advice given by the new Appointed Actuary.

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4.4.4 *Structure and business*

4.4.4.1 C's LTBF incorporated both traditional WP and non-profit business in one sub fund and UL business, including UWP, in the other. The new shareholder was entitled to 100% of the profits from the UL business excluding the pooled pension business, and was fully responsible for any losses. The position relating to UWP business, which was not included in the purchase referred to in ¶4.4.3.2, is considered later. As for B, this arrangement required the Appointed Actuary to recommend an equitable apportionment of expenses between two effectively separate LTBFs.

4.4.4.2 C transacted life assurance, general annuity, pensions and permanent health business, both in the U.K. and in the Republic of Ireland, but no business was transacted elsewhere overseas or in other member states of the European Union. The Irish business was conventional and written through local branches. Liabilities were in punts, and Irish assets were held to match the currency risk. No new business had been written for several years.

4.4.4.3 On the acquisition of C, the decision had been taken to cease writing new business until the Board of A were confident that the financial position of the company was satisfactory. The steps taken led the Appointed Actuary to conclude, in his report, that the position had improved and C could be re-opened to new business if required.

4.5 *Company D*

4.5.1 *Structure and business*

4.5.1.1 D was a very small company, and its LTBF incorporated only pooled pension fund business. It was wholly owned by the WP policyholders of A, into which its entire portfolio was reassured.

4.5.1.2 D transacted group pensions business, but only in the U.K.

4.6 *Financial Summary*

4.6.1 Table 1 gives an indication of the relative sizes of the four companies.

Table 1. Financial comparison as at 31 December 1993

Company	A	B	C	D
Number of contracts	133,475	212,790	223,755	2
	£m	£m	£m	£m
Annual premium income	26.4	65.3	63.7	0.019
Mathematical reserves	603.0	1,019.0	955.8	2.6
LTBF assets	608.7	1,094.6	1,030.1	2.6
Free assets	5.7	75.6	74.3	0
Shareholder's assets	50.1	18.4	14.2	0.8
Total free assets	55.8	94.0	88.5	0.8
Minimum solvency margin	21.0	48.1	34.4	0.6
Excess over MSM	34.8	45.9	54.1	0.2

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4.6.2 With reference to the Republic of Ireland business in C, the respective figures were 9,905 contracts, annual premium income of £1.2m and mathematical reserves of £51m.

4.6.3 Although the scheme referred to in Section 4.4.2 had an effective date of 1 January 1994, the figures above show the consolidated position assuming the transfer had already taken place.

4.6.4 The figures are not directly comparable, as the underlying valuation bases were not identical. This issue is discussed further in Section 10.

4.6.5 The Appendix provides additional summarised detail of the long-term business and assets of each of the companies.

5. Rationale, Objective and Requirements of the Scheme

5.1 *Current Structure*

5.1.1 The building society and the management and board of A had agreed that economies of scale could be achieved more quickly through a strategy of acquisition than by organic growth alone.

5.1.2 The subsequent purchases of B and C resulted in the total size of the group becoming comparable to a medium-sized life assurance company, better able to compete in the market of the 1990s, where size as well as control of distribution was, and still is, important.

5.1.3 As can be concluded from Section 4, the companies were relatively complex organisations which differed significantly. Without rationalisation, the enlarged group would still have all the problems associated with administering the separate companies, and anything other than minor economies of scale would be difficult to achieve. This continuing complexity would act against the interests of shareholder and policyholder alike.

5.2 *Rationale for Scheme*

5.2.1 *Overview*

There were no technical reasons why separate companies were needed, and the obvious solution was to transfer the long-term businesses of three of these companies into the fourth.

5.2.2 *Capital and solvency considerations*

5.2.2.1 Shareholder capital was spread around A, B and C, resulting in a dilution of the available committed capital to B and C. A, as the parent company, was able to count the capital in B and C for solvency purposes, and, in fact, the full capital in the group is credited to A in Table 1 and effectively double counted.

5.2.2.2 Shareholder capital in each subsidiary is taken into account in assessing solvency. Theoretically, if each subsidiary utilised all its capital to cover its minimum solvency margin (MSM), but the parent could only cover it by taking into account subsidiary shareholder capital, then individual technical

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solvency is achieved, but not on a consolidated basis. It seems unlikely that any Appointed Actuary would agree to such a position resulting in practice. The same could apply to a wholly owned subsidiary of the policyholders' fund.

5.2.2.3 The distribution of capital did not reflect individual corporate requirements as measured by financial commitments, which could require the shareholder to alter that distribution in certain circumstances from time to time. This was considered a potentially inefficient use of capital, and disadvantageous to both shareholder and policyholders.

5.2.2.4 For technical reasons, there were two internal reassurance agreements between A and B, which, in accordance with the valuation regulations, resulted in additional solvency requirements of £5m. On transfer these agreements would not be required, and the solvency margin would reduce by that amount in the consolidated valuation. A similar release had been achieved when C had merged with its subsidiaries.

5.2.3 *Costs and savings*

5.2.3.1 A transfer, even without rationalisation, would achieve savings through the elimination of additional accounting and actuarial administration. Major advantages in administrative efficiency would not be achieved until all business, existing and new, was operated on one computer system. This was a medium-term aim, which was not evaluated in the project.

5.2.3.2 Rationalisation of the different tax positions of the companies would result in much greater tax efficiency.

5.2.3.3 In summary, the Appointed Actuary estimated that the potential cost savings would be equal to £750k p.a. against one-off costs of £600k. It is interesting to note that, before a scheme is presented to court and the policyholders circulated, the majority of the costs will already have been incurred.

5.2.3.4 Costs were to be allocated to each individual policy including non-profit and UL at a fixed level per policy. In respect of WP policies and associated non-profit policies, asset shares would be adjusted. With over 500k policies, the individual adjustment per policy would be nominal. Thus, the shareholder and policyholders would share the cost in proportion to their rights to surplus. In respect of business comprised of policies to which the shareholder was entitled to 100% of the surplus, the total cost would be borne by the shareholder.

5.2.3.5 Savings anticipated would be reflected in bonus allocations resulting from future assessment of asset shares for WP policyholders, and, therefore, would also benefit the shareholder. UL policyholders were expected to benefit in future through charges which should be less than if the rationalisation had not taken place, although the differential was not expected to be significant.

5.3 *Objectives for Scheme*

5.3.1 *With-profits*

5.3.1.1 The rights to surplus distribution are summarised in Table 2.

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Table 2. Rights to distributable surplus

Company	A	B (Traditional)	B (Growth pension fund)	C
Policyholder	90%	90%	94.4%	93%
Shareholder	10%	10%	5.6%	7%
Additional tax paid by	Shareholder	Policyholders	Policyholders	Policyholders

5.3.1.2 If the scheme were implemented without any rationalisation, then the future corporate structure would be a hotchpotch of different surplus distribution rights in respect of existing WP business. If not merged savings would be nominal, and if merged there would be continuing complexity in identifying the surplus arising in respect of each original fund to ensure correct allocations were made to each original set of policyholders and shareholder.

5.3.1.3 A decision would be needed on surplus allocation for future new WP business, again requiring separate identification of the surplus arising.

5.3.1.4 The conclusion was clear. A restructure was essential to rationalise the disparate surplus distribution policies in line with that most appropriate for future new business.

5.3.1.5 Sections 8, 9 and 10 deal with how this was achieved.

5.3.2 *Unit-linked*

5.3.2.1 The structure relating to ownership of the UL business is summarised in Table 3. The use of the word 'ownership', when referring to business within one company, should be taken to mean the entity to which all profits and losses accrue.

Table 3. Unit-linked business structure

Company/Fund	Business	Ownership
Company A	Pensions only — Open	Company A policyholders
Company B	Life only — Open	Shareholder
Company C	Pensions/Life — Closed	Shareholder
Company C	Pooled pensions — Closed	Company C policyholders
Company D	Pooled pensions — Closed	Company A policyholders

5.3.2.2 As can be seen from Table 3, new pensions business was written in a policyholder owned fund and new life business in a shareholder owned fund. With or without transfer, the potential conflict of interest between shareholder and policyholders would continue in respect of future allocation of resources and attractiveness of the different classes of new business. There would be the further problem of an equitable allocation of expenses between funds, which not only could be particularly contentious for those associated with the procuring of new business, but also would result in complex administration to identify them.

5.3.2.3 In addition, as each company had written UL business, there were over 20 individual life funds and over 20 pension funds spread between the companies. Many of these had similar investment objectives, for example U.K. equities.

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5.3.2.4 Clearly there would be advantage in merging funds with similar investment objectives, but this would be complicated under the different ownership patterns and further exacerbated, as not all funds were open to new business.

5.3.2.5 As profit streams differed, it would be necessary to calculate the embedded value of each fund to determine the percentage ownership at date of merger. Future profits and losses from existing business would then accrue in accordance with these differing percentages.

5.3.2.6 Unless the different owners agreed entitlement to the same percentage of profits and losses from future new business, continuation of that structure would be untenable. The funds in C were closed to new business and could theoretically be re-opened to facilitate that approach, but there was no clear consensus that it would be equitable to share profits from future new business in the proportions of percentage ownership at the date of merger.

5.3.2.7 It was clear that further rationalisation of the ownership structure was essential, with either shareholder or policyholders owning all UL business in future.

5.3.2.8 Section 7 deals with how this was achieved.

5.4 *Requirements for Scheme*

5.4.1 *Content of scheme*

5.4.1.1 With the proposed rationalisation, the scheme would be complex. The legal advisors recommended that the scheme should only contain the essential conditions necessary to secure court approval for the transfer, but incorporating the structure of the sub funds, the merging of the WP funds and reference to future principles of financial management.

5.4.1.2 The rationalisation issues, namely changes in surplus distribution rights and ownership and merger of UL funds, were excluded. These changes would be covered by irrevocable board undertakings, under which they had to be implemented if the scheme received court approval. This was not only to avoid the scheme becoming extremely complex and lengthy if the issues were to be worded to the satisfaction of the lawyers, but also in case the court considered that such technical issues might not be within its jurisdiction under the provisions of S49. Both scheme and associated undertakings were included in the court documentation and advised to policyholders.

5.4.1.3 All issues during development were discussed with the DTI and GAD, and were considered and commented on by the independent actuary in his report, as though an integral part of the scheme. In this paper a similar approach is adopted for simplicity.

5.4.2 *Policyholders' safeguards*

5.4.2.1 The terms of the scheme were determined by the board, but subject to comment and scrutiny by the Appointed Actuary, independent actuary, DTI/GAD, approval by the Court of Session in Edinburgh and the policyholders would have a right to object.

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5.4.2.2 The objective must be to ensure that the scheme does not jeopardise PRE and that the rights and security of all policyholders, both participating and non-participating, will not be adversely affected. In particular, the bonus expectations of each set of WP policyholders must not be impaired.

5.4.2.3 Whilst, theoretically, the independent actuary is presented with a finalised scheme on which to comment and the DTI do not become involved until formal notice is served on the Secretary of State as required by S49, in practice informal discussions take place from the outset. This is not to imply that the final independent actuary's report and the formal approval of the DTI are simply a 'rubber stamp', but to ensure that their views are taken into account as the scheme is developed. This helps to safeguard the interests of the policyholders and reduces the risk of an adverse comment from the independent actuary. GN15 recommends this early involvement. No reference should be made in the documentation to this involvement, as both independent actuary and DTI have a formal procedure to follow when finally commenting on the proposals. This will avoid implying that the process has been circumvented.

5.4.2.4 As the scheme evolves, the DTI/GAD will expect to discuss it with the independent actuary, with the expectation that their views will be carefully considered when drafting the final report. In fact, they place heavy reliance on the independent actuary to investigate and consider all issues on their behalf.

5.4.2.5 I would venture the opinion that policyholders have very little impact on the approval of the scheme. There is a legal requirement to ensure that they are informed, but, by necessity, at a stage where the process is well advanced with actuarial reports already prepared and presumably commenting favourably on the terms.

5.4.2.6 In a demutualisation, the policyholders will probably have a right to attend a meeting and vote on the scheme as members of the society. Even then, as mentioned in Needleman & Westall (1991), and commented on in the discussion on that paper, they tend to take no action. This can be assumed to be tacit approval, but is more likely to reflect the difficulty of policyholders organising to take concerted action.

5.4.2.7 It is even more difficult for policyholders in a proprietary company where there is no voting requirement. Policyholders do have the right to object or to be heard by the court. Faced with favourable professional opinions of Appointed Actuary and independent actuary on the scheme's technical terms and no formal objection from the DTI, it is highly unlikely that the court will refuse to grant approval. In this respect, the DTI, on behalf of the Secretary of State, will not advise the court that 'they do not wish to be heard' until close to the scheduled hearing, in case many policyholders do object or register an intention to appear in court.

5.4.2.8 Policyholders could object on procedural grounds, but all documentation has already been scrutinised by the court reporter who is appointed by and on behalf of the court. This is the practice in the Court of Session in Edinburgh, and is not present in the English procedure. The reporter

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submits a report which should confirm that all legislative requirements have been correctly complied with and appropriate dispensations have already been granted by the court or are to be requested as part of the hearing. This report is comprehensive, and in the case study consisted of 45 pages for each scheme plus accompanying documentation. If favourable, it is unlikely that a policyholder will find a technical flaw.

5.4.2.9 In the case study, the responses from policyholders in respect of the circular summarising the scheme, in what was intended to be plain English, varied from 'this is just gobbledygook' to 'how dare you insult me with such a simplistic explanation of such a complex matter'. Perhaps, therefore, the balance was right!

5.4.2.10 More seriously, there was a relatively small number of policyholders who wrote to the company to object, but virtually none of these complaints related specifically to scheme terms which, without professional actuarial advice, it is unlikely they would have been competent to do. Complaints related to areas such as service and performance, which were not relevant to the scheme, or just a bald objection without explanation. The numbers were so minimal that all were handled personally by myself internally. In fact, only one was submitted to the court, but was discounted as not being valid to the S49 approval.

5.4.2.11 Notwithstanding the difficulty that the policyholders have in becoming involved or objecting, they remain well protected under the S49 process from implementation of any scheme which would adversely affect their interests.

5.4.3 *Shareholder's interests*

5.4.3.1 There are no external procedures designed to safeguard the shareholder's interests. It is the board who must consider that issue on the advice of the executives, and obviously the scheme is unlikely to be approved if not in the shareholder's interests. This is particularly true in circumstances such as this case study, where the companies are all wholly owned subsidiaries.

5.4.3.2 As the scheme was anticipated to improve the future returns to policyholders, the shareholder should also benefit through a share of future profits. Policyholders' interests were protected by the statutory process, which ensured that the balance was not tilted in favour of the shareholder. The board, in approving the scheme, will ensure that the balance was not tilted too far in favour of policyholders.

5.4.3.3 Board approval was granted to the principles proposed, and it was then necessary to proceed to develop the scheme in detail.

6. Selection of Transferee and Effective Date

6.1 *General*

6.1.1 The natural assumption was that A would automatically be selected as transferee, as the parent life company bearing the name of the group. Where the

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transferee company, in these circumstances, is many times larger, then that may be the decision regardless of other considerations. It can be seen from Table 1 that A was actually smaller than both B and C, but this, in itself, did not make it unsuitable to be transferee. Company D was never considered as the transferee, in view of its size and as it only transacted pooled pension business.

6.1.2 However, B was selected as transferee, a choice principally driven by tax considerations, although, as explained in Section 6.2.4, once the relative tax positions had been evaluated, another issue was ultimately the deciding factor. Similarly, the selection of an effective date of 30 December 1994 was also driven by tax considerations, although different from those considered in selection of the transferee.

6.1.3 It is worth emphasising that careful analysis of tax is essential, with the objective of minimising the future tax assessment. For example, in the transfer of the businesses of its subsidiaries into C, retrospectively the selection of C as transferee was queried, as there might have been additional tax advantage if one of the UL subsidiaries had been transferee.

6.1.4 As a relatively minor issue, the problem of name was resolved easily, for, with a little administration, B was renamed A immediately after the effective date.

6.2 *General Tax Issues*

6.2.1 *Principles*

In any transfer, taxation issues arise in three main respects whereby:

— it is necessary to utilise specific relieving provisions to avoid unfavourable tax consequences;
— planning is required to mitigate any tax disadvantages which might result; and
— opportunities may arise to achieve a beneficial tax position.

The identity of the transferee and selection of the effective date are critical points for decision, as they will affect the tax issues arising. In addition, it is essential to ensure that policyholders are not disadvantaged through a change in their tax liabilities. In the following, the intention is more to ensure appreciation of the complexity of the tax issues than to provide a comprehensive review of these issues.

6.2.2 *Clearances and confirmations*

6.2.2.1 It is not my intention to outline the procedures to be followed to ensure that certain clearances and confirmations are received in advance from the Inland Revenue, the Pensions Schemes Office and Occupational Pensions Board. However, it is appropriate to outline why this is essential. (Pell (1991) gives more detail to the tax background, although the references to Acts must be updated to allow for more recent legislation.)

6.2.2.2 With reference to clearances, there is no statutory or application procedure to obtain advance agreement from the Inland Revenue that the specific

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statutory relieving provisions applicable to a S49 transfer will apply. However, there is a procedure under which clearance can be given that relief shall not be prevented from applying by reason of a particular statutory bar. Although there is no obligation on the Inland Revenue, it is not unreasonable to assume that, when giving such clearance, they would draw attention to any other problem which might preclude availability of the provisions. Certainly in the case study, they did comment on a particular issue which would have caused a problem, but turned out to be invalid. Clearances should therefore ensure that:

— there is no crystallisation of Capital Gains Tax on transfer of assets; and
— unrelieved expenses (XSE), postponed expense relief (postponed E) and Case VI losses are carried over to the transferee.

6.2.2.3 Although there should be no difficulty in obtaining clearances, it is perhaps worth mentioning a word of caution. Relief will be denied unless the transfer is effected for bona fide commercial reasons and does not form part of any scheme or arrangement where the main purpose is avoidance of liability to corporation tax. The attitude of the Revenue to S49 transfers has been to interpret the legislation strictly, and the tax advisors in the case study intimated that applications have been refused where tax advantage was sought. Applications and, indeed, schemes themselves are usually drafted to emphasise the other benefits of the scheme and avoid or minimise references to potential tax benefits. On the other hand, I have been advised that in one scheme a construction to avoid stranding tax losses did not cause any problem, although there was a clear tax motive.

6.2.2.4 It is also advisable to obtain confirmation of the taxation treatment in other areas, to ensure that after transfer:

— LAPR will continue on transferred policies;
— the qualifying status of transferred policies will not be prejudiced;
— no document will be liable to stamp duty in respect of the scheme; and
— exempt approved status of pensions schemes will not be prejudiced.

This is not an exhaustive list, and other items specific to a company or its policyholders may need to be included.

6.2.2.5 The scheme is invariably made conditional on the receipt of both clearances and confirmations. However, it is normal to incorporate a provision permitting the transferee to waive any of these conditions, subject to confirmation from the independent actuary that the interests of the policyholders will not be materially adversely affected.

6.2.2.6 These general considerations did not affect the choice of transferee, as the principles would have applied to whichever company was selected.

6.2.3 *Tax evaluation*

6.2.3.1 Realised capital losses are not transferable. Any existing in the transferors at the date of transfer will remain in the dormant companies, which

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will normally be retained in existence as shells for some years before winding up, in case of future opportunities to utilise the losses. In theory, losses could be relieved against gains on assets transferred in from other group companies prior to external disposal. As transfers of assets from the long-term fund of a life company are not covered by the normal intra-group transfer provisions, no utilisation against life company gains is possible. In the case study, as the building society was taxed on a trading basis in respect of investment gains, there was little scope for offsetting losses against its taxable profits. The fixed capital assets of other group companies were not significant, so that the capital losses would be effectively stranded on transfer.

6.2.3.2 The position of pre-entry capital losses (i.e. realised losses of an acquired company at the date of purchase and losses realised after that date on previously held assets) is complicated. The potential for post-transfer utilisation was further restricted by the rules introduced in the Finance Act 1993. The provisions are only applicable where a company joined a group after 31 March 1987, and therefore applied to B and C. The effect is to restrict the offset of pre-entry losses to gains on assets of that company, whether acquired before or after purchase.

6.2.3.3 As stated in ¶6.2.3.1, capital losses in the transferors are stranded, and therefore the pre-entry rules will only affect the losses on pre-entry assets. The application of the rules is complex and is not discussed further, other than to state that the impact in the context of the transfer was that unrealised losses on pre-entry assets of the transferors as at the date of transfer would not be capable of future utilisation. The practical significance depends on whether, ultimately, a loss will be realised, for, if the asset regains its lost value, there can be no loss of relief.

6.2.3.4 In the transferee pre-entry losses, realised and unrealised, can continue to be offset after transfer in the manner described in ¶6.2.3.2, and also against gains on assets acquired from third parties, subject to certain conditions being met. In particular, they can be used to shelter the transferee's deferred gains on deemed disposals of unit trusts.

6.2.3.5 The deemed disposal rules have effectively required the unit trust holdings of life companies to be sold and immediately re-acquired at the end of each year since 1993. Gains or losses are spread evenly over seven years, but there is specific legislation relating to S49 transfers, whereby the deferred element of the gain or loss arises in the transferee in the same way as it would have arisen in the transferor. The deferred element of these gains will arise in the transferee, but there is no provision in the legislation for transferor capital losses to be carried forward in the transferee to offset them. Without spreading, full offset of realised losses would have been available, and, although clearly inequitable, no concession was to be expected from the Revenue.

6.2.3.6 Both B and C had substantial deferred gains from 1993 deemed disposals, six sevenths of which would still be spread forward at the effective date. C also had significant capital losses, but these would be stranded and could

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not be set off against deferred gains in B if B were transferee. On the other hand, if C were transferee, its capital losses would be offset against its deferred gains, but not against the deferred gains transferred from B because of the pre-entry capital loss rules. Alternatively, there was a possibility that the losses in C might be partially mitigated before transfer by converting unrealised losses into realised losses and offsetting them against gains created through *bed and breakfasting* other assets.

6.2.3.7 There were tax assets within the life companies in relation to:
— Notional Case 1 losses (NC1);
— XSE;
— postponed E; and
— Case VI losses.

6.2.3.8 Considering NC1 losses first, A and C had such losses, which would transfer to B if B were the transferee, but these would have to be streamed, i.e. offset only against profits from the transferred trade where they occurred. However, by agreeing to a slightly lower loss, it may be possible to agree a simpler method with the Inland Revenue, such as in proportion to mean fund ratios. If A or C were the transferee, then that company's NC1 losses could be offset against the total profits of the enlarged business and could accelerate utilisation.

6.2.3.9 C had the largest NC1 losses, but the position was further complicated, as these had been transferred into C under the scheme transferring its subsidiaries in 1993 and were already subject to streaming in C. It is possible to enlarge that streamed trade if another sufficiently similar business is transferred in, subject to certain provisions regarding companies which have changed ownership within the previous three years, which applied to both C and its subsidiaries.

6.2.3.10 XSE and postponed E were significant in A and C, but there were none in B. These expenses transfer from the transferor and can be offset in full against investment income in the I-E tax computation of the transferee without streaming and, in the combined entity, this would probably accelerate the utilisation of XSE. Selection of transferee was, therefore, not important for this relief. A similar position applied to Case VI pension business losses which existed in all the companies.

6.2.3.11 The basis of taxation of each company was as follows:
— A was NC1;
— B was I-E; and
— C was probably NC1 following the transfer of its subsidiary in 1993.

The combined entity would be unlikely to pay any I-E tax in 1994, depending on the effective date (see ¶6.2.5.10). Case VI losses were likely to eliminate any pensions business tax liability in the short term, so that the important issue was, therefore, the level of NC1 tax, if any, which would be payable.

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6.2.3.12 The preceding paragraphs attempt to summarise the initial assessment of the tax considerations which had to be evaluated, and clearly the identity of the transferee would have a bearing on the outcome. This is a very complex area requiring specialist expertise, and outside advice had been provided, with the resultant report considering the outcome in the whole group and not just in the life companies.

6.2.3.13 Having received the expert tax analysis, it was necessary to review the position to obtain further clarification of the potential position at the effective date. This review had to take into account the different potential investment scenarios as they would impact on the tax issues. In addition, the present values of the tax losses had to be assessed, as the timing of their utilisation varied, depending on the selection of the transferee. From this evaluation it was readily apparent that A was the least attractive for tax purposes and should not be the transferee. C was the most attractive as transferee overall, but the difference in the values between it and B was well within the bounds of error, bearing in mind that the relative tax positions could quite possibly change in future.

6.2.3.14 It should also be appreciated that tax losses stranded on transfer might have had minimal value if the companies had continued as separate entities because of their probable individual future tax position. In the combined entity, such tax assets could well increase in value as a result of the transfer (e.g. XSE), and, as long as the net effect was not considered disadvantageous to policyholders, taking into account non-tax issues, the scheme could proceed. That was the considered opinion.

6.2.4 *Other issues*

6.2.4.1 The final decision on transferee was driven by other factors, although these would not have been sufficient, in isolation, to outweigh any substantial tax disadvantage.

6.2.4.2 As stated, C was the most attractive choice, but it was governed by an Act, and any restrictive conditions which required amendment would involve material delay, deferring the effective date beyond the end of 1994. The Act directed in mandatory terms that "...the proportion of the life divisible surplus so credited to ... policyholders shall not be less than ninety per centum of the life divisible surplus."

6.2.4.3 This Act had been drafted in 1964 before the advent of UL business. As is explained in Section 7, it was decided to transfer ownership of all UL business to the shareholder, but C's Act precluded the shareholder receiving 100% of the surplus to which entitlement would be due. (The discerning reader will have already realised that the prior purchase of the UL business in C would give rise to a potential problem of distribution if the business were not transferred!)

6.2.4.4 Consideration was, therefore, given to B being transferee, but this resulted in a further complication. Discussions had been held with the Department of Employment and Enterprise (DEE) in Dublin regarding the transfer of C's

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Irish portfolio, which comprised around 5% of its liabilities. If C was to be a transferor, then the requirements of the Regulations would apply, requiring statutory notification to the DEE whose consent was a condition of the scheme receiving approval in the U.K.

6.2.4.5 The DEE insisted that their consent required approval in the Irish High Court in Dublin under their relevant transfer legislation, even though, as explained in ¶¶2.8 to 2.10, prior to 1 July 1994 no approval from them might have been necessary. There was concern that this process might result in deferral of the effective date of the U.K. scheme.

6.2.4.6 The solution was to prepare three schemes, one for approval by the Irish High Court and the others by the Court of Session in Edinburgh. Consent by the former would not, in itself, result in transfer, but simply permit the DEE to issue a letter of consent to the DTI, who could then advise the Court of Session accordingly.

6.2.4.7 One of the two U.K. schemes dealt solely with the transfer of C's Irish business and the other with the transfer of all other business of A, C and D. Only the former required the consent of the DEE, and, to facilitate approval in the Irish High Court, it was identical to the scheme transferring C's Irish business apart from references to relevant legislation. It incorporated a provision that the scheme would not become effective unless the approval of the Court of Session was obtained in respect of the scheme transferring all other business.

6.2.4.8 Thus one scheme could be approved and result in the transfer in isolation of all business except the Irish business, but the absurdity of the Irish business in C transferring to B in isolation was avoided. Paragraph 11.1.3 explains how it was intended to deal with the former situation in allocating assets etc., although such division was never required in practice, as both U.K. schemes received court approval.

6.2.4.9 The resultant choice of B as transferee was not unreasonable from a tax perspective, and had the advantage of avoiding the problem of transferring B's overseas business, which also included E.U. and EFTA business. Under the U.K. legislation, although procedurally complex, there was provision in the ICA for its transfer. However, the other overseas business written in B could not be transferred as part of the U.K. scheme unless the court accepted that it fell within the definition of *long-term business carried on in the U.K.*, and this was by no means certain.

6.2.5 *Effective date*

6.2.5.1 A mid-year date will result in additional administration, as accounts will have to be struck and many of the more essential forms in the returns to the DTI completed. Tax computations will also be required as at that date.

6.2.5.2 Thus it is preferable to select the effective date as the end of the accounting year, which in this case was 31 December, where only one set of published accounts and DTI returns will be necessary. These can be consolidated from each company's individual accounting and actuarial records, which will also

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provide information necessary for individual tax computations and detailed submissions to the DTI.

6.2.5.3 There are contrasting reasons for selecting the 31 December or 1 January as the actual date, and again, as with the choice of transferee, careful consideration of the tax impact is essential. Indeed, the actual year itself can be important. In another scheme with which I was involved, there was a potentially substantial tax advantage within the transferor by carrying out in separate accounting years certain actions prior to transfer, and this resulted in the effective date being deferred a year.

6.2.5.4 The selection of 1 January will result in the transferors being deemed to dispose of their unit trust holdings on 31 December with a further deemed disposal on 1 January, although, in practice, the latter would be disregarded. If the effective date is 31 December, the position will be less clear.

6.2.5.5 Gains or losses from deemed disposals are proportioned between gross and net funds. Thus, only the proportion of any gain or loss referable to the Basic Life Assurance and General Annuity Business fund (BLAGAB) is taken into account in the tax computation. The allocation fractions which attribute these to BLAGAB will, therefore, be different in each company in accordance with the gross and net percentages. Thus, the impact of the rules will be affected by whether the deemed disposal of unit trusts occurs in transferor or transferee, i.e. before or after transfer.

6.2.5.6 As can be seen from the Appendix, A had the highest proportion of pension business. If the disposal was deemed to take place in B as transferee after transfer, then the consolidated BLAGAB fraction for the combined entity would be lower, and accordingly the amount taken into account would also be lower. Unit trust holdings linked solely to BLAGAB are fully chargeable, so that the impact of the fractions might be limited in practice.

6.2.5.7 If the effective date was 31 December, then options potentially would be left open. If losses arose as a result of deemed disposals, it could be argued that these occurred in the transferor, thereby maximising the allowable proportion to offset against previously spread gains. If gains arose and the impact on the allowable fraction was significant, then the option would remain available of arguing that the gains arose in B as transferee, thereby reducing the chargeable proportion, as more would be allocated to the pension fund.

6.2.5.8 Furthermore, as the transfer was to take place at the end of the current accounting period, then the apportionment fractions calculated in accordance with the taxes Acts would be affected. This arises as the opening liabilities of the transferee, and closing liabilities of the transferors, will depend on whether the transfer takes place before or after the end of the current accounting period.

6.2.5.9 If the effective date was 1 January, the mean fraction based on opening and closing liabilities in 1995 might be affected by the opening liabilities of the transferee being based on the original liabilities of the transferee alone. If the effective date were prior to 1 January, the opening liabilities of the transferee would reflect the combined business, and the proportion of pensions business

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would be higher than if the opening position were based on the transferee company pre-transfer (assuming the transferee was not A).

6.2.5.10 With regard to the impact on the XSE and postponed E position, referred to in ¶6.2.3.10, an effective date prior to 1 January would result in these being available for offset in the previous year, 1994, and thereby accelerate their utilisation.

6.2.5.11 Finally, there was doubt on how the European Accounts Directive, which affected periods beginning after 31 December 1994, would be implemented, and the way in which the accounting changes would affect the tax position of companies. It seemed probable that transfers to the fund for future appropriations would only be deductible for tax purposes if they could be demonstrated to represent a sufficiently accurate estimate of future liabilities. Transfer by 31 December would avoid any potential complications under the new rules which could increase the tax liability of the transferee.

6.2.5.12 For these reasons, it was agreed that the effective date should be prior to 1 January. Finally, to avoid any possibility that an effective date of 31 December was deemed to cause the transfer to take place immediately after midnight on 1 January, the actual effective date selected was 30 December, which was possible as 31 December was a Saturday! An alternative would have been to stipulate a precise time of day on the effective date.

6.2.5.13 There can be no certainty over the tax outcome, as this will not be resolved until some time after the transfer during the normal tax assessment with the Inland Revenue.

6.2.6 *Actions prior to 30 December*

6.2.6.1 In view of the complex application of taxation to life assurance companies and the impact of a transfer, it was advisable to consider if any prior actions could be taken.

6.2.6.2 There would be potential to relieve some of the capital losses, otherwise stranded in C on transfer by *bed and breakfasting* the investment portfolio.

6.2.6.3 In Ireland tax clearances were also required. Unlike the U.K., no statutory reliefs are available, with all items subject to discretionary agreement by the Revenue Commissioners, although no problems were envisaged.

6.2.6.4 However, it was known that stamp duty would be applied to the transfer of Irish equities. An earlier investment decision, unrelated to the scheme, had been taken to liquidate these holdings, which were not considered attractive, and replace them with Irish gilts, so that the currency matching position would be maintained. This change in asset allocation was advanced to ensure completion before the effective date and avoid any stamp duty liability.

6.2.7 *Alternative procedure*

6.2.7.1 Because of the differing impact of tax depending on which company was transferee, the possibility of a two-stage scheme was considered, but

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ultimately rejected as, indeed, was the option of forming a new company as in a demutualisation.

6.2.7.2 Under the former, B would transfer into C and then the enlarged entity would transfer into A. The intention would have been to offset NC1 profits in B against NC1 losses in C with no restrictions. Any remaining profits in C would be offset against the NC1 losses in A. There were intermediate steps to improve the position further.

6.2.7.3 However, apart from the probable requirement that the enlarged company after the first transfer would need to trade for a reasonable period to be recognised as a corporate entity, more importantly it would be obvious that the purpose of the two-stage transfer was to obtain tax advantage which could impact adversely on the application for tax clearances.

7. Restructure of Unit-Linked Portfolios

7.1 *Principles of Restructure*

7.1.1 Section 5.3.2 described the existing UL structure, and concluded that rationalisation of ownership was essential. In ¶4.4.3.2 reference was made to the prior purchase by the shareholder of the UL business in C from the WP policyholders, and Table 3 showed the structure after that purchase.

7.1.2 The bulk of future new business was expected to be UL, and there was concern that, if future WP business was minimal, then the WP fund might have difficulty in financing new business strain if that strain became disproportionate.

7.1.3 Thus, the Appointed Actuary concluded that the ownership of future new UL business rested more appropriately with the shareholder. In addition, for purely practical reasons, in order to align the shareholder interest in the business, it was clear that ownership of the existing UL business currently owned by the WP policyholders should also be transferred.

7.1.4 This was recommended to, and agreed by, the board, subject to payment of appropriate compensation by the shareholder. The shareholder agreed, in principle, to this conclusion, subject to the levels of compensation required.

7.2 *Unitised With-Profits*

7.2.1 It was next necessary to determine the future structure of UWP business, as this would have a bearing on whether it would be included in the purchase of the UL business and, obviously, on the level of compensation. It would also have an effect on whether shareholder or WP policyholders financed UWP new business strain.

7.2.2 The result of the UL restructure would be to divide the LTBF into two sub funds, one comprising WP business and the other UL business, under which the shareholder's rights to distributable surplus differed. A third sub fund, comprising only UWP business, was an option not developed in any detail, principally because of the difficulty of establishing that sub fund without support from the estates of the long-established existing WP funds.

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7.2.3 UWP business would be more complex to manage in future, as the assets backing it could be in either of the sub funds or split between them, and these proportions could change at the option of the policyholder. There are two principal methods of managing UWP business to ensure equity is maintained in surplus distribution. There are variants, but only the main methods are considered.

7.2.4 The first option can be referred to as the proportionate method, under which the WP portion of the UWP goes to the WP sub fund and the balance to the UL sub fund. The second option can be referred to as the UL method, under which 100% of each UWP policy goes to the UL sub fund, with the allocations to the UWP fund being reassured into the WP sub fund. Only the broad principles underlying these alternatives are considered in the paper.

7.2.5 The proportionate method results in a similar theoretical position to traditional WP business for the WP portion of the UWP. The surplus arising from that business, including mortality and morbidity, is allocated to shareholder and policyholders in the same proportion as traditional WP business. The UL proportion is treated exactly the same as other UL business, with profit arising, including mortality and morbidity, being allocated in the same manner.

7.2.6 The UL method applies the same charges to the UWP business as would apply to UL business, with the statutory profit to the shareholder calculated as the difference between these charges and actual expenses. All mortality and morbidity profits arise in the UL sub fund. The shareholder is not entitled to any investment profit, as the assets reassured into the WP fund are used in full to provide the investment return to UWP policyholders. As these assets provide risk capital, then there is entitlement to share in profits from non-profit business in that sub fund, but not mortality, morbidity or expense profits, assuming any losses from such sources are borne by the other classes of WP policyholders.

7.2.7 The UL method was the approach adopted in the demutualisation of both Scottish Mutual and Scottish Equitable, but the proportionate method was originally proposed in the case study for the following reasons, principally from the perspective of the shareholder.

7.2.8 The proportionate method was anticipated to provide a common interest for both shareholder and policyholders in achieving good investment and expense performance, with less exposure in respect of the latter in determining shareholder profit. Also, the WP fund would share in the financing of new UWP business.

7.2.9 The UL method was regarded as potentially aligning the UWP and UL funds, resulting in easier administration, particularly with reference to switches, but the exposure of shareholder profits to investment return would be restricted. The shareholder would receive a full return on any capital allocated to finance new business, but would have to provide all the capital financing of new business strain. The WP fund would meet any strain associated with the smoothing philosophy of the company in allocation of bonuses.

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7.2.10 The emergence of statutory shareholder profits would be different under the two methods. The proportionate method would defer statutory shareholder profits, but not necessarily embedded value profits, which was an important consideration to the shareholder. The UL method is not affected by this consideration.

7.2.11 On the other hand, the proportionate method is administratively more complex, requiring sophisticated systems to ensure that switching between UWP and UL funds is carried out on a basis equitable to both shareholder and policyholders.

7.2.12 In general, the theoretical profitability of each method is similar, but the share of that profit between shareholder and policyholders differs as conditions vary. In periods of high investment returns the proportionate method will result in higher profits to the shareholder and vice versa, but the shareholder is virtually guaranteed to make a statutory profit through the 10% share of distributed surplus. Under the UL method, the profit per policy will probably be much more uniform regardless of differing investment scenarios, although the actual profit will, of course, depend as much on product design as the formula for shareholder profits. Statutory losses are possible.

7.2.13 Finally, the proportionate method was that currently utilised by C, and the UWP business had not been included in the business previously sold to the shareholder.

7.2.14 The weight of the argument for the shareholder came down in favour of the proportionate method, which would align the existing and new business, share the capital financing requirements and provide more stability through having a portion of the business less exposed to fluctuations in expenses than under UL business. In addition, the compensation required would be less. This decision was subsequently reversed in 1995, post the transfer.

7.2.15 The paper by O'Neill & Froggatt (1993) covers many of these issues in more detail.

7.3 *Unit-Linked Fund Mergers*

7.3.1 Under the new ownership structure, the anticipated advantages from merging UL funds with similar investment objectives could be realised. An appropriate merger schedule was prepared, but, as the associated systems work was substantial and completion could not be guaranteed before the effective date, power was taken to effect the mergers not later than 31 December 1995. These were to be certified by the Appointed Actuary as being equitable between policyholders and by the external auditors that the correct funds were transferred.

7.3.2 As a prerequisite to merger, it was considered desirable to rationalise the fund and policy charges which differed between funds. Differences occurred in the bid/offer spreads, policy fees and fund management percentages, with the last named being the most complex to continue at different levels.

7.3.3 Any proposed changes had to be in accordance with policy conditions and market practice, and must neither compromise PRE nor be seen as increases

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purely as a consequence of the proposed scheme. In general, policy conditions were similar regarding fund management charges, but it would be more difficult to justify rationalising the other charges.

7.3.4 The proposed changes were discussed with the independent actuary to ensure he did not disagree with the conclusions, and a sentence to this effect was included in the report.

8. Rationalisation of Surplus Distribution

8.1 *Options*

8.1.1 Paragraph 5.3.1.4 concluded that a rationalisation of the disparate surplus distribution rights was necessary, and that the common basis should be appropriate for new business. New business was considered the driving force and was relevant in view of UWP business, even if there was minimal new traditional WP business in future.

8.1.2 B was to be the transferee, and its articles placed no restriction on the proportion of distributable surplus which could be allocated to the shareholder. In addition it was the most aggressive, in that the shareholder received 10% of the distributable surplus and the WP policyholders paid the additional tax. In theory, there was no restriction on the future surplus distribution percentage, but the limiting factors were market forces, the impact on the company's competitive position and, of course, PRE.

8.1.3 In addition, the decision had to balance the risk/reward relationship between shareholder and WP policyholders. The shareholder wished to receive an adequate return on capital appropriate to the associated risk, but this had to take into account the relative contributions to financing from shareholder and WP policyholders.

8.2 *Shareholder's Percentage of Distributable Surplus*

8.2.1 The first step was to review market practice, and a simple survey of the practices in other offices was carried out by examination of Form 58 in the DTI returns. These figures had to be treated with great caution, as a more detailed examination might reveal factors affecting the results. For example, no adjustment had been made for the existence of sub funds with non-standard participation proportions.

8.2.2 For this reason Table 4, which sets out the result of that survey, does not show the names of the companies.

Table 4. Proportion of surplus distributed to policyholders

Company	%	Company	%
E	90.32	O	88.48
F	90.00	P	89.27
G	79.70	Q	90.00
H	90.00	R	90.38
J	90.00	S	94.62
K	89.70	T	91.00
L	86.19	U	90.30
M	79.03	V	90.98
N	90.07		

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8.2.3 Despite the limitations of the survey, it confirmed the expectation that the 90/10 split between WP policyholders and shareholder was the most common in the market. Support for that conclusion is given in Needleman & Roff (1995).

8.2.4 Such an approach for existing business would not conflict with the limitations on surplus distribution in A and C. Although B was transferee, it was considered that any change breaching these limitations might produce adverse comment from the DTI and independent actuary.

8.3 *Payment of Tax on Shareholder's Transfer*

8.3.1 It is first appropriate to provide a brief explanation of how this additional tax liability arises. Surplus is distributed net, and has to be grossed up to cover the tax liability. A transfer of surplus to the shareholder is liable to additional tax equal to the difference between that applicable to shareholder and policyholders. For example, in C the effective rate of the former was estimated to be 32% and that for the latter 25% for life and nil for pensions business. Thus the extra tax liability in respect of the shareholder's share of surplus is:

— (1/0.68 − 1) = 32/68 of the transfer of pensions surplus; and
— (1/0.68 − 1/0.75) = 7/51 of the transfer of life surplus.

8.3.2 It was more difficult to establish market practice on the approach to payment of the additional tax. The governing clauses in A, B and C made no reference to it. The limited research concluded that it was more common for that tax to be paid by policyholders.

8.3.3 That position had probably arisen more by chance than through a specific corporate decision. The reason for this situation is referred to in Needleman & Roff, who explained that it had been highlighted as a result of taxation changes in 1990. Previously it had only applied to transfers in respect of pension business, but this could then be minimised by reservations of profits, and responsibility for payment had not, therefore, been an issue. They refer only to one office who reduced the shareholder's transfer to reflect the extra tax, which would seem to confirm the conclusion in ¶8.3.2.

8.3.4 On the other hand, in the case study it was suggested that the practice of the policyholders paying the additional tax might not be sustainable if the basis of life company taxation moved closer to that applicable in Europe.

8.3.5 The shareholder had agreed to pay or receive compensation as a result of both this and the UL rationalisation, but clearly wished to limit the net amount due.

8.4.2 The final decision was driven by the approach which had applied in the demutualisation of A, i.e. 90/10 split of distributable surplus, with the shareholder bearing the cost of the additional tax. There were three reasons advanced in that:

— it would be difficult to justify a change to the policyholders in A after such a short period of time;
— the approach should allow competitive returns under products in future; and
— it was less likely to be affected by any future changes in the tax regime.

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9. Compensation Considerations and Calculations

9.1 *Controls*

9.1.1 S49 provides a strict legal procedure designed to protect the interests of policyholders whose policies are included in a long-term business transfer, and extends to protect the interests of those policyholders remaining in the transferor.

9.1.2 Surprisingly, there is no statutory procedure governing an internal restructure of LTBFs, provided that it does not breach the governing articles of that company, which themselves may be changed without reference to the policyholders. This, in my opinion, is inconsistent with the objectives of the S49 legislation, as the impact on the policyholders may be substantial, requiring the payment of appropriate compensation.

9.1.3 Section 30 of the ICA limits the rate of increase in the proportion of surplus which can be appropriated by the shareholder to 0.5% p.a., unless certain procedures are followed. There have been well publicised examples in the recent past of companies restructuring internally in order to allocate a significant proportion of the free estate in the long-term fund to the shareholder. A recent example is that involving United Friendly, in a restructure which recognised that a substantial proportion of the profits retained as investment reserves could ultimately accrue to the shareholder, as the articles gave no clear indication of the allocation rights. B's articles similarly gave no such indication.

9.1.4 In the case study, assuming there had been no transfer, the changes proposed were not limited by Section 30, with the exception of C, where the move from 7% to 10% could have been implemented over 6 years.

9.1.5 These comments are not intended to imply that such reconstructions are carried out without regard to PRE, and, indeed, in the United Friendly example it is understood that the principles used to establish the new structure were fully discussed and agreed with the DTI.

9.1.6 However, if a company carried out an internal reconstruction in private and abided by the terms of Section 30, no legislation would have been breached. When the matter becomes public, there seems to be no clear procedure for reversing the process if considered by the DTI/GAD to impact adversely on PRE. The DTI has wide powers of intervention under the Regulations, but these would be retrospective. The only protection would be the duty of the Appointed Actuary to inform the DTI in accordance with GN1 if concerned over PRE, although, again, that is dependent on the integrity of the Appointed Actuary.

9.1.7 Reconstructions are, therefore, dependent on the integrity of the Board of Directors, the Executive and the Appointed Actuary in protecting PRE and the implicit requirement to discuss any proposals in advance with the DTI/GAD. There is no legal requirement for a report from an independent actuary, although the DTI will now require one in connection with reconstructions involving ownership of the free estate. The responsibilities of the Appointed Actuary are paramount in recommending any appropriate compensation and in explaining and

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justifying these recommendations to the DTI and, now, to the independent actuary.

9.1.8 These issues are not novel, and have been known for some time. In the discussion on Salmon & Fine (1991) it was referred to in the context of WP policyholders having no voice in a takeover because S49 does not apply, whereas in the most straightforward scheme it does. In addition, reference was made to the possibility under the articles of the company concerned in the Salmon & Fine case study, of an increase from 10% to 20% of surplus distributed to the shareholder as being very similar to a demutualisation, which is normally governed by the requirements of S49. Although changes to surplus rights are similar to a partial demutualisation, the policyholders have no right to a vote, as the company is proprietary.

9.1.9 The Working Party Report noted that the management can act against or enhance the interests of the policyholders within the constraints implicit in insurance company law, with or without a change of ownership. As a result, they concluded that policyholders are not parties to the transaction of a takeover, but that a S49 transfer did require the added protection, as the transfer was being made to a different entity as the insurer. Despite this conclusion, I still believe that there may be a gap in the protection in major internal reconstructions.

9.1.10 Having raised the issues in the preceding paragraphs, it is worth again stating that, in this case study, although the rationalisation issues were not incorporated in the scheme document itself, they were progressed in tandem with the transfer.

9.1.11 Thus, they were recommended by the Appointed Actuary, approved by the board and the shareholder, the principles approved by the DTI and then investigated in detail by the independent actuary. In this respect, the DTI/GAD relied very heavily on the independent actuary to express satisfaction with the levels of compensation, subject to their overview.

9.1.12 Finally, the full proposals for transfer and associated rationalisation were summarised in the circular to the policyholders, who were entitled to object. However, it is difficult to imagine how the court would have reacted to policyholder objections to the reconstruction issues and, in particular, the levels of compensation, as its principal role under S49 was to approve only the terms of the scheme itself.

9.1.13 This is clearly the correct way to proceed if policyholders' interests are to be protected, but I repeat that it is strange that such major issues are not governed by legislation.

9.2 *Compensation Considerations*

9.2.1 Having determined the principles, attention turned to the level of compensation required to ensure that the interests of both shareholder and policyholders were protected.

9.2.2 The first consideration was whether the changes justified compensation,

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as a matter of principle, and as initial calculations suggested that the net payment might be minimal.

9.2.3 It was obvious that compensation was needed, as the rights of each set of WP policyholders had to be protected, and the cash flows were in different directions so that no netting off was appropriate. The shareholder could have waived any right to the compensation due from policyholders in B, but this was inappropriate, as payments were required from the shareholder to policyholders in A and C.

9.2.4 It was, therefore, necessary to determine the level of compensation required for each separate part of the reconstruction. Table 5 is derived from Tables 2 and 3, and summarises the direction of the resultant cash flows, where S stands for shareholder and P for WP policyholder. Although this table shows the direction of the compensation change, as is discussed later, payment could potentially be negative, depending on the embedded value of the business transferred.

Table 5. Cash flows between shareholder and policyholders

Company	A		B		C	D
	With-profits fund	Assured growth fund	With-profits fund	Growth pension fund	With-profits fund	Total fund
Surplus/Tax change	Nil	Nil	P to S	S to P	S to P	N/A
Ownership change	S to P	N/A	N/A	N/A	S to P	S to P

9.2.5 The approaches to the different calculations were the same, but the arguments for and against compensation varied in each case.

9.3 *Methodology*

9.3.1 As part of normal reporting to its parent, the company regularly calculated embedded values. The technique had been employed during the takeover of C and in calculating the value of C's UL business when purchased by the shareholder shortly thereafter.

9.3.2 In the embedded value calculation, 100% of the assets were assumed to be utilised either to meet guaranteed benefits or through reversionary and terminal bonus. The discount rate was based on the shareholder's perspective of the yield expected on the assets within the fund increased by an appropriate amount to cover the additional risk, or, alternatively, to an overall rate which provided the shareholder with the return on capital required. These points are referred to again later.

9.3.3 A consistent approach, following similar principles, was utilised in the calculation of compensation payments. The assumptions used were set after consideration of the past experience of each company, and were based on the then current economic conditions. Embedded values change in accordance with

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different asset allocations, and as compensation was only payable if the scheme was approved, then the most appropriate basis should be in accordance with the anticipated notional asset allocation for the combined fund after merger.

9.3.4 The sensitivity of the calculations to changes in the assumptions were tested to the satisfaction of both Appointed and independent actuaries. In considering these sensitivity tests, it is important to appreciate that a positive change of compensation to the policyholders in A and C resulted in a negative change in B. Thus, the central rates were most important to ensure fairness between the different sets of policyholders.

9.3.5 Of these sensitivity tests, it emerged that the lapse assumption was the only one which might materially affect the levels of compensation. An increase or reduction of 20% in the central rate assumed resulted in a change of 8% in each direction to the compensation value. However, a 20% variation was considered unlikely to occur in practice with an established portfolio of business, and more probable variations were considered to be within acceptable bounds.

9.3.6 An increase in expenses of 10% p.a. in excess of the central assumptions had very little impact.

9.3.7 Changes in the risk discount rate (RDR) resulted in significant changes, which varied in impact between companies depending on the maturity of the business. However, the central rate actually used was considered to be in line with then current economic conditions.

9.3.8 The RDR was the most difficult assumption to agree, as there is a fundamental difference in approach to risk between WP policyholders and shareholder in its selection, even where there is no disagreement on the basic investment assumptions.

9.3.9 This dichotomy is well known, and is referred to whenever a compensation payment is being calculated, in order to place a value on a stream of future surplus arising from existing WP business. The shareholder's approach is that outlined in ¶9.3.2. However, policyholders would value the surplus at a rate based on the net rate earned on the underlying investments, which might be around 2% less than the RDR favoured by the shareholder.

9.3.10 This problem must also be considered in the valuation of UL and non-profit business owned by the WP policyholders. I believe that the problem is less acute, and there should be no difference in principle between the RDRs appropriate to shareholder and WP policyholders, as both can be regarded as shareholders in assessing the value of future profits.

9.3.11 However, their tax liabilities differ, depending on the proportion of pension business included in the WP fund, and therefore the net rate applicable. For example, if the LTBF pays tax on an I-E basis in respect of life business and no tax on investment returns in respect of pensions business ignoring any tax liability on distributed profits, the semi-net return to the WP policyholders is higher than the fully net return to the shareholder.

9.3.12 Ultimately, to ensure policyholders were no worse off under any of the transactions, it was decided to calculate the compensation payments in accordance

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with RDRs based on the policyholders' perspective in each case, which was consistent with the basis adopted for the prior purchase of C's UL business.

9.3.13 Calculations were made 6 months in advance of the effective date, and used a best estimate of the experience to the end of 1994. This required a projection of actual new business, taking into account business written in the first 6 months and a projection of the levels of in-force business to the end of 1994. Compensation payments were calculated as at the effective date, and were not adjustable for any differences in actual experience prior to that date or to any later date of implementation allowed under the scheme. This was considered essential, as rationalisation was inextricably linked with scheme approval, which could not be conditional on later agreement on compensation.

9.3.14 Finally, it is perhaps worth identifying the probable accounting loss which would arise from the difference between the compensation basis and the embedded value basis used for reporting to the building society at the year end. The movement in that embedded value between the end of 1993 and 1994 would reflect the change in value of the restructured company from the shareholder's perspective. Unless some change in the normal basis could be justified, that movement would differ from the net compensation payments, as these were calculated from the policyholders' perspective.

9.4 *Compensation Considerations*

9.4.1 Each of the changes in structure shown in Table 5 will now be considered in turn to identify any special factors relating to each and explain how these were resolved.

9.4.2 *Company A — sale of unit-linked business to shareholder*

9.4.2.1 As can be seen from Table 3, there were three separate tranches of UL business owned by the WP policyholders, but by far the most important was the pensions business in A.

9.4.2.2 An analysis of the value of items not included in an embedded value was carried out. This encompassed the extreme considerations of either paying for the creation of a similar structure/goodwill or as a multiple of the profit which might be expected to be produced by one year's business. (The arguments for and against various methods of assessing goodwill value are considered in detail in both Hunter & Jones (1986) and Needleman & Westall (1991).)

9.4.2.3 This analysis produced an interesting conundrum as to whether the WP policyholders or the shareholder owned the goodwill value of that new business.

9.4.2.4 The building society operated its own sales force and submitted business to the company through a tied agency relationship. As the shareholder effectively controlled these sales through its ownership of that distribution channel, then it also owned that proportion of the goodwill value. Without that source of new business, it was questioned whether the new business emanating from other distribution channels would be profitable, but, at the very least, the goodwill value of that residual business would be significantly reduced.

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9.4.2.5 Furthermore, the shareholder had the freedom to switch new business from one company to another with resultant changes to the profit flows, and, for example, could have determined to write all future new pensions business in B where it already owned the UL business. This was stated in the Appointed Actuary's report as the intention if the scheme failed or no rationalisation took place.

9.4.2.6 With these considerations in mind, it was decided that the compensation payment would not include any allowance for profits from future new business. However, the shareholder would pay for the cost of any work involved in the transfer of ownership, such as associated systems development, and no proportion of that cost would be charged to the WP policyholders in A. Bearing in mind the approach to the RDR which favoured policyholders, this was not unreasonable.

9.4.2.7 A similar approach had been adopted when purchasing the UL business in C, although the reasons advanced at that time had been different. Then the consideration had been that the value of the new business was negative, but no adjustment would be made to the embedded value of the existing business as C had been closed. On the other hand, no payment was made for the structure value in C, which, in particular, included a recently developed computer system which was then utilised to administer the new business written in B.

9.4.2.8 Similar arguments had also been expressed during the demutualisation of A, as referred to in ¶4.2.1.2.

9.4.2.9 Although possibly obvious, it is worth making clear that the compensation payment made to A was not adjusted for the shareholder's 10% of the UL business already effectively owned by the shareholder through its rights to distributable surplus in A. This arises as 10% of the compensation payment emerges through the shareholder's 10% share of surplus, assuming the payment is fully distributed through future bonus allocations.

9.4.3 *Company A — assured growth scheme*

As explained in ¶4.2.1.7, the demutualisation scheme had made no change to the rights of policyholders in that fund. The scheme proposed no change to these rights, and therefore no compensation was due.

9.4.4 *Company B — surplus change in with-profits fund*

At the time of the reconstruction there were no contentious issues, and all that was considered necessary was to calculate the compensation due for the transfer of the tax liability in accordance with the agreed methodology.

9.4.5 *Company B — surplus change in growth pension fund*

9.4.5.1 The requirement was to calculate the appropriate compensation payable by the shareholder to the WP policyholders for the increase in the former's share of distributable surplus from the current level, as described in ¶4.3.1.3.

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9.4.5.2 The first problem was to determine the base level of surplus allocated to the shareholder, which had been variable in previous years. This was a matter of judgement, but in the end allowed for the most recent percentage, as the trend had been increasing in favour of the shareholder. No reduction was made to allow for any upward continuation of this trend.

9.4.5.3 Compensation was based on the embedded value of the existing business. An appraisal value was considered inappropriate.

9.4.6. *Company C— surplus change*

9.4.6.1 The requirement was to calculate the appropriate compensation for the increase in the shareholder's share of distributable surplus from 7% to 10%, with the liability for payment of extra tax passing from policyholders to shareholder. Again an appraisal value was considered inappropriate.

9.4.6.2 However, this was the most contentious area in view of the shareholder's entitlement under the Act to a maximum of 10%, an entitlement considered stronger than, for example, in B, which stipulated no maximum percentage and could only rely on established practice.

9.4.6.3 The 7% share had been standard since the previous shareholder had purchased C in 1968, although a potential increase in this percentage had often been raised by that shareholder. This had always been successfully resisted by the then management, despite 10% being the most common in proprietary offices.

9.4.6.4 Part of that resistance had been based on the timing difference in payment of surplus, the shareholder receiving an immediate cash payment and the policyholders a deferred payment. The valuation rate of interest was lower than the future expected rate of investment return. Thus, the relative value of the shareholder's immediate payment compared to the policyholders' deferred payment, calculated on a best estimate basis, was greater, as the additional surplus generated in future from the difference in the rates is also distributed between shareholder and policyholders in the same proportion. In reality, the standard 90/10 split is subject to the same reasoning.

9.4.6.5 An argument was advanced that no compensation was due to policyholders, as the move from 7% to 10% should be regarded as within PRE. This could have been achieved in 6 years under Section 30 of the ICA. As B was to be the transferee and 10% was the established level in that company, theoretically the increase would be achieved automatically on transfer. On the other hand, most policyholders were almost certainly not aware of the shareholder's entitlement and the 7% level had become established practice and therefore part of PRE, and it had been stated in the with-profits guide. In addition, it would almost certainly result in an adverse comment from the independent actuary, even if the Appointed Actuary did not object.

9.4.6.6 It was agreed that it would not be equitable for any change in the percentage to reduce prospective returns for existing WP policyholders. The argument remained that the shareholder should not have to pay directly for a

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share of surplus which could be regarded as an entitlement, and the discussion turned to alternative means of financing the increase.

9.4.6.7 The first option was to increase future surplus allocations to ensure no change to policyholders' benefits, but to a level sufficient to allocate 10% in future to the shareholder. The second was a one-off increase to the asset shares of the policyholders, with future right to only 90% of the distributable surplus. Both these methods would be financed from the free estate. Neither of these options found favour with the DTI/GAD and, indeed, were not strongly supported internally, despite considering it necessary to discuss the issue.

9.4.6.8 Ultimately, it was determined that compensation was due. The decision was strongly supported by the consideration that, in assessing the value of C for purchase, the price had been based on 7% of the embedded value, which inherently assumed that the shareholder was entitled to only that percentage of the free estate.

9.4.7 *Company C — sale of unit-linked business*

The UL business in C still owned by the policyholders comprised pooled and segregated pension funds. These were projected to make losses which would have resulted in a negative embedded value and, theoretically, a reverse payment by the WP policyholders to the shareholder. However, an investigation of the policy conditions determined that charges could be increased to produce a break even value and could be justified without compromising PRE. Accordingly, it was agreed to transfer the business to the shareholder without compensation.

9.4.8 *Company D — sale of unit-linked business*

No compensation was considered necessary for the transfer of the pooled pension fund business in D from the WP policyholders of A to the shareholder. This business was already fully reassured to A, and this arrangement would continue. Thus D was not expected to make any profits or losses in its own right, and therefore its value on transfer was nil.

9.5 *Compensation Values*

9.5.1 The actual compensation payments made were as shown in Table 6.

Table 6. Compensation payments

Company	A		B		C	D
	With-profits fund	Assured growth fund	With-profits fund	Growth pensions fund	With-profits fund	Total fund
Surplus change	Nil	Nil	£3.24m P to S	£1.17m S to P	£2.90m S to P	N/A
Ownership change	£4.26m S to P	N/A	N/A	N/A	£0	£0

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9.5.2 The compensation in C comprised two elements, £2.856m in respect of U.K. business and £0.044m in respect of Irish business. The figure was proportionately lower for the latter as it contained a higher proportion of pensions business. Thus the compensation for the increase from 7% to 10% is offset by different proportionate amounts as compensation for the shareholder paying the additional tax. This split was necessary in view of the separate scheme being progressed for the transfer of that business.

9.5.3 The total amount due by the shareholder to policyholders was, therefore, £8.33m and, with £3.24m being due from policyholders to shareholder, there was a net cost to the shareholder of £5.09m. Whilst the actual amounts are sizeable, when expressed as a percentage of WP fund assets the impact is less than 1% in each case. This does not reduce the importance of an equitable result being ensured.

9.5.4 Warranties were prepared, under which payment of compensation was irrevocable if the scheme received approval, and these were included in court documentation. Payment would be made on the effective date and the amounts were to be financed from existing shareholder assets within the companies. Shareholder assets in the transferors did not transfer as part of the scheme, but under a separate agreement and at the same time.

9.5.5 This reduction in available shareholder capital did not impair the solvency of the merged company, as the total assets in the company did not reduce. In fact the solvency would be improved, as the compensation payments would form part of the LTBF and the additional yield generated would be taken into account in the statutory valuation.

9.5.6 In conclusion, the actual payment of cash now available within the WP fund for investment in fixed-interest and equities well compensated the policyholders for the exchange of an uncertain future flow of profits which, in respect of the compensation for UL business, had also freed these assets from an illiquid investment medium.

9.5.7 It was appreciated that the compensation payments to policyholders could be considered by the Inland Revenue as giving rise to a capital gains tax charge, but it was considered that the structure of the scheme should avoid any such liability. The payment to the shareholder in isolation would also be potentially liable to tax, but as compensation would be settled by transfers in the combined entity, it would be argued that only the net payment by the shareholder was relevant. The outcome would have to await the future tax assessment.

10. WITH-PROFITS FUND MERGER

10.1 *General Background*

10.1.1 In merging WP funds, it is necessary to compare the relevant strength of each. The purpose of this comparison is to determine if any policyholders will be adversely affected, and if so, the form and level of adjustment necessary to

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eliminate the perceived difference and ensure that their prospective entitlements and security are not reduced.

10.1.2 Many transfers of WP funds have not involved a merger, rather the transferred assets and liabilities became a separate sub fund within the transferee. Each sub fund is then treated as a separate entity in determining appropriate investment allocations, with asset shares based on their separate experience. There may be potential benefits from reduced costs, increased capital support allowing increased investment in equities, a more equitable smoothing policy and improved solvency from forming part of a larger and stronger LTBF.

10.1.3 This was the original intention in the transfer of London Life to AMP in 1989, with London Life remaining open to new business, although it was recently announced that it had now closed to new business. The most recent is the demutualisation and transfer of Provident Mutual to General Accident. Here again there is no current intention to merge the funds, although Provident Mutual will be closed to new business.

10.1.4 United Kingdom Provident Institution (UKPI) was already closed to new business when it was transferred to Friends Provident (FP) in 1988. The original scheme followed the separate sub fund route, as the Appointed Actuary considered it to be impractical to merge because of differences in financial strength and as it had not then been possible to find a simple formula relating the different bonus levels.

10.1.5 The original UKPI/FP scheme made provision for a future change, and in 1993 a supplemental scheme was approved which resulted in their merger. The reasons advanced referred to all the disadvantages to policyholders of running a sub fund which was contracting, such as cash flow problems, restricted investment allocations and escalating expenses. The Appointed Actuary's concerns over the merger being impractical were no longer considered a problem, partly as a result of the development of the technique of calculating asset shares.

10.1.6 Asset shares were calculated at the date of the UKPI/FP merger based on the separate experience of each fund, but in future would be based on the combined experience. The freer investment policy and possible expense savings were expected to benefit UKPI WP policyholders, but, in order to give FP WP policyholders a potential benefit, the asset shares in the former are accumulated at 0.25% less than in the latter. This will enhance the free assets of the combined fund at the expense of the UKPI policyholders, and provide scope to pay benefits in excess of asset shares at FP's discretion. There was no time limit on the investment differential.

10.1.7 This differential was the subject of an article in the *Financial Times*, which referred to policyholder criticisms and suggested that there should have been an incentive payment not a disincentive. Such arguments did not suggest who was to bear the cost of that incentive in a mutual company, and I suggest that they ignored the weak position of the UKPI at the original date of transfer. Indeed it can be argued that a greater differential was justified by the difference in strength between the FP and UKPI funds as measured by free asset ratios,

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calculated to be 116% and 108% respectively on a comparable valuation basis. This opinion is dependent on the view of who owns the free estate, to which the paper returns later.

10.1.8 In conclusion, it seems probable that the separate existence of two sub funds remains viable initially and into the future if both remain open to new business, although there must be additional costs and administrative complexity in the medium to long term. However, that viability diminishes rapidly if one is closed, as happened in the FP/UKPI merger.

10.2 *Technical Considerations*

10.2.1 In 1986, Hunter & Jones referred to merging funds and suggested that the security of the present generation of policyholders in the fund with the stronger valuation basis would not be adversely affected, but future generations would be less secure. I suggest that this must depend on the relative differences. 'Bonus Linkages' would establish an appropriate differential in future bonuses and, in their words, would be 'set in concrete' by the actuaries' reports to ensure 'fair treatment for a class of policyholder that could be seriously disadvantaged by a merger'. Little mention is made of the technique of asset shares which permits a less rigid approach.

10.2.2 By 1994 the principle of asset shares was well established, and it was concluded that this technique would be utilised in the case study to ensure equity between the different sets of policyholders before and after the effective date.

10.2.3 If the difference between the relative strengths of the funds justified an equalisation adjustment, that would be effected through the asset shares.

10.2.4 The problem resolved itself into two related, but separate, investigations to be progressed simultaneously. The first investigation would compare strengths and the second develop a consistent asset share methodology applicable as at the effective date. This methodology would be utilised in the future financial management of the merged fund.

10.3 *Comparing Financial Strength*

10.3.1 *Principles*

At a very early stage, it was agreed that the terms of the scheme should recognise the following points:

— There should be no need for separate identification of the assets comprising the original WP funds for purposes of surplus distribution.
— Precise requirements should be avoided to which rigid adherence would be required in later years. Otherwise any future changes might require court approval. Less precise wording would not disadvantage policyholders, as the Appointed Actuary would still be bound to ensure PRE was protected in accordance with the spirit of the scheme.
— Equalisation, if any, should be implemented fully by adjustment to asset shares at the effective date. If not feasible, then equalisation should be amortised over as short a period as possible, with a maximum of five years.

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No time limit was deemed to impose long-term administrative complexity in return for spurious accuracy.

— No *sweetener,* such as included in the original demutualisation of A, would be offered, as it was difficult to justify financing. As the shareholder had already agreed to generous compensation payments, it would have to come from the free assets. Potential amounts were likely to have a nominal effect on asset shares. A cynical view might also be that the policyholders had no voting rights.

10.3.2 *Free assets — statutory basis*

10.3.2.1 Direct comparison of free assets from the DTI returns as at 31 December 1993 was not possible, as the underlying net premium valuation bases were not identical. In particular, asset allocations were substantially different and inadmissible assets were excluded.

10.3.2.2 Needleman & Roff (1995) followed similar lines to those adopted in the case study in evaluating assets and liabilities to produce their financial management framework. For example, they allowed for the full value of investments such as subsidiaries rather than their net asset value, and recognised that non-profit reserves may contain margins which, when released over time, will increase free assets. An example of such a margin at 31 December 1993 was the 7.5% interest margin on the assumed yield of an asset attributed to the long-term business.

10.3.2.3 Thus, it was first decided to restate the DTI returns incorporating full value for inadmissible items, as shown in Table 7.

Table 7. DTI Returns restated

All figures in £m	A	B	C	D	Combined
1. Assets in DTI Returns	608.7	1,094.6	1,030.6	2.6	2,736.5
2. Inadmissible assets	44.7	6.2	33.4	0	84.3
3. Liabilities	603.0	1,019.0	956.0	2.6	2,580.6
4. Solvency margin	21.0	48.1	34.4	0.6	98.3
5. Free assets (1+2-3-4)	29.4	33.7	73.6	(0.6)	141.9
6. WP and deposit administration liabilities	286.7	612.2	460.9	0	1,359.8
7. Free asset ratio (5/6)	10.3%	5.5%	16.0%	N/A	10.4%
8. Shareholder assets	50.1	18.4	14.2	0.8	50.1
9. DTI free asset ratio ((5-2+8)/3)	5.8%	4.5%	5.7%	7.7%	4.2%

Due to the impact of the valuation regulations, the combined figures are not always straight horizontal addition. The combined figure in line 4 is adjusted because of the release of the additional solvency margin. The combined figure in line 8 is the same as that for A.

10.3.2.4 Line 2 in the table comprises the policyholders' share of the embedded value of non-profit business in the WP funds, the embedded value of

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the UL business owned by the WP policyholders (in particular the £18.3m received as cash by C later in 1994), the excess of market value of head office buildings above the statutory value on vacant possession, tax assets (e.g. tax relief on as yet unrelieved expenses), fixed assets, release of a special provision for cost of closure to new business in C and the excess market value of investment subsidiaries in A over their net asset value.

10.3.2.5 The level of funding in the respective pension schemes which were also to be merged was considered. Differences would impact on the level of inadmissible assets, but these were not significant. In that investigation conflicts of interest were avoided by retaining both actuaries (A and B were in a combined fund) until the funds were merged.

10.3.2.6 Line 7 of Table 7 conceals the impact of a range of factors, including the different valuation bases, and, in particular, the effect of asset allocations backing the WP liabilities. These were as shown in Table 8. The impact such variances will have on the statutory results is significant.

Table 8. Asset allocations as at 31 December 1993

Company	Equities	Property	Fixed-interest
A	66%	6%	28%
B	51%	23%	26%
C	35%	15%	50%

10.3.2.7 The adjusted statutory comparison in line 7 of Table 7 does not allow for shareholder assets, which would only be relevant if there were different owners. These assets were not considered as allocated to any specific company, and could be moved to support a weaker company at the shareholder's discretion.

10.3.2.8 The net impact of compensation payments, taking into account financial reinsurance, would reduce shareholder capital as at 31 December 1994 to approximately £36m. This reduction would not affect security, as capital was transferred to the LTBF. In any event, additional security was provided to policyholders by virtue of Section 22 of the Building Societies Act 1986, which requires the shareholder to stand behind its subsidiaries and thus invest further capital into the transferee should it be unable to meet its liabilities.

10.3.2.9 Whilst that Act implies additional security, it is difficult to envisage the circumstances in which support would be triggered. In my experience, a shareholder will only be willing to subscribe capital into the LTBF if guaranteed liabilities are at risk, but not to support bonuses. That might change if PRE was affected, but obviously this will depend on whether the shareholder is deemed to have contributed to the deterioration in PRE. PRE is difficult to define, but certainly intervention on these grounds by the Secretary of State in accordance with Section 37 of the ICA would help the shareholder to decide! On the other hand, statutory solvency can be dramatically improved by switching equities to fixed-interest, and this, in my view, is more likely than an injection of fresh capital required under Section 22.

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10.3.2.10 This view conflicts with the opinion of the Appointed Actuary, who suggests in his report that such potential backing permits a more aggressive approach to asset allocation. A deterioration in solvency as a result of such a policy might not be regarded as affecting PRE if solvency could be secured by an asset switch. Who is to determine the minimum equity percentage which is justifiable before PRE is fulfilled?

10.3.2.11 These restated figures gave an indication of the relative strengths of the WP funds. The Appointed Actuary's initial conclusion was that they were broadly comparable, but that additional investigations would be necessary to confirm that view. In reaching that conclusion, allowance was made for the potentially inhibiting nature of the high level of inadmissible assets held by A, even though expected to give a satisfactory return in future. Whilst A would benefit from a reduction in that high percentage of inadmissible assets, B and C would benefit from the increase in the shareholder assets in the combined company.

10.3.2.12 The independent actuary noted this point, and stated that in the combined company the ratio of inadmissible assets to DTI assets in Table 7 of 3.1% was well within acceptable limits. I would point out that, after the payment of £18.3m to C, that percentage further reduces to 2.4%.

10.3.3 *Net premium and bonus reserve investigations*

10.3.3.1 The asset values for each company at 31 December 1993 were adjusted to approximate to the mid-1994 market values, as the relative position had altered in the intervening 6 months because of the differing asset allocations. The resultant yields determined the interest rates to be used in a revised liability valuation, which was redone as at 31 December 1993 for each company on a consistent statutory net premium basis. The inadmissible assets were treated as cash placed on deposit.

10.3.3.2 Direct comparison of the results was still not possible, as the asset allocations differed. Thus the results were again recalculated for each company, assuming various asset switches between equities and fixed-interest. In these investigations non-profit liabilities were always assumed to be backed by appropriate fixed-interest securities, and variations only related to the assets backing WP liabilities.

10.3.3.3 The first determined the different asset allocations required to meet standard solvency targets in line with the corporate objective of a specific percentage of assets over the value of liabilities plus the minimum solvency margin. The second measured the impact on solvency of allocating 20% to 25% of assets to fixed-interest. The Appointed Actuary assumed that equities/properties would be higher yielding than fixed-interest assets, but taking into account guarantees inherent in the different contracts, deemed 20% to 25% in fixed-interest to be an appropriate minimum for WP policies.

10.3.3.4 Certain policies, particularly in A, incorporated a higher level of guarantee than other WP contracts and required to be backed by a higher fixed-

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interest percentage. Thus the 20% to 25% applied only to the remaining WP business. In general, although the WP funds would be merged, it was appreciated that it would be necessary to assume a notional asset allocation for products with higher guarantees and make allowance for this difference in the asset share calculations. This approach would also apply to UWP contracts and to the growth pension fund, where discrete sub funds would not be maintained in future.

10.3.3.5 Discussion took place over whether the effect of different guarantees inherent in the respective premium bases was allowed for in the net premium valuation. It was agreed that this depended on the extent to which the net premium was restricted. In respect of single premium business the effect could be significant. Similarly, the relationship between reversionary and terminal bonus implied different levels of guarantee, which should be allowed for in the comparison.

10.3.3.6 The results led to broadly the same conclusions as had emerged from the crude comparison of the figures in Table 7, but with the relative positions of A and B reversed. In particular, it was noted that C's position had stabilised and could justify a higher percentage of equities than that shown in Table 8, whether or not the scheme was approved.

10.3.3.7 In view of concerns over meaningful comparisons on the net premium basis, consideration was given to comparisons based on bonus reserve valuations. This would make no allowance for future bonus declarations, but would compensate for differences in levels of guarantee. The comparison of resultant free assets might demonstrate a more accurate reflection of relative strength. Asset allocations supported in each fund by these different levels of free assets would determine a basis for a further bonus reserve valuation to evaluate the respective bonus earning power of each fund. This approach could then be used to equalise the level of free estate to ensure equity in the merger.

10.3.4 *Asset share comparisons*

10.3.4.1 However, it was finally decided that the assessment of relative strength of the WP funds would be best investigated by a comparison of the free estates, measured by the excess of total assets allowing for inadmissible items over the aggregate asset shares. As a result no bonus reserve valuations were carried out. The asset share methodology is discussed in Section 10.3.8.

10.3.4.2 Table 9 shows the results of that investigation, by expressing the free estate as a percentage of the WP assets remaining after deducting assets equal to the liabilities backing non-participating and UL business as at 31 December 1993.

Table 9. Free estate

Company	Free estate	% of WP assets
A	£17.4m	5.8
B	£36.5m	6.7
C	£43.8m	8.6
Combined	£97.7m	7.2

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10.3.4.3 In ¶10.3.3.3 it was stated that the Appointed Actuary believed that 20% to 25% was the minimum percentage he deemed necessary for each fund to invest in fixed-interest. In view of the differences in free estate, the valuation results of all three companies were combined to ensure that this minimum percentage could be maintained by the combined fund in a statutory net premium valuation. This, of course, had to exclude the inadmissible assets. The holding was shown to be possible without impinging on technical solvency, and therefore it was determined that no policyholders would be adversely affected by any future restriction in asset allocation.

10.3.4.4 The Appointed Actuary concluded that these results confirmed his initial assessment of relative strength. The independent actuary agreed that the differentials in free estate were within an acceptable range, taking into account the corporate smoothing policy and the approximations in the methodology.

10.3.4.5 Accordingly the scheme would propose no adjustment to the asset shares as at the effective date or introduce any future differential, since the relative security and bonus prospects of the WP policyholders in each company would not be adversely affected.

10.3.5 *Other considerations*

10.3.5.1 The Appointed Actuary stated the reasons leading to that conclusion in his report, but, in addition, other points were advanced internally and discussed with the independent actuary to support that conclusion.

10.3.5.2 First, relative strengths had been affected by the decision where to write new business. Although separate companies, A and B had been operated on a joint basis since 1991 and this had also applied to C in 1994. If no rationalisation took place, then the shareholder would still retain the discretion of where to write new business, taking into account the ability of each company to finance it and total levels of business written. Subject to the Appointed Actuary confirming that there was no adverse impact on PRE, any existing differential in free estate could be gradually eroded.

10.3.5.3 Second, assuming that the scheme did receive approval, then the corporate philosophy regarding the free estate would continue. This raised two related issues, consideration of the effect on policyholders of closing the fund and the ownership and purpose of the free estate.

10.3.6 *Closed fund option*

10.3.6.1 It was appropriate to consider this option in the light of PRE, although the specific reference in GN15 requires the independent actuary to consider the effect only in a demutualisation. The option was rejected in the Appointed Actuary's report.

10.3.6.2 Although correctly eliminating this as an issue, I do not believe that closing to new business as an alternative to the restructure is relevant in a proprietary company. A had demutualised, and, at that time, the option of closing

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had been considered and rejected as less advantageous to policyholders. B and C were already proprietary, and had been purchased with the intention of strengthening A's market position. B and C had been sold as an alternative to closing, not just in the interests of the respective shareholders, but also because the interests of policyholders were thought to be better served as part of a going concern. In the case of C, this had been discussed with the DTI, who did not disagree with that view. Therefore, reconsideration of closing should be unnecessary, as the purpose of rationalisation was to improve the expectations of policyholders through streamlining administration and reducing costs through participation in a combined fund, open to new business, with an expectation of growth.

10.3.6.3 The Appointed Actuary stated in his report that an open fund should be better able to control costs, and that investment policy should be less restricted. These were the arguments expressed for merger of the UKPI fund following experience of operating as a closed fund. This general conclusion was not endorsed in all circumstances by the model investigated by the Bonus and Valuation Research Group of the Faculty of Actuaries (1991).

10.3.6.4 The contentious issue in a proprietary company relates to how the estate will be distributed in a closed fund. Ownership and use of the estate is discussed in Section 10.3.7, but, even if it was to be distributed fully as bonuses, there would still be problems of equity between different generations of existing policyholders.

10.3.6.5 The tontine effect implies that distribution of the free estate is delayed through the adoption of a more conservative bonus policy in the early years, possibly just in line with asset shares, but increasing well above asset shares in later years. Thus, claims in the early years will, at best, not participate in the distribution of the estate and, at worst, receive reduced returns as a result of closing. The alternative is to begin an immediate distribution of the free estate, but, even if by terminal bonus, this would still gradually impair investment freedom, with an adverse impact on returns to policies in later years. The effect would be exacerbated if distributed in proportion to the liabilities in force at the date of closure. Neither approach is equitable.

10.3.6.6 Table 9 shows that none of the companies incorporated a significant free estate, and thus the increase in returns to policyholders by its distribution would be relatively limited, if not negative, as a result of increasing unit costs. In addition, the companies being proprietary, the shareholder could restrict returns to the asset shares to ensure PRE and collect the amount remaining when the last WP policy exited! This presumes ownership of the free estate.

10.3.7 *Free estate considerations*

10.3.7.1 Ownership of the free estate in a proprietary company is very topical as a result of disclosure, and a working party has been set up by the Life Board to report on the matter. Following the restructure of United Friendly and London and Manchester, the DTI issued a statement making its position clear. In

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particular, the DTI stated that any restructuring should preserve a proper balance of interest between policyholders and shareholder. As stated in ¶9.1.7, it now requires a report from an independent actuary, and it will be interesting to see the outcome of further cases.

10.3.7.2 Opinion is divided in the profession on ownership, and independent actuaries will have differing views with the conclusion of the report, depending on which independent actuary is involved. I would go even further and suggest that there is a danger that the selection process could be biased towards the actuary most inclined towards the view of the party making the appointment. This is different from the position of an independent actuary in a S49 scheme, where the room for extreme differences of opinion is much more limited.

10.3.7.3 The issue was relevant in the case study as part of the justification for no equalisation at the effective date. If the present generation of policyholders were considered as joint owners with the shareholder and expected to share in its distribution, then clearly C's policyholders would be disadvantaged at the expense of the policyholders in B, and both at the expense of the policyholders in A.

10.3.7.4 Corporate policy, assuming the companies remain open to new business, is set out in the Appointed and independent actuaries' reports, and both expressed their agreement with it. Under this philosophy the free estate, which brings benefit from the greater freedom in investment allocation, is not distributed to the current generation of policyholders, whose reasonable expectations are met from their asset shares. It continues indefinitely as an unallocated amount, and there is no intention of increasing the level other than from normal investment growth, including the return from financing new business strain.

10.3.7.5 This is referred to in the actuaries' reports as the *revolving fund* approach, under which existing WP policies provide the finance to write new business, and on exit are credited with a fair return on this finance. Replacement is then provided by the next generation of policies, allowing the fund to continue on a self perpetuating basis.

10.3.7.6 This definition conflicts with Needleman & Roff (1995), who define the term as one in which there is no estate and all assets belong to the current generation of WP policyholders. They would use the term *entity fund* to describe the situation in the case study. The difference is the free estate, which provides a non-distributable buffer supporting smoothing policy, increased policyholder security and access to additional finance to support a higher level of new business growth. However, if the estate grows at a slower rate than the growth in new business, then, in the long term, it will steadily reduce in percentage terms and will tend towards the alternative definition.

10.3.8 *Asset share methodology*

10.3.8.1 An asset share is basically the accumulation at the investment rate of return of the premiums paid under a policy less expenses and mortality/morbidity costs with due allowance for the impact of tax. Within that definition there are potential variations, but these have recently been discussed fully in Needleman &

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Roff, and I consider only aspects impacting on the case study.

10.3.8.2 A and B had developed a consistent asset share methodology, but that differed from the embryo method being developed in C. Obviously the methodology had to be consistent in respect of experience after merger, but a decision was required on applying that methodology retrospectively and adjusting existing asset share levels.

10.3.8.3 A retrospective approach to the standard methodology was agreed as the only equitable approach. It was interesting to note that, as payouts in recent years had exceeded asset shares, the increase would not have had any impact if the methodology had been standardised earlier. The level of surrender values was not expected to change, as the increase would be minimal.

10.3.8.4 The introduction of a standard methodology required a decision on the allocation of miscellaneous profits, an approach which varies between offices, as Needleman & Roff found from their survey. It was decided to include profits from non-profit business and surrender values spread equally across life and pension policies. The methodology restricted the extra allocation to the difference between the asset share without such allocation and the surrender value. Any balance was credited to the estate, with the intention of precluding any tontine effect from excessive surrenders.

10.3.8.5 In calculating asset shares at the effective date, special provision was made for items such as costs already committed to, or arising from, past events. These amounts applied to a specific company, but had not yet been fully incurred, and included leases on unoccupied buildings, decommissioning computer systems and bringing into line certain running costs of different lines of business. In addition, compensation payments had to be allocated to the correct asset shares, and the special demutualisation arrangements for surplus distribution in A had to be continued.

10.3.8.6 Compensation for change of ownership did not affect the asset shares, as they already included the embedded value of the respective business, and simply replaced a notional figure with a cash sum. Compensation to policyholders for changes in surplus distribution rights was allocated depending on the type of policy and the remaining term to maturity, with the impact inversely correlated to the outstanding term. Thus, for a policy very near to maturity the adjustment to the asset share would be nil or minimal and vice versa. As compensation was in respect of future profits, initially there would be no change to surrender values, as the impact would be the same as for a policy close to maturity.

10.3.8.7 While equity was important, the compensation was minimal in comparison to total WP assets, and the impact might well be hidden in later years by the normal smoothing process of maturity payouts or margins in the surrender value basis. Similar considerations apply to death claims.

10.3.8.8 In summary, compensation from the shareholder would be apportioned per policy, based on the amount calculated as appropriate to that policy class. Thus policyholders would be given a clear, but deferred, boost to

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asset shares in exchange for an uncertain benefit. If assumptions utilised in the compensation basis were realised in practice, the impact would be neutral, with no change to ultimate claim values.

10.3.8.9 In respect of B, where the compensation was funded from the investment reserve, the approach worked in reverse, with the per policy amount eventually to be deducted from the asset shares in proportion to the projected future benefit they would obtain.

11. Scheme Terms and Future Financial Management

11.1 *Scheme Terms*

11.1.1 The schemes themselves were relatively simple and did not incorporate the rationalisation issues, which, although inextricably linked, were dealt with separately. There are only three scheme issues worthy of specific mention.

11.1.2 Assets transferred from the transferors had to be allocated to either the WP or the UL sub fund. To avoid complex wording, the UL transferred assets were defined as those determined by the Appointed Actuary as appropriate to meet the UL liabilities. Such assets had to include the non UL reserves held in the management account, hence the wording. Thus, any assets remaining were automatically transferred to the WP sub fund.

11.1.3 In case the Irish scheme failed in isolation, it was necessary to determine the assets remaining in C. This would be done by first calculating the asset shares for the Irish business and then dividing the free estate in proportion to the Irish and U.K. WP asset shares. The actuary retained total discretion in the selection of the assets. This was important, as the Irish liabilities remaining in C would be reassured into B on the effective date and the assets transferred as cash, without cost, as the single premium. The result would be effectively the same as if the scheme had been approved, except that no change would be made to the surplus distribution policy in view of the restrictions of C's Act. Generally, reassurance is a poor substitute for a scheme, in view of the dual accounting, etc. required.

11.1.4 The scheme defined the broad principles of future financial management as they related to asset shares. A general condition was included to permit retrospective adjustment to the asset shares calculated at the effective date to allow for any event arising after that date in respect of prior experience not known at the date of merger. This was particularly important in respect of potential compensation for pension transfer and opt out business, the impact of which might have been difficult to assess at the effective date. Any adjustment would have to take into account whether policyholders or shareholder were responsible, but the approach would ensure no adverse impact on policyholders in the other companies who had no responsibility for that compensation.

11.1.5 Irrevocable undertakings were given, as referred to in ¶5.4.1.2, in respect of the compensation payments. However, B incorporated no restriction on

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the maximum distributable surplus which could be appropriated by the shareholder, whereas A and C limited it to 10%. Thus, further undertakings were given not to increase the share above 10% without prior consultation with the DTI as a protection to the WP policyholders in A and C. I remain uncertain of the position if the company wished to increase that appropriation, but the DTI objected at the consultation stage!

11.2 *The Scheme in Retrospect*

11.2.1 *Equalisation issues*

11.2.1.1 It is of interest to review the final terms of the scheme to consider if other interpretations might have resulted in alternative conclusions. It is important to stress that the following are not intended as criticisms of the actual terms deemed equitable by the actuaries, board, etc. These conclusions were reached from perfectly well reasoned arguments, but different arguments, equally well argued, could have resulted in alternative recommendations.

11.2.1.2 In ¶10.1.7 I queried whether the UKPI adjustment was sufficient to allow sharing in the stronger free estate of FP, but that view depended on the ownership and use of the free estate. The same applies to the case study, where the argument advanced was that the free estate remained in existence indefinitely. I would query whether the free estate should not have been equalised downward, as the differentials were relatively small, through extra bonus allocations or, alternatively, for the weaker funds to have a differential such as that imposed on the UKPI policyholders.

11.2.1.3 I also query the conclusion, in ¶10.3.4.3, that, as long as a minimum holding could be maintained in fixed-interest, then policyholders in the stronger fund were not disadvantaged. I do not disagree with the Appointed Actuary's opinion that over the longer term equities/property should be higher yielding. Therefore, if solvency considerations permit, is a minimum holding appropriate if one of the purposes of the free estate is to allow more freedom in asset allocation, and improved returns are anticipated?

11.2.1.4 It will be interesting to hear the views of others as to which arguments are considered more appropriate.

11.2.1.5 It is interesting to note the impact that different approaches to the ownership of the free estate will have on the embedded value. If it is considered to be in existence indefinitely, as in the case study, then no allowance should be made for the shareholder's share of surplus from that source. This would have an impact on the value in the parent company's accounts and on the price to be paid for a company being taken over. Salmon & Fine (1991) consider this point in more detail.

11.2.2 *Compensation issues*

11.2.2.1 In Section 8.3 it was stated that compensation was paid to the shareholder for assuming payment of the additional tax liability arising as a result of a transfer of surplus to shareholders. However, in retrospect, I would now

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question whether this payment was justified. As stated in ¶8.3.3, this had not been an issue prior to 1990, with virtually no additional tax liability, and that practice had simply continued with no specific justification of the decision.

11.2.2.2 If debated, then the more natural conclusion would seem to be that the liability falls on the shareholder, whose entitlement has generated the extra tax. Prior to 1990 the gross distribution required by both policyholders and shareholder, to produce the same net figure, was virtually the same after reservation of profits. Under the current regime, the grossed up total is greater, to allow for the additional tax on the shareholder's transfer.

11.2.2.3 It can be argued that the 90/10 division should apply to the gross figure, with policyholders and shareholder paying their own respective tax rates. However, this would result in the former receiving more net than required to finance the bonus allocation. Keeping the net amount the same for policyholders leads me to the conclusion that the gross distribution should also be unchanged, which implies that the shareholder should be paying the extra tax.

11.2.2.4 Even if it is argued that the shareholder must receive 10% of the net distribution, it seems unreasonable that the policyholders should have the extra tax charged to their asset shares. This implies that, if not borne by the shareholder, then it should have been charged to the free estate, as I believe many offices do.

11.2.2.5 If that reasoning had been followed, then either no compensation would have been due to the shareholder or the payment should have come from the free estate. This would have applied to both B and C. Since these companies had respectively greater free estates than A, and bearing in mind the views I expressed in Section 11.2.1, financing from that source would have justifiably reduced the differential.

11.2.3 *Valuation of assets and inadmissible assets — impact on asset shares*

11.2.3.1 Asset shares were to be calculated for each company at the effective date, after which they would be based on the combined experience. Any overstatement or understatement of performance would thus be spread across all three companies. This was appreciated, and care was to be taken in assessing the impact of certain costs, whilst retrospective adjustments were permitted, as explained in ¶¶10.3.8.5 and 11.1.4 respectively.

11.2.3.2 In respect of most assets, market values are readily available, but that is not the case for items such as shares in smaller companies and properties, where the values cannot be determined accurately unless actually sold. This suggests to me that the retrospective adjustment should have applied to these items as well, for a limited period, perhaps on a reducing scale.

11.2.3.3 The percentage of such assets held in the funds was at a level such that a difference of 10% to 20% would have equalled the compensation payments over which great care was taken to establish values. For example, C owned a property which was sold in mid-1995 for £20m, which may well have differed significantly from the value placed on it in 1994, and which represented 4.6% of

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its WP and deposit administration liabilities, as shown in Table 7 as at 31 December 1993. This is the relevant percentage when considering the impact on asset shares.

11.2.3.4 Similar considerations apply to inadmissible assets. From Table 7 the percentage of such assets in A was 15.6% of WP and deposit administration liabilities. In mid-1995, it was announced that the building society had purchased the company's holding in the investment management company for an undisclosed sum. Again the price could have varied within acceptable limits and still differed from the Table 7 value by an amount equal to a compensation payment. (Presumably the board of the life company as the major client will now be driving a hard bargain on charges, certainly they are duty bound to do so in the interest of the WP policyholders!)

11.2.3.5 Another example was that C owned some 20 paintings of golf scenes commissioned by C in the early 1900s on which no value was placed, although they were thought to be worth £200k. In fact they were sold at auction in St Andrews in mid-1995 for over £400k.

11.2.3.6 I suggest similar examples would exist in any merger, and I repeat the opinion that some form of retrospective adjustment should have applied to these items.

11.2.3.7 In ¶10.3.2.12, I referred to the independent actuary, stating that in the combined company the overall figure of 3.1% for inadmissible assets, as a percentage of DTI assets, was well within acceptable limits. This was in a different context, but perhaps the percentage would have been more appropriately expressed as 6.2% of WP and deposit administration liabilities, to which the same opinion is probably applicable.

11.3.1 *Future financial management*

The neatness of the proposed restructure should be considered in the context of future administration and other considerations.

11.3.2 *Expense allocation*

11.3.2.1 It was noted, in ¶7.2.2, that the restructure of the UL business would result in two sub funds, which was already the position in B. This will require the Appointed Actuary to allocate all expenses, both fixed and variable, equitably to ensure that the profit streams emerging correctly represent the costs associated with each sub fund.

11.3.2.2 This will also apply to allocation of tax. For example, it was stated that the combined fund would be able to utilise its XSE in 1994 and 1995. However, it is quite probable, if viewed separately, that one sub fund may be I-E and the other XSE. Thus, in the combined assessment, the total tax payable will be less and the advantage must be equitably shared.

11.3.2.3 Allocation of expenses is always a difficult exercise, but where the impact on shareholder profit is sensitive to variations, the allocation will be carefully scrutinised by the shareholder. Clearly each £1 of expenditure allocated

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to the UL sub fund will change the shareholder's statutory profit by that amount.

11.3.2.4 In market conditions where the volume of new business applied to loadings produces expense profits, then, even if a statutory loss arises as a result of new business strain, growth in embedded value should provide the desired return on capital. However, in current market conditions losses on new business are quite possible. On a statutory basis, this may be masked initially by release of margins from previous years' business, but not in the impact on embedded value. As a result, there may well be considerable pressure on an Appointed Actuary to skew the allocation of expenses to the advantage of the shareholder (exposure reduces from 100% to 10% in respect of the difference), but to the disadvantage of the WP policyholders.

11.3.2.5 In the actual restructure, the WP fund remains open to new business through the approach adopted in respect of UWP business. This, as previously stated, reduces the exposure of the shareholder to variation in expense profit, but the principle of equitable allocation remains.

11.3.2.6 Allocation will be complicated, as the bulk of the expenditure lies in the area of marketing, sales and associated systems. Equitable allocation of overhead and fixed expenses is particularly difficult. An interesting problem relates to branch premises, presumably owned by the WP policyholders as they should receive rent from the UL sub fund, although no formal rental agreement probably exists.

11.3.2.7 It is worth identifying another issue regarding the purchase of the UL business in C, which, as stated in ¶4.4.3.2, had been partly financed by financial reassurance. Repayment was to be made from deductions out of margins on charges. After the scheme became effective, it was necessary either to continue to identify separately the cash flows from the original business in C or allow repayments to be a general charge on the UL sub fund. As the UL fund was 100% shareholder owned, it was deemed unnecessary to restrict repayments and a general charge would be allowed. This approach will necessitate a decision on whether additional sterling reserves are necessary, this being dependent on the repayment period.

11.3.3 *Unitised with-profits*

11.3.3.1 The proportionate approach for UWP business introduces substantial accounting and actuarial complications. At the point of sale the correct proportions will be allocated to each sub fund. If that proportion remained unchanged then no problem would arise.

11.3.3.2 However, as soon as a switch takes place difficulties do arise, particularly in respect of initial expenses. Charges will now be deducted in the fund to which the switch has been directed, but initial expenses were allocated to the original sub fund. Thus, either the appropriate proportion of the charges must be redirected back to the original sub fund or the balance of the initial expenses (including share of overheads and fixed costs) not yet recovered must transfer with the switch.

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11.3.3.3 Another problem relates to embedded value. For example, if 100% of the policy is initially invested in the UL sub fund, what is the embedded value, as at any time it can be switched to the WP sub fund and the embedded value becomes zero in the original fund?

11.3.3.4 An approximate method of accounting was proposed and considered sufficiently accurate to give proper effect to these issues, which was critical if the reasonable expectations of both shareholder and WP policyholders were to be safeguarded. This may prove more difficult to operate in practice than in theory. (In fact, I was advised that during 1995 the difficulties of developing such a system had led to a change of approach, and the UL method has now been adopted. This information came at too late a stage to allow any significant rewriting. However, although many of my comments on UWP are no longer applicable to the case study, they remain valid in the general sense.)

11.3.3.5 In order to comply with GN22 under the proportionate basis, it will be necessary for WP projections to allow for the expected cost of shareholder transfers. This may create a potential anomaly with the UL projections which only allow for charges. It is necessary to determine if the reductions in yield also differ, resulting in one fund being projected as more expensive. It is appreciated that there are other considerations, such as differences in guarantees, but the basic anomaly remains.

11.3.4 *Future bonus policy*

11.3.4.1 The scheme simply stated that future alterations to asset shares would be determined in accordance with the combined experience. No reference was made to the different relationships between reversionary and terminal bonuses existing in A, B and C.

11.3.4.2 Consideration will presumably be given in future bonus declarations to bringing these differences gradually into line. Otherwise there will be a continuing differential in the guarantees, which is probably not justified by any variations in the underlying premium bases.

11.4 *Unit-Linked Fund Merger*

11.4.1 In merging the funds, it was agreed that two principles were worth following. First, subject to regulatory requirements, it was important not to lose a record of good investment performance in any particular fund. Second, it was considered less likely to cause adverse policyholder reaction if more units were offered at a lower price than fewer units at a higher price when equalising unit prices in a merged fund.

11.4.2 Again, I was advised at a late stage that the merger of the assets was completed, and considerable time had been spent on developing robust box management and pricing spreadsheets. However, it is possible that unification of prices may never happen, as cost justification is difficult.

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11.5 *Policyholder Rights in Future under the Scheme*

11.5.1 If any policyholders consider that their rights under the scheme have not been properly implemented, then their only course of action is to refer the matter back to the court. Since the terms are drawn in a general fashion, such action is unlikely to be successful.

11.5.2 However, the Appointed Actuary has a duty to protect policyholders' interests and to abide by the terms of the scheme. Thus, although given discretion in interpretation, this professional duty will ensure that policyholders' rights are protected.

11.5.3 The changes to the original intentions, referred to in ¶¶11.3.3.4 and 11.4.2, were not irrevocable requirements and, indeed, did not appear in the court documentation. This is an example of such discretion which certainly does not impact on policyholder rights.

12. Conclusion

12.1 I would suggest that the reconstruction forming the basis of this case study incorporated almost every conceivable actuarial issue which might arise in a complex S49 transfer where funds are being merged.

12.2 To the extent that readers disagree with the approach taken, it is stressed that there are no unique solutions, but the conclusions reached were considered to be the most appropriate in the circumstances in order to protect the interests of both policyholders and shareholder. This applies equally to the alternative views expressed.

12.3 The Irish scheme duly received approval from the High Court in Dublin, and both the U.K. scheme and the Irish scheme received approval from the Court of Session in Edinburgh, albeit the date of that approval was only one day before the court rose for its Christmas break!

Acknowledgements

I would like to thank Dorothy Reilly for reading through and commenting on the draft version, Chris Russell who made several comments on an earlier draft, which, I trust, has ensured my description of the general tax issues in the final version is not only correct, but understandable, and Tom Ord for confirming that I had not misrepresented any of the facts and for additional comments.

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APPENDIX

RESERVES AS AT 31 DECEMBER 1993

Company	A	B U.K.	B Other	B G.P.F.	B Total	C U.K.	C Irish	C Total	D
	£m	£m	£m	£m	£m	£m	£m	£m	£m
CONVENTIONAL									
Life, with-profits	74.5	380.9	0	0	380.9	180.4	5.4	185.8	0
Life, non-profit	3.2	19.6	0	0	19.6	42.3	2.6	44.9	0
Pensions, with-profits	127.3	160.2	0	44.9	205.1	210.8	33.6	244.4	0
Pensions, non-profit	256.6	315.3	0	0	315.3	213.1	7.9	221.0	0
General ann.,with-profits	0.3	2.4	0	0	2.4	3.8	0	3.8	0
General ann., non-profit	5.2	29.9	0	0	29.9	11.3	0	11.3	0
P.H.I.	0.3	0	0	0	0	0.8	0.7	1.5	0
Reassurance out	193.4	4.9	0	0	4.9	124.5	0.6	125.1	0
Total conventional	274.0	903.4	0	44.9	948.3	538.0	49.6	587.6	0
UNIT-LINKED									
Life	0	141.9	0.4	0	142.3	155.5	0	0	0
Pensions	319.9	6.5	0	0	6.5	252.9	0	0	2.6
P.H.I.	0	0	0	0	0	0.8	0	0	0
Reassurance out	0.2	112.6	0	0	112.6	59.2	0	0	0
Total unit-linked	319.7	35.8	0.4	0	36.2	350.0	0	377.7	2.6
OTHER	0	2.7	0	0	2.7	0	0	0	0
TOTAL BUSINESS	593.7	941.9	0.4	44.9	987.2	888.0	0	965.3	0
Cost of bonus	9.3	29.6	0	2.2	31.8	16.6	1.6	18.2	0
Reserves	603.0	971.5	0.4	47.1	1,019.0	904.6	51.2	955.8	2.6
L.T.B.F.	608.7				1,094.6			1,030.1	
Free assets	5.7				75.6			74.3	0
Shareholder's assets	50.1				18.4			14.2	0.8
Solvency margin	21.0				48.1			34.4	0.6
Excess	34.8				45.9			54.1	0.2

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ABSTRACT OF THE DISCUSSION

HELD BY THE FACULTY OF ACTUARIES

Mr R. M. Paul, F.F.A. (introducing the paper): In the case study described in the paper, the merger was based on asset share methodology, as a result of which future performance would be based on common experience. Thus, I was surprised to note recently that, at the first bonus declaration since merger, the press announcement suggested otherwise. However, on reflection, I realised that I was not comparing like with like. Maturity comparisons are based on a specific unvarying term, such as 25 years, and, therefore, the experience period reviewed varies. The latest included one new year where the experience should be the same for all, but discarded one old year where the experience will have varied. Of course, the asset share change from 24 years to 25 years should have been in the same proportion for all sets of policies.

When considering bonuses, in the case study there was no sweetener paid, and, therefore, not much discussion of that issue. It is, therefore, worth mentioning that, in the current climate, whilst compensation for a change in rights to surplus can only be distributed through bonuses, there is nothing to prevent a sweetener being paid in cash, although probably it would be subject to tax.

Turning to the subject of tax, I found that section the most difficult to write. I suggest that the detail is less important for the non-expert than the appreciation of the importance of investigating most carefully the impact of different transferees and varying effective dates.

I want now to speak on a point of principle. The Insurance Companies Act only states "The Court shall not determine an application...unless the petition is accompanied by a report on the terms of the scheme by an independent actuary...".

From a simplistic legal view, the independent actuary's report is just one of the documents required by the legislation, and provided it concludes that policyholders are not disadvantaged, then the legal requirements are probably satisfied. What precedes the reaching of that conclusion is irrelevant legally.

No guidance is given on scope, and the legal view is that the independent actuary is only to comment on the scheme presented to the court, and has no requirement to consider potential alternatives. I am sitting on the committee attempting to redraft GN15, and there are quite significant differences of opinion as to the professional responsibilities of the independent actuary.

I am of the view that professional guidance should instruct, or at least strongly recommend, that the independent actuary should not limit his investigations only to the proposed scheme. He or she should also investigate, or question, either whether alternatives would have been better for the policyholders, or the reasons why they have been discarded. In such considerations, much reliance will need to be placed on investigations either already carried out by the Appointed Actuary or requested by the independent actuary. Whilst the Appointed Actuary always has responsibilities to protect PRE, I would suggest that some specific guidance in this area should be given.

Whatever the legislation may require, the actuarial profession must adopt a wider role in these matters. With all the current talk of restructuring, it is essential that actuaries ensure that policyholders are protected and receive their full rights, whatever they may be, and that the board adapt their strategic objectives accordingly.

Mr M. J. Breingan, F.F.A. (opening the discussion): As I read the paper, I asked myself: "If Section 49 of the Insurance Companies Act 1982 did not exist, would we be obliged to invent it?"

Based upon the summary given by the author, the scheme under Section 49 was structured to minimise its content, as described in ¶5.4.1.1. Because of the complexity, it contained, simply a description of the funds being merged, the structure of the new fund and general principles of financial management. Changes in the distribution of surplus, and the ownership and merger of the unit-linked funds were excluded from the scheme, instead being implemented by irrevocable board undertakings. Such changes are, therefore, not an integral part of the Section 49 process, although

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they were treated by the independent actuary and DTI/GAD as if they were part of the scheme. This being the case, was the permission of the court for the 'framework' of the scheme actually required?

The author outlines the history of Section 49, describing, in Section 2.2, how court approval for a transfer of business was introduced in 1870, following a fund merger which produced adverse consequences for policyholders. Is that same protection still needed today, given that we have the requirement for an independent actuary, maintenance of PRE, and the informal requirement for a report from the Appointed Actuary?

For this case study, I question whether the board could have proceeded on the merger process (even without the court's permission being required) without ensuring that the Appointed Actuary was satisfied: in fact, much of the rationalisation took place 'outside' the scheme, so it is clearly possible to undertake such changes without the court's involvement. For this situation, we have to thank the draftsmen who introduced PRE into the Insurance Companies Act; they provided a concept which (although not defined) can be useful, in such circumstances, to prevent the board from taking action to the detriment of policyholders. If PRE was breached, the Secretary of State could intervene directly. Has the requirement for the court approval, therefore, become simply a means of stiffening the backbone of the Appointed Actuary in his own 'PRE responsibilities'?

A consideration which should, I believe, further strengthen the backbone of the Appointed Actuary, is the complexity of the scheme. The author mentions, in ¶5.4.2.9, that policyholders seemed to be divided on whether or not they understood the scheme. Including the rationalisation issues, it is certainly complex for most. Can policyholders really be expected to understand these issues? Indeed, how many policyholders understand the nature of their with-profits policies and the structure of their share in surplus, far less changes in surplus distribution? How many policyholders or IFAs pore over our with-profits guides to learn the answers? (Will they find the answers there anyway?). Surely policyholders affected by such a scheme will be out of their depth, and have to rely on actuaries and other experts to ensure equitable treatment.

If this view is correct, then the Appointed Actuary (and other actuaries involved) are vital to the process — the Section 49 mechanism becomes secondary to the professionalism of the actuary in ensuring that PRE is maintained.

In ¶4.4.3.2 the author notes that, without the requirement for any court approval, the unit-linked business in Company C was transferred from ownership of the with-profits policyholders to the shareholders. The previous Appointed Actuary (the author) reported to the board that the price paid was reasonable, and the DTI were informed — following which the transaction took place.

In Section 9 the author comments that internal reconstructions are not included within the Section 49 process, and he explicitly suggests, in ¶9.1.9, that there may, therefore, be a gap in protection for policyholders in major internal reconstructions. Indeed, it may seem anomalous that the amount of compensation paid between the with-profits policyholders and the shareholders could be excluded from the scheme. However, consider the day-to-day realities. There exists a great deal of discretion available to any Appointed Actuary in the operation of asset shares and the allocation of surplus in with-profits funds. It would seem inconsistent to require the capitalised value of the future discretionary surpluses, which is brought in as the compensation payment, to be subject to the court process.

My conclusion is, therefore, that the provisions of Section 49 have had their day, and that it is a 'false' comfort that is given by requiring such schemes to be approved by the court.

I now turn to issues arising for the actuary (as outlined by the author). In a scheme like this, we see again the very large responsibility explicitly resting on the Appointed Actuary; in particular to maintain asset shares, ensure that the PRE of with-profits policyholders is protected, ensure that the unit-linked funds are merged fairly, assess the relative financial strength of the funds, etc. These tasks, of course, arise day-to-day in normal circumstances as we navigate our funds through choppy waters. However, the case study brings them all together for us.

In ¶9.1.6 the author notes that the DTI supervision in respect of PRE and other matters is retrospective; realistically only the Appointed Actuary can intervene at the time of an internal reconstruction. As the author comments, the 'integrity of the Appointed Actuary' is vital throughout the Insurance Company Regulations.

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In general, it should be an encouragement for us that the actuary is at the centre of all the issues being debated in the case study. This should be a fresh spur for us to aim to enhance our profession's status in other complex areas. The case study shows the actuary having to deal with such generalised issues as:

(1) equity between different financial entities;
(2) the requirements of providers of capital;
(3) interpretation of such issues in a 'reasonable' manner;
(4) practical application of theoretical principles; and
(5) a quantification of all these principles into actual financial payments.

I am sure that these general issues can be applied in most of the areas where the profession operates — but, perhaps more importantly, in a number of areas where we do not operate yet. The paper reminds us that we have plenty of skills to demonstrate to the 'wider fields' waiting for us out there.

In Section 3 the author highlights some possible conflicts and difficulties for the actuaries involved. The author suggests, in Section 3.3, that there are possible conflicts when the same actuary is the Appointed Actuary to the two funds involved in the transfer, since it may be difficult to obtain a well-balanced report between the two funds in respect of the proposals. He suggests that this difficulty will be particularly keen where the actuary has been Appointed Actuary to one of the funds longer than to the other. The author thinks that a report from the previous Appointed Actuary in the merger situation would be helpful. However, the former Appointed Actuary may well also be an employee of the new owner, and the author suggests, in ¶3.2.1.2, that such an individual will be mindful of his relationship to the new owners. I suggest, therefore, that this approach may lift the 'conflict' from the shoulders of the new Appointed Actuary, but not eliminate it altogether — just move it to the former Appointed Actuary.

In ¶3.2.3.4 the author suggests that the role of the Appointed Actuary should be recognised in Section 49 work, as well as that of the independent actuary. It is surely impossible to think of a Section 49 transfer taking place without the involvement of the relevant Appointed Actuary, so it seems sensible to include this role within the Guidance Notes.

Section 3 deals with the role of shareholders in the whole process, including the different perspectives of shareholders and policyholders. The author states, in ¶3.1.1, that the with-profits policyholders should be consulted in any transfer of ownership of a life company. I feel that this is going too far, and that it places upon the directors an impossible conflict; instead, they should run the company in the interests of shareholders, but this will involve taking care to avoid intervention by the DTI because of breaches of PRE. The Appointed Actuary is there to advise them on this. Indeed, the author suggests, in ¶3.1.8, that the DTI and the Appointed Actuary will look after the policyholders; this gives 'comfort' for the directors. The paper provides, in Section 9.4.6, a striking example of the 'power' of PRE, where shareholders had to pay compensation to receive 10% of surplus (rising from the 7% level) even though 10% was their right under the constitution of the company. When all is said and done on this issue, the author, nevertheless, concludes, in ¶3.1.5, that "the interests of the shareholders must prevail".

In Section 7.2 the author describes the different approaches which were considered for the structure of the unitised with-profits fund. We are told, in ¶11.3.3.4, that the board initially chose the proportionate method, but, for easier administration, moved to the unit-linked method after the scheme had been implemented.

The unit-linked method, under which unit-linked charges are deducted from the unitised with-profits fund, means that shareholders are indifferent to which investment medium is chosen (unitised with-profits or unit-linked), as both produce broadly the same surplus to shareholders. However, the unitised with-profits structure resulting does mean that surplus is held back from unitised with-profits policyholders' benefits to allow for smoothing of returns — resulting in a smoothed unit-linked fund whose returns are determined by the directors (under the advice of the Appointed Actuary). Is this half-way house a sensible compromise between traditional with-profits and modern unit-linked, or is it simply a staging post on the way towards the end of with-profits altogether?

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In ¶¶10.3.2.8 and 9 the author questions whether the shareholder would really supply additional security for PRE (arising from its obligations to provide capital under the Building Societies Act). I understand his point that shareholders would not be prepared to contribute to sustain PRE if any deterioration in it was not their fault. However, it seems counter-intuitive that there is no benefit for policyholders in having a wealthy parent, especially when the life company is perceived as being the 'offspring' of the building society, perhaps bearing a similar name to the parent company.

The author describes, in ¶11.1.4, how a general condition was included within the scheme to permit retrospective adjustment to asset shares for unforeseen events, particularly compensation for pension transfer and opt-out business. Any adjustment will have to be preceded by a debate on whether shareholders or policyholders are responsible, and also which generation of policyholders should bear the cost. This leads to deep questions about who was 'responsible' for writing the personal pension transfer business from 1988 onwards. However, such discussions will not be restricted to the board and actuaries of Company A.

In ¶11.2.1.4 the author asks for views on whether the free estate of the merged fund should have been equalised downwards to the lowest common level by additions to the asset shares of the stronger constituent funds. This question cannot be answered on the basis of the evidence available in the paper. However, it would seem appropriate to examine the approximations which had to be made in drawing up the asset shares in the first place (accuracy of historical expenses and investment data, for example). What are the sensitivities and their size? Could the free estates, in fact, be closer together than presented in the scheme within a range of acceptable assumptions? It also seems germane to ask how the separate companies had been run — with or without an estate? If the estate in none of the companies belonged to the policyholders, then it is easier to argue for its continuance at the merged 'average' level. We, therefore, need to seek guidance from previous corporate policy. However, perhaps the most pragmatic solution is to promulgate a new corporate policy that says that the desired new level of the free estate is the average figure arising from the merged funds.

So wide is the range of issues covered by the paper, that I have been able to raise only a few of them here. It is rewarding to get to grips with the scheme and revisions to the company structure, because it is helpful to think through the different actuarial issues in the context of a real example. It moves our thinking away from the 'theoretical' situation, which is often presented in the interests of simplicity, into the real world where things are certainly not simple!

Mr W. W. Stewart, F.F.A.: The author suggested, in his remarks, that the independent actuary should consider, not just the scheme being proposed, but all the possible alternatives. The options available will be quite widespread. To expect the Appointed Actuary to sit like Solomon and make, not only judgement, but actually to come up with the ideas himself, is asking for something which is totally impossible. If one is looking at a simple internal re-organisation, it may certainly be possible to ask an independent actuary to consider the possibilities within that framework; but, in what may well be a burning issue in some quarters at the moment, demutualisation, to ask the independent actuary to consider all the theoretical options is really asking too much. The independent actuary should comment on the appropriateness of the scheme for the policyholders, and stick to that.

Mr J. E. Paterson, F.F.A.: I was project manager, in 1995, of an internal re-organisation using Section 49, which included an Irish element. My project was, however, much simpler than the author's, in that there were no changes in the underlying ownership of any funds and there were only very minor changes to the rights of with-profits policyholders.

It is stated, in ¶3.4.1.4, that the independent actuary reports to the court. The independent actuary does not report to the court; he reports to whoever commissioned him, who will usually be the directors of the petitioner. The Act simply requires that the petition be accompanied by a report.

In ¶5.4.2.8. the Court reporter is mentioned. Although experience tells me that the involvement of the reporter can seem extremely tiresome, it may, in fact, simplify counsel's work, in that counsel in England may have more to do, perhaps having to present to the court problems which have already been resolved in Scottish procedure by the reporter.

I agree entirely with the author that it seems very inequitable that realised losses cannot be

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transferred. I do not think the argument for that rests only on the fact that one might be carrying forward something on the expense front. It is wrong in principle, since the other elements of the transfer involve the new company stepping into the old company's shoes. I do not see why realised losses should be an exception to the principle. Effectively, unrealised losses *are* transferred, because investments are transferred at acquisition cost with the continuing benefit of indexation.

In ¶8.3.1 the author states the extra tax burden from shareholders' transfers. It looks quite ferocious, but it is not for a life fund when spread over the whole fund. For instance, using his figure of 32% actual tax liability in connection with shareholders' transfers, consider a fund which was sized at 100 after 25% tax, with 90 going to the policyholders and 10 going to the shareholders and with the shareholders bearing the extra tax separately. If the extra shareholders' tax is borne within the fund, the figures come out as 89.1 going to the policyholders and 9.9 to the shareholders. The remaining 1.0 goes to the taxman. In other words, the extra tax reduces the fund from 100 to 99. The cost would be bigger in the case of pension fund business. I saw the life fund effect in reverse, since my scheme involved taking a with-profits fund from a proprietary company and inserting it into a mutual.

Mr N. H. Taylor, F.I.A.: I start by declaring an interest. I acted as independent actuary in the case before us. Accordingly, I read the very comprehensive paper with a certain amount of trepidation. Maybe the author had found something important that I had not considered. He has not, although, in Section 11.2, he has challenged some of the conclusions. It would not be appropriate for me to respond to these challenges. However, I would support his comment, in ¶12.2, that there are no unique solutions. Certainly there was very considerable debate internally among the actuaries, as well as with me and with the regulatory authorities.

The need for an independent actuary to prepare a report on the scheme applies whether the situation is big and complicated, or is simply a transfer of a small block of business from one company to another as a tidying up operation. Guidance Note GN15 is the actuarial Bible. This is currently being reviewed by a small working party.

The independent actuary requires a lot of information — accounts, DTI returns, Appointed Actuary's board reports, marketing literature, with-profits guide, etc. There is a need to come up to speed very quickly in order to discuss issues with the Appointed Actuary and 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 seems to come as a surprise to actuaries in a large office when a small block of business is being transferred to them and the effect is *de minimis* — the independent actuary needs to say that, however. Benefit expectations 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 also wise to bring in the independent actuary early. In the case study this happened, and I believe that it was not only helpful to me, but also to the company, as ideas could be bounced around 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. My experience of cases which are not well managed is that costs are increased 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.

I also like to know broadly what alternatives are being discussed. I agree with the previous speaker, that we could not look at the lot. Similarly, when I write my report — and this applied in the case before us — the summary of the scheme and my comments take in other changes being made which are outwith the scheme. 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.

As has been remarked by Mr Paterson, the court procedures in the Court of Session in Edinburgh,

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the High Court in London, and the High Court in Dublin have subtle differences. In Scotland we have the reporter system, which tends to mean that the legal documents have to be out earlier than they do for the High Court in London or in Dublin. Also, 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, they can be inserted as a part of the scheme. They give added flexibility, but make sure, for instance, that policyholders do not get trapped in a small unit-linked fund which cannot be properly managed. 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. However, the independent actuary should not be a consultant, but merely make comments to improve the scheme proposed. In the event of any of these changes occurring in the future, I like to see a provision that the Appointed Actuary will certify that all is equitable.

I would like to comment on the information given to policyholders. Quite frankly, I have been appalled at the amount of paper that has been sent in some major public cases. It is not necessary, and seems designed to confuse — a real case of obfuscation. All that the policyholders need to have is a summary of the scheme and the independent actuary's report. They can inspect detailed copies or they can ask for a copy. My advice, when I am acting as independent actuary, is simply to put in my conclusion — generally three paragraphs. If anyone wants more, then give them 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 refers, in ¶2.12 and Section 3.4.2, to including a 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. In the smaller cases, it is only yet more paper to confuse the policyholders and the courts.

I would like to mention a practical issue. 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 one of our larger mutual offices, I find it surprising that 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.

Mr C. G. Thomson, F.F.A.: I should like to concentrate on three general themes: policyholders' reasonable expectations; professional principles; and the closed fund option.

In ¶¶1.4.2 and 1.4.8 I thought that the author was equating policyholders' reasonable expectations with security. While I do not agree with that, and the author later broadens out the concept, I have a lot of sympathy for the idea of treating the concept narrowly, at least at first.

It is instructive to follow the same sort of reasoning, in ¶¶9.4.2 and 9.4.6, when trying to identify what are the expectations of a reasonable policyholder who has a with-profits contract in a proprietary fund. He knows — or he should know — that he has no expectation of future profits from non-profit business, since that can be written in a different fund, as shown in ¶9.4.2.5. Correspondingly, although ¶9.4.6.5 says that the shareholders' 7% level had become established practice and therefore part of PRE, I am not sure that that is entirely sound. There seem few reasons why this level should not be increased to 10%, since that is the position in the majority of proprietary with-profits funds. If a company sought to increase its shareholders' allocation from, say, 8% to 9%, would the Secretary of State act? There is a suggestion, in ¶11.1.5, that 10% is a magic number which would be defended by the DTI, so the Secretary of State might act if a company tried to move from 10% to 11%. If the Secretary of State is not prepared to act in other cases, such as a move from 8% to 9%, then should the Appointed Actuary act? That is yet another uncomfortable decision for our profession. Thus, policyholders' reasonable expectations for a with-profits policyholder in a proprietary fund generally extend only to 90% of the surplus arising in respect of his or her own policy. Payments being made beyond that simply represent a short-term addition, possibly for commercial purposes, as in ¶10.3.8.3, where the payouts had exceeded asset shares. If the expectation is formed that this position will

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continue, it is unlikely to be reasonable. Another strand to the same question is raised in ¶11.3.2.4. What expectation does a policyholder have as to expense allocation in a proprietary with-profits fund?

Concerning professional principles — I was much amused by ¶3.2.1.2, where the author suggests that the Appointed Actuary should be mindful of the impending relationship with the new owner. I have to say that if this means bending principles, then the Appointed Actuary should consider very seriously which bridges are worth fighting on. On the basis of past form, few Appointed Actuaries have a long-lasting relationship with the purchaser, but we should not see that as a failing of the actuaries involved or of the Appointed Actuary system. We should rather see it as a strength — Appointed Actuaries are prepared to stand up for their principles. However, if the position of Appointed Actuary is being weakened by commercial pressures at the moment — and I think that there is some evidence that it is — then, perhaps, we should be moving in the opposite direction from other companies and be recommending that all Appointed Actuaries should have contingent three-year service contracts, which would become effective on any change of ownership.

There are some sections of the paper, like ¶3.3.6, which cause me some concern. If the actuary is representing two sets of interested policyholders, then he has an obligation to be equitable to both; or if the interests are sufficiently diverse, he has an obligation not to act for both groups, but to call in external advice. I had thought that these principles were reasonably clear in our professional guidance.

In ¶9.1.7 it is observed that reconstructions are dependent on the integrity of all the parties involved. While this is very true, the Appointed Actuary's responsibilities do seem quite clear. More interestingly, in ¶9.1.9, there is a suggestion that there may be a gap in the protection in major internal reconstructions. I think that there is some truth in this. There is no equivalence between the providers of capital when they are policyholders and the providers of capital when they are shareholders; but, perhaps, this is simply, as I said earlier, that the reasonable expectations of with-profits policyholders in a proprietary fund include only a portion of their own investment return and no capital provider return. If this seems harsh, it may not be so, in that the policyholders do not stake their capital in the way that the shareholders do. However, the position varies enormously from company to company. It is quite easy to visualise a proprietary company where the policyholders have contributed the great bulk of the capital, and where that is being used to generate profits from non-profit and unit-linked business. Do they then have a reasonable expectation to be paid a shareholder rate of return on that capital?

Loosely connected to professional responsibilities is the comment made in ¶3.1.9 about directors of subsidiary life companies. When I was involved in setting up a new life company, the DTI recommended that there should be at least one non-executive director on the board, even though the life company was a subsidiary within a large group. One reason seemed to be that a non-executive director was more likely than an executive to consider the reasonable expectations of policyholders. Given the clear obligations which we already have for directors and the 'fit and proper' conditions, this seems very close to admitting that those standards are not always met. 'Fit and proper' is supposed to encompass honesty, integrity and competence. While Scotland Yard check out honesty, at least at the criminal level, there does not seem to be any hurdle for competence other than election to the board — perhaps there should be.

Moving on to the closed fund option, I am not at all clear why this has become so widely accepted as something which must always be considered. In particular, I think that this is inconsistent with the normal practice of refusing to compensate non-profit policyholders for the loss of voting rights. If the rights of voting non-profit policyholders, as a group, can be worthless, the same argument can surely be applied to the interests of voting with-profits policyholders, but this then sounds like nonsense. The way to make sense of it is to accept that the ownership is simply vested in the current members in trust for future members. There is an analogy which those of us who play golf in Scotland would understand. We have not provided the capital to set up our courses, and unless there is some pressing reason, like compulsory purchase or impending bankruptcy, we would not consider it morally right to use our votes to change the financial structure of the club for our own benefit. In the same way, in a mutual life office restructuring, it is to be expected that the re-organisation will benefit, not only the current, but also the future policyholders. If that is accepted, then the closed fund option should be rejected for any reasonably strong mutual, even if it would suit the current generation of policyholders

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better. I do not see this as inconsistent with PRE in any way. For example, if the future of a company is not as a mutual, it means that the free assets should be protected by the scheme, so that they cannot be attacked by the shareholder. The portion for the current generation will also be defined by the scheme, leaving the balance for future generations. If that sounds impractical, I should point out that there are elements of that approach in at least two existing demutualisations.

Mr D. O. Forfar, F.F.A.: It was very interesting to see the range of problems faced in the reconstruction of A, B, C and D; not least the fact that there were differences in;
(1) the shareholder's participation in the with-profits funds;
(2) the shareholder's liability to the excess tax; and
(3) the shareholder's interest in the unit-linked business.

If the funds of A, B, C and D were to lose their individual identities, then the swapping of cash flows between policyholders and shareholder, with suitable compensation, was necessary to put the arrangement on a rationalised basis. This is well described by the figures which are shown in Table 6.

The question of the profit streams from future new business, the 'goodwill' element, is an interesting one. I appreciate that there is scope for a range of views as to payment, if any, for this goodwill. It seemed to me, on first reading, however, that it was possibly a little harsh to give the with-profits policyholders of A a zero value for goodwill in A's unit-linked business, although I fully recognise that, in compensation, the with-profits policyholders were relieved from paying anything for the transfer of ownership (such as for systems development), and new unit-linked business could be switched from A to another company.

I now turn to the merger of the with-profits funds, where, according to ¶10.3.4.5, no adjustments to asset shares or future differentials in investment returns were proposed. I wondered, somewhat, about this, in view of Table 8, which gives the differences in the asset allocations. I am not quite clear what asset allocation was proposed for the merged with-profits fund, but, if the equity allocation for the merged fund was less than 66%, as it had been in A, would the policyholders in A not feel a little disadvantaged?

I think that there may be a general point applicable to mergers that, if the different strengths of the various funds being merged had occasioned different asset allocations in the past, then these asset allocations would need to be compared with the asset distribution of the merged fund. If some policyholders see their equity content fall as a result of the merger and other policyholders see their equity content enhanced, then, it could be argued, that some differential in future asset growth may be appropriate. I assume that this is what is behind the differential of a quarter per cent between the Friends Provident policyholders and those of UKPI.

Mr P. H. Grace, F.F.A.: Given the amount of press comment and rumour at the present time, the timing of this paper seems very appropriate. The issue I would like to mention was floated by a journalist at a press lunch held in Staple Inn last week. The journalist asked about the possibility of a hostile bid for a mutual life office. Such a bid would have been unthought of a few years ago, just as it was amongst the building societies until one happened. Not surprisingly, the subject caused some discussion at that lunch; the overall reaction was that it could not happen, but one was left with the thought that that might not be the case. There have been hostile bids for proprietary offices, but Section 49 has not been invoked, as the merger of a life fund was not involved.

Clearly the issues would be somewhat different from those arising with the demutualisations that have occurred so far, all of which have been on a basis agreed between the parties in advance. For example, the independent actuary would probably be appointed by the transferee, who would, in turn, petition the court. The independent actuary would not have the co-operation from the transferor that he usually receives. It is possible that two hostile bids could emerge. In such circumstances, the policyholders might have to decide between the offers, and when the decision has been made an independent actuary would have to prepare his report for the court. The court would probably want to be satisfied that the independent actuary had considered the alternative. If GN15 is to be revisited,

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perhaps this issue should be considered. It would reflect badly on the profession if the situation arose and we were unprepared.

Mr C. B. McKay (a visitor): I am with the law firm which was involved in the case study in question, and I have a couple of legal observations.

First, the case study in question allowed the lawyers to see the Third Life Directive in practice in relation to Section 49 transfers for the first time — certainly north of the Border. It proved quite illuminating. One of the transferor companies, as has been mentioned, had historically written some business in the Republic of Ireland. The United Kingdom regulations implementing the Third Life Directive were worded in such a way that Republic of Ireland business fell within the U.K. regime. In other words, the transfer had to be approved by the relevant U.K. court. The domestic Irish law required that the transfer of that Republic of Ireland business should be considered by the Irish courts also. On first analysis, this seemed to be as a result of the fact that the Irish had not caught up with the Third Life Directive, but it emerged, after consideration, that, even after they had introduced the Third Life Directive by means of domestic legislation, the situation would have remained unchanged. That led us, as the legal advisers, to the unavoidable conclusion that parallel court proceedings on two sides of the Irish Sea were required, each in respect of exactly the same Irish business. It seemed to us that this was a rather dismal failure in the light of the Directive's underlying objective — to harmonise insurance legislation across Europe.

Mr Taylor stated that a scheme should include provisions regarding the merger of unit-linked funds. This is a matter on which I think it is fair to say, in Scotland anyway, legal thinking has developed slightly since the case study in question. The regulations prescribe categories of order which the court can make in respect of a Section 49 transfer, and there is a growing feeling among the lawyers involved, and, indeed, senior counsel in a recent Section 49 transfer advised quite firmly that these categories of orders do not include an order permitting the merger of unit-linked funds. This leaves us, the lawyers, with a dilemma. On the one hand, the client wishes the court's blessing of the proposed merger of the unit-linked funds, but we, strictly speaking, cannot see a basis upon which the court can deliver that blessing. The result, in recent Section 49 transfers, has been something of a fudge, with the relevant court documents referring to the proposal in a rather low key manner, but without any inclusion of the proposal within the scheme itself. The comfort, if any, which the petitioner obtains is that, at least, the matter has been drawn to the court's attention.

Mr H. J. A. Scott, F.F.A.: I would like to clarify a potentially misleading reference, in Section 7.2, to the company for which I work. This is where the author describes two options for managing unitised with-profits business. The statement, in ¶7.2.7, that Scottish Mutual uses the UL method is correct, but the suggestion in ¶7.2.6 that profits from non-profit business may accrue to UWP business does not apply in Scottish Mutual, as the non-profit business is written in the same sub-fund as the UL business and not in the same sub-fund as the UWP business.

The author presumes that many policies can be split between UWP and something else. Such hybrid contracts are likely to cause many of us a certain amount of trouble in the future, as the new version of the Accounts and Statements Regulations, which is to be published shortly, and to apply from the end of 1996, will require, in Schedule 4, a separation of UWP from both UL and traditional WP, and I know that, at least in my own office, this is going to be tiresome.

Also on a regulatory matter, ¶5.2.2.1 refers to the fact that there is double counting of capital in Table 1 and ¶5.2.2.4 refers to the need to provide twice over for solvency margins in the case of reassurance arrangements. There is a current proposal for a new European Directive on the supervision of insurance groups which aims to prevent the double counting of capital for solvency. As far as I can understand it, however, it does nothing to reduce the double counting of solvency requirements on reassurance transactions.

Mr G. M. Stewart, F.F.A.: I was, at one point, Appointed Actuary of all four companies (for varying lengths of time).

Mr McKay gave a lawyer's view of some of the court procedures, and particularly the problems

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that the Irish caused us. I think that one of the benefits we saw from a commercial viewpoint was that, if we put an item on the future operation of the merged company in front of the court, it gave us greater protection against somebody in the future objecting or proposing an alternative approach. If it was open to public scrutiny, whether the court officially approved it or whether it was in the accompanying documents, then, certainly commercially, we saw that there was comfort to us. It had been open to scrutiny, people had the chance to object, and, if no objections were raised, that must be some defence in the future.

The opener commented on the possibility of a shareholder standing behind policyholders' reasonable expectations. I would say that, in the particular circumstances of the case study, it was very specifically pointed out to the shareholder that, if it wanted certain aspects to be operated in a particular manner, it was imperative that it agreed that it would stand behind PRE. In that instance this was accepted. It was undoubtedly easier, given the fact that we never had occasion to call it in, but it was the subject of debate at board level, and should have been appreciated by the shareholder.

Mr Forfar mentioned the differing asset mixes of the funds pre-merger. Certainly, the expectation in our internal debates was that the asset mix post-merger would not disadvantage any particular class of policyholders. We anticipated that we would be able to operate with a mix that was about 20% to 25% in fixed interest, which was consistent with the 'best' mix of any of the companies prior to merger.

The question of goodwill and the position of unit-linked funds within Company A raises another of the interesting conflicts that arise when there is a shareholder involved. Company A had built up a reasonable unit-linked business, owned by the policyholders. In the enlarged life assurance interests of the shareholder, there were, by that time, two other companies where the entire profits of unit-linked business would accrue to the shareholder. There was a fairly clear message from the shareholder that this was fine, and while they absolutely loved the products of Company A, if it could get 100% of the profits arising from products that had been designed, built up and paid for out of Company B and Company C, then it was much more interested in its salesforce selling the products of Company B and Company C. Therefore, in reality, the goodwill that may have been there for Company A's products would be vastly reduced.

Mr T. K. Ord, F.I.A.: I was, and still am, the Appointed Actuary of what was Company B in the paper, now named Company A. I want to make a brief comment on the question that is really behind the paper "was it all worth it?". I am the only one of the speakers involved who still has to deal with the issues concerned, with PRE and all the funds, since the merger, which was just over a year ago.

The purpose of the transfer was two-fold. One was to achieve administrative savings through making the business easier to manage, and secondly, there were some tax advantages in putting the four funds together. Taking the last one first, tax advantages were achieved on 31 December 1994, one day after the transfer, and that can now be forgotten. The amount of tax we gained is in our books. We can concentrate on the second reason for the transfer, which was the potential administrative savings. This has proved more of a problem. The Section 49 transfer gave us the wherewithal to make changes to the way we administer the business. From the beginning of January 1995 we had the problem of actually making these changes. Here we are, $13\frac{1}{2}$ months later, and we have made quite a few changes which have allowed us to reduce administration costs, but there is still a very long way to go. The transfer itself added some extra work in the accounting for company A's unit-linked business, which has had to be transferred from the with-profits fund into the unit-linked fund. To answer the question, was it all worth it? — it definitely was.

Mr H. W. Gillon, F.F.A.: My experience in this area is extremely limited — indeed, it is confined to the same project that Mr Paterson spoke about. That was a project in which the business of four life companies was transferred to the parent company, which is a mutual. I was the Appointed Actuary for all five companies at the time, and I was very aware of the need to balance the interests of the various groups of policyholders. I felt that I was able to do that satisfactorily without involving any conflict of interest. Perhaps this was because these particular transfers were relatively simple. I

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think that it was helped because we managed to engineer matters so that the schemes were kept relatively simple.

Three of the subsidiary companies had been acquired on the authority of the parent company's board, but without, of course, the explicit approval of its policyholders (or 'members', as it was a mutual). The acquisitions involved important decisions for a mutual company. In many ways the subsequent transfers of business under Section 49 were little more than a consequential tidying up operation. Therefore, it seemed a little odd that it was necessary to go through the whole process of Section 49 when the original transaction had been authorised by the parent company's board alone. I think, on reflection, that it probably does make sense.

In this case it was necessary to amend the parent company's constitutional documents ('regulations') to accommodate the transfers. This required the approval of members at extraordinary general meetings in advance of the court hearings. Some of us approached these members' meetings with a degree of apprehension. In the event, not a single member attended other than the board of directors and senior management!

Two of the transferring companies had written with-profits business. In one case, the with-profits business was in a ring-fenced fund operating on a 90/10 basis. We took the view that this block of business, although not massive, would remain viable on a stand-alone basis for a number of years. As the administrative benefits to be obtained were small, we decided against attempting to merge this business with the parent company's own with-profits business within the scheme of transfer. We explained, within the scheme, that the ring-fenced fund would not remain separately viable for an indefinite period. It was closed to new business. In the meantime, it will continue to operate as a ring-fenced fund within the parent company, with the so-called shareholders' 10% of surplus to be transferred to the other funds of the parent to provide a return for its other with-profits policyholders, who had, in effect, provided the capital required to finance the original acquisition. Another of the transferring companies had just 13 with-profits policyholders. That fund was being merged into one with nearly one million with-profits policyholders. We quickly came to the conclusion that the small with-profits fund was not a viable proposition on its own — probably it never had been — and it was relatively easy to treat these 13 policyholders relatively generously, and transfer them into the with-profits fund of the parent at a cost which, relatively speaking, was minimal.

Reference has been made in the discussion to the fact that it is not necessary for an Appointed Actuary to report on schemes of this kind. In this instance I did put a report in the document that was circulated to policyholders, in order to provide evidence that I was satisfied that their rights and expectations were suitably protected. I managed to confine it to two sentences. I was persuaded to pad it out a bit for the report to the boards. I still managed to put that on one sheet of A4 paper. It seems to me unnecessary for the various parties involved in these transactions to repeat particulars of the scheme, especially if the repetition involves using different words which might have different connotations, or, indeed, for the Appointed Actuary to cover ground that has been dealt with perfectly adequately in the independent actuary's report.

I agree with earlier speakers and with the author in his conclusion that there are no unique solutions to the problems that these sorts of mergers involve. As in so many other areas of our actuarial work, it must depend very much on the judgement of the actuaries concerned. These are, inevitably, complex matters, and my message, if I have one, is that, as actuaries, we should do everything we possibly can within that complexity to keep matters as simple as possible.

Mr C. B. Russell, F.F.A.: I think that I was involved in the case study. I was asked a lot of hypothetical questions by insurance companies and by consulting actuaries at the relevant time, and many of the issues in the paper look very familiar.

I should like to make a few comments, first on some of the tax issues, but then on a more general issue. In ¶6.2.1 the author sets out his two objectives for the tax section. The lesser one is to provide a review of the issues, and he does this exceptionally well. His greater objective is to ensure appreciation of the complexity of the tax issues — in that I think he does superbly. Turning to ¶6.2.2.3, the author refers to a scheme to avoid stranding losses in which there was a clear tax avoidance motive in its construction. I think that the situation he has in mind was a particular case of

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a company which was largely pensions, but had a small amount of basic life, and there was a desire to transfer from an overseas company to a U.K. subsidiary. There would have been stranded losses, and the method used to avoid those stranded losses was to transfer all except a part of the business, leaving some basic life policies and certain assets behind. The effect was that, in the following year, instead of being a small percentage basic life, it became 100% basic life, and, for reasons which I will not go into, it was able to use up the losses. The remaining business was then transferred. The Revenue did not raise any objection. It should be understood that the tax problem arises if tax avoidance is an object of the transfer, or if it is the object of a greater scheme of which the transfer is part. There is no objection to part of the scheme having a tax avoidance motive if the whole does not. In this case, the whole scheme clearly had a commercial motive — the fact that the detail was organised for tax purposes was not a problem. It is, of course, necessary to be very careful in these situations not to shoot oneself in the foot. I have seen arrangements where people were able to produce tax liabilities to use up stranded losses, but, effectively, they were bringing forward tax liabilities or creating tax liabilities and convincing themselves that they were actually making losses more valuable. In doing that they were achieving nothing.

I turn to another aspect that the author raises, more a matter of principle, in ¶8.3.1. He refers to the extra tax which arises because of a shareholder transfer. In ¶11.2.2.3 he refers to the question of who should pay the tax on the shareholder transfer. The question is this: in a 90/10 office, for instance, who should pay the tax that arises from the 10 which the shareholders take? I think that we would all agree that in a static situation there is no problem. It does not really matter whether you say that shareholders take 10% of the profit before tax and pay their own tax, or whether you say that tax is charged to the life fund as a whole, and they take about 7%. It comes to much the same thing. PRE depends upon how the fund is set up in the first place, and also depends on continuity thereafter.

The problem arises when tax systems change, as they did in 1990. Traditionally, all tax has been charged to the fund. Actuarial surplus was determined, and then it was split 10%/90% and the shareholders took their 10%, which, at least in a composite company, was normally grossed up for presentational purposes, so that it looked like 13% or 14%. The question is: what then happens upon changes in tax rules? Effectively, there is an additional tax imposition on shareholders' transfer. In my view, and it is a view with which I have struggled, it is still correct to charge all tax to the fund before splitting net surplus. If one looks at the 1990 changes, there are a number of effects going in opposite directions. First of all, the tax rate was lowered so that the funds — on (I − E) — generally suffered only basic rate tax. However, the system was tightened up so that additional tax was charged on the transfer. Effectively, these two were trade-offs, and they might produce much the same total liability. If they did produce the same liability, it would be unfair to hit shareholders with an extra tax charge.

On a more general principle, if the parties have a system of 90% and 10% sharing of net surplus, and an outside agency, such as government, effectively changes the rules, is it not fair that the parties should take the benefit or loss of the change of rules in proportion to their proprietary interest? Should not the shareholders still take their 10% after tax? I think I am disagreeing with the author's conclusion on this point.

I wonder whether enough consideration is given to non-profit business and to discretions in respect of unit-linked business. Nowadays most unit-linked policies have fairly open charges. In buying pension policies, I am happy to accept discretion on the part of the company when I know that the company is a mutual and I know something of its ethos and management attitude. If there is then a transfer to a proprietary situation, I think that the whole game changes. For instance, where you have variable fund charges, in the former circumstances there may be no need to tie down the circumstances in which the fund charges could be raised, because one is aware of the corporate approach. However, if transferring to a proprietary company, it seems to me that the Appointed Actuary should think about whether it is possible to lay down more explicitly the circumstances in which unit-fund charges can be changed.

Mr W. B. McBride, F.F.A.: My life office experience has not been with any of the companies in the case study, but with London Life, referred to in Section 10. My current experience is more with

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friendly societies, and I was interested in ¶3.3.10, where the author refers to the different provisions in the Friendly Societies Act over those of the Insurance Companies Act, in particular the criminal offence involved if the independent actuary is deliberately misled. Recent precedents may suggest that this is acceptable as long as there was no duplicitous intent! However, I suspect the differences only arise because the Friendly Societies Act is more recent. Perhaps there will be corresponding amendments to the Insurance Companies Act in the future.

One difference which I do not remember the author pointing out is that, in a transfer between two friendly societies, there is no involvement of the court. The Commissioner of Friendly Societies is the sole arbiter of transfer. He *may* direct that an independent actuary be appointed. I had imagined that an independent actuary would only *not* be involved in transfers between relatively small societies. However, recently I was involved with a transfer between two Directives (larger friendly societies where there were Appointed Actuaries in that position), and I was surprised to find that there was no independent actuary appointed. The reports of the two Appointed Actuaries were considered sufficient.

Getting back to my life office experience, I was Appointed Actuary at the time of transfer. I formed the conclusion that the independent actuary's prime function, certainly in a transfer between two mutuals, should be as a second opinion. However, I think that the court looks upon his report as its prime source of advice, but I think that this is unsatisfactory. The independent actuary should restrict himself to the scheme, and not comment on alternative schemes.

It could be argued that, as the independent actuary is appointed by the transferring party, and not by the court, he is free to report as he pleases. Perhaps that is what Mr Taylor had in mind. However, in our merger, the court was not interested in anyone's opinion of the merits of alternative schemes. This included any merits of a scheme of closure, to which Mr Thomson referred. Ours was the merger of two open funds, and I had tried to resist any reference to closure on that score; but closure got dragged in; not by the court, but by some of our policyholders.

As to how much information should be given to policyholders, Mr Gillon seemed to want to make it simpler and Mr Taylor more detailed. Our initial attempt to explain the transfer simply was howled down by the press, who would not rest until a mass of irrelevant figures was produced. Perhaps policyholders are only happy when they are not understanding masses of figures put forward by actuaries.

I agree with ¶10.1.2, but would add that there was another factor involved, which did not apply in the case of the Friends Provident merger; London Life was an international fund merger, and the sub-fund created was non-statutory. The prime motivation for our transfer, however, was not any of the points listed by the author; it was to promote mutual support between two open funds and enable a smooth flow of capital from Australia to the U.K. and, we hoped, in the other direction at some future stage.

In every transfer a balance has to be struck between policyholders. An equalisation payment may be needed. In several places the author refers to it as a sweetener, which is not a word that I like in the circumstances — it smacks of bribery. We were involved in a payment from one fund to the other; this was a measurement of the extent to which the free entry of capital from the Australian fund to the U.K. fund was seen to confer a greater proportionate benefit to the Australian policyholders.

Where a life office is operating two separate with-profits funds with very different characteristics, particularly with regard to guarantees, one can run a sub-fund approach equitably. It is not necessarily a feature only of transfers. However, the London Life fund remains a U.K. fund with separate assets and management structure; and the further advantages of a more integrated sub-fund approach, which the author refers to, would not apply.

Mr R. M. Paul, F.F.A. (replying): The opener and Mr G. Stewart mentioned the structure separating the scheme and the associated rationalisation. That arose because counsel doubted whether we could get the court to give effective endorsement to the very complex actuarial issues of compensation payments. Therefore, it was removed and dealt with separately, but still part of the scheme. The issue was how it tied in with the court application, as the court was approving only the scheme.

Mr Grace mentioned the possibility of hostile bids for a mutual and the consequent role of the

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actuary. I am not certain of the likely process, but if it does arise, it is going to be very interesting to decide how the mutual life company defends its position or what will result if it finds itself unable to do so.

Mr McKay mentioned the legal problems, and certainly they have not got any easier. There are still many difficulties. Habitual residents, who are mentioned in the paper, are a complex issue. Even if you have only one policy in, say, Germany, you have to go through all sorts of hoops which (potentially) involve delaying the whole process by three months. The DTI advised me that some countries are very quick to respond; others do not, Spain for example, so you have to wait for the full three months. When you set the timetable you must allow for this, as there is no way that you can speed it up.

Much has been said about the Appointed Actuary and the independent actuary and what their roles are. Taking Mr W. Stewart's point, I do not disagree with him. It probably is not possible for an independent actuary to check every possible option. What I want to stress is the principle that somebody somewhere has to look at the other options. The independent actuary should question whether or not other options have been considered, and, if they have, why they were rejected. The Appointed Actuary undoubtedly has a role in this issue, and should consider the other options, in case the board are attracted by a particular strategy which may not be the best strategy for the policyholders.

Mr Thomson mentioned PRE, which is very important. The question of moving from 7% to 10% in C was debated very strongly, but, at the end, it was agreed that this would act against PRE, because 7% was what policyholders had come to expect. The policyholders probably never knew that that is what they expected, but it was deemed by the actuaries that that is what their expectation now was, and the DTI agreed. Whether the policyholders understood the relevance of the issue is most unlikely. However, the actuaries involved have a responsibility to protect PRE on their behalf.

I find it difficult to decide when a building society would provide support, despite colleagues' assurances. My experience with my previous shareholder in discussions on whether or not they would provide capital support produced the comment from one of the directors employed by the parent that "we will not provide capital to support your bonuses". Shareholders will provide capital to support solvency, but how to define solvency is always an issue. Shareholders will probably not inject capital to support bonuses.

The President (Mr G. M. Murray, C.B.E., F.F.A.): We have had a very healthy discussion on an extremely interesting paper. In today's active life assurance market, considerable use is likely to be made of this paper as a reference document for the benefit of the profession.

The concept of hostile bids raises interesting professional issues. It is difficult to conceive of a hostile bid being other than heavily qualified and contingent on access to independent reports. Yet, should there be a requirement to provide that sort of information purely on the basis of a speculative statement? There may be professional issues for those who become involved in such situations.

We should be grateful to the author for leading our discussion this evening, and I am sure that you will all join me in thanking him for an excellent paper.

WRITTEN CONTRIBUTION

The author subsequently wrote: The opener concluded that the provisions of Section 49 may have had their day, as associated significant reconstruction issues are carried out simultaneously, but without formal court approval. That argument was advanced further by Mr McKay, who pointed out that even the relatively simple requirement to insert a clause in the scheme giving the right to reconstruct or merge unit-linked funds, may not now be possible. The issue, therefore, becomes more and more dependent on the judgement and opinion of the actuaries involved. Strictly speaking, the independent actuary is only required to comment on the scheme, and, therefore theoretically, could ignore such associated reconstructions. I suggest that the extent of professional involvement requires very careful consideration, and I hope that this will be addressed in the revised version of GN15. If

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the legal scheme document is simplistic, I wonder what court approval in isolation achieves other than meeting the Act requirements, but that is a question for the legal profession.

Turning to the question of shareholders' support, even after reading the comments of the opener and Mr G. Stewart, I still find it difficult to determine exactly at what point the shareholder will provide capital support to the with-profits fund as opposed to simply increasing shareholder capital. The latter will permit an immediate reconsideration of the asset allocation with a view to increasing the equity/property content. However, if, contrary to normal expectations, a much reduced investment return results, is this not assumed to be within PRE? There would then be no requirement for the shareholder to inject capital into the fund itself to cover the investment losses and support bonuses. Apart from the case study, where the shareholder injected capital into the with-profits fund to make the company more attractive to a potential purchaser, I am not aware of similar support from a shareholder, except, perhaps, where it is clear that some transgression has arisen in the operation of the company, the responsibility for which can clearly be placed on the shareholder. It would be interesting to consider in what cirumstances, and without such transgressions, a shareholder would actually inject capital to support PRE.

Mr Paterson correctly pointed out that the independent actuary provides a report to whoever commissioned that report, rather than to the court. However, I prefer to leave the wording in the paper unchanged, as it is imperative that the independent actuary and readers of the report appreciate that, under the legislation, that report must be submitted to the court. I endorse Mr McBride's comment that the court would look upon the opinion expressed in the report, by the independent actuary, as the prime one to the court.

I would endorse Mr Taylor's comments regarding the importance of managing the project correctly with a view to curtailing external costs. In addition, he is correct in commenting that the problems over rationalising future administration should not be minimised. Indeed, the transfer of the business is probably the simplest part of that overall rationalisation.

Mr Forfar suggested that the policyholders in Company A might have felt a little disadvantaged since, prior to the merger, they had a higher proportion in equities than Company C. However, it is necessary to take into account the difference in the valuation basis and also the level of free assets. As explained in the paper, after standardising the valuation basis, various models were examined using different equity proportions which demonstrated that, at the date of calculation, Company C was actually stronger than Company A. Consideration was already being given to increasing the equity proportion in Company C as a result of the improved solvency position. Mr Forfar asked for my view on the principle behind the differential of a quarter percent in the Friends' Provident/UKPI merger. I have no knowledge other than that gleaned from the documentation, which states that the reduction in the equity content required in the former company was minimal, and well within any reasonable range of asset allocation. It can, therefore, be assumed that the differential was to compensate for such a potential reduction.

Mr Grace raised the very interesting issue of hostile bids. There is no doubt that Appointed Actuaries of mutual companies and those interested in providing independent actuarial reports should consider very carefully how to react in such circumstances. Again, the issue may well be considered in a general context as part of the review of GN15.

On the question of tax, I accept Mr Paterson's view that the impact of the policyholder bearing the additional tax is relatively small, but I would suggest that it is the principle which is most important. I also note that Mr Russell disagrees with my views on who should bear the additional tax burden, but that seems to make the vote at present one all, and I would be interested, in due course, to hear other comments on that responsibility!

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