B.A.J. **2**, V, 1273–1322 (1996)

OWNERSHIP OF THE INHERITED ESTATE (THE ORPHAN ESTATE)

A DISCUSSION PAPER

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[Presented to the Institute of Actuaries, 24 June 1996, and to the Faculty of Actuaries, 18 November 1996]

ABSTRACT

In recent years there has been increasing interest in clarifying the respective interests of shareholders and participating policyholders in the inherited estate of the proprietary life offices. This paper defines the inherited estate, considers the sources of surplus contributing to it and suggests an approach for quantifying it. Views are expressed on the attribution of the inherited estate to the parties involved with a view to a consensus emerging from a discussion of the underlying factors. The role of the supervisory authorities and of the Appointed Actuary and the independent actuary are considered and methods of accessing the inherited estate attributed to shareholders are examined.

KEYWORDS

Orphan Estate; Inherited Estate; Policyholders' Reasonable Expectations

1. INTRODUCTION

1.1 The basis for distributing profits from long-term business between those entitled to share in them is, in some cases, defined by the Articles of Association and, in others, by practice established over many years.

1.2 In some cases substantial surpluses have accumulated over many generations of policyholders. In the last few years there has been increasing interest in determining the respective rights of shareholders and participating policyholders of proprietary life offices in these retained surpluses, which have been referred to as the Orphan Estate (OE). This reflected, in part, possible merger and acquisition activity, and also the new proposals covering the reporting of financial results of companies.

1.3 Three applications for such a determination have recently been dealt with by the Secretary of State. The principles for dealing with the first two applications were formalised after considering the issues arising from these two cases, and were set out in a statement made by the Department of Trade and Industry (DTI), the full text of which is contained in Appendix 1.

1.4 Important aspects of the first two cases referred to are summarised in

https://doi.org/10.1017/S1357321700004906 Published online by Cambridge University Press

Appendix 2.

1.5 Other companies have announced that they propose to make similar applications in the near future. The Life Board of the Institute of Actuaries and the Faculty of Actuaries decided to establish a working party to consider and report on the issues involved.

1.6 In framing its report, the working party took account of the views expressed in *The Actuary* and in correspondence with members of the profession.

2. Terms of Reference

Suggestions were made as to the matters the working party might wish to consider, but it was left to the working party to frame its own terms of reference, having regard to the issues involved. The following terms of reference were adopted :

(1) Define the OE. Is it a suitable expression to pass into actuarial literature?
(2) Quantify the OE. Explore the methodology and approaches to be used. Suggest ways of dealing with data and other limitations.
(3) Having regard to the importance of protecting the interests of policyholders, consider the factors involved in attributing the OE to shareholders and with-profits policyholders.
(4) Define the roles of the Appointed Actuary and the independent actuary.
(5) Examine the methods by which life offices could distribute the OE.
(6) Investigate the financial reporting of the OE attributed to shareholders.

3. Defining the 'Orphan Estate'

3.1 It was generally felt by the working party and by others that the expression 'Orphan Estate' was an inappropriate description of the funds under consideration, and should be replaced by a more suitable expression. Inherited Estate (IE) was felt to be more suitable, and this term will be used instead of Orphan Estate. We defined the IE as follows:

— the residual part of the long-term business fund assets after setting aside that part of the assets sufficient to satisfy the obligations owed to all the fund's policyholders (including their reasonable expectations), shareholders and creditors.

3.2 The nature of the actuarial assumptions to be used in determining the IE was considered. On balance, it was concluded that, having regard to the need to make adequate provision to cover the company's obligations, an element of prudence should be included in the actuarial assumptions. This is the approach described in Sections 4 to 7. A variant on this approach would be to use best estimate assumptions throughout, and this approach was favoured in several comments and submissions to the working party. The implications of this variant are discussed in Section 8.

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4. QUANTIFYING THE INHERITED ESTATE

4.1 Central to the quantification of the IE is the question of the reasonable expectations of policyholders. Policyholders have a contractual right to the benefits guaranteed under their policies, including bonuses already declared. In addition, legislation implies, but does not directly impose, an obligation for the company to meet the reasonable expectations of policyholders (PRE). PRE are referred to, but not defined, by legislation. The courts have not had an opportunity of interpreting them. It is, however, generally accepted within the actuarial profession that PRE are formed and influenced by :

(a) any reference to participating rights in the company's Articles of Association;
(b) promotional and publicity material and subsequent statements as to the company's bonus philosophy and the entitlement of policyholders to a share in profits;
(c) the with-profits guide;
(d) the history and past practice of the company; and
(e) practice within the life assurance industry generally.

The interpretation given to these items would be based on expert actuarial and legal opinion, on the views of the supervisory authorities, and not on those of a lay person.

4.2 A working party was set up in 1989 to consider how the expression PRE was used in practice, and to recommend how it should be regarded within the United Kingdom actuarial profession. In its first report, the working party on PRE concluded that, normally:

(1) PRE are virtually synonymous with equity, and that asset shares were a generally accepted measure of them; and
(2) the orphan surplus did not form part of PRE.

The conclusions of the PRE working party's first report is reproduced in Appendix 3.

4.3 It was generally agreed that reasonable expectations were a minimum and not a maximum obligation.

4.4 There are, of course, a number of ways in which asset shares may be calculated, ranging from accumulating the net premiums (viz. office premiums less expenses and cost of death claims) at the earned rates of investment return allowing for tax and transfers to shareholder funds, as appropriate, to including the profits or losses from surrenders and lapses and from non-profit business, where these contribute to PRE. It is felt that asset share calculations made for the purpose of quantifying the IE should take account of all those sources of profit or loss earned during the in-force period in which participating policies are eligible to share under the company's Articles of Association and its established practice. It was accepted that, in many cases, it would be difficult to identify and quantify all relevant factors.

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4.5 In recent years an office may have followed a policy of consistently enhancing payouts over and above asset shares by means of contributions from the estate. To the extent that directors have formulated and are implementing a policy to realign payouts with asset shares, it would be appropriate to reflect the cost of a reducing contribution from the estate in the quantification of the IE. PRE require that any change of policy in this regard should be implemented gradually. For example, where a company has decided on a policy in which claim payouts are to be reduced to a level of 100% of asset shares over a period of years, the quantification of the IE should reflect the anticipated level of overpayment during that period. Where, on the other hand, it is the policy of the company to continue to pay claim amounts at a level consistently exceeding asset shares (for example, enhancing payouts by using the investment return on the estate), these enhancements should be carried through into the quantification of the IE, and may reduce it substantially.

4.6 Appendix 4 summarises the approach of companies, as set out in their literature, to PRE and contributions from the estate. More detailed disclosure of bonus policy and practice has recently been introduced. Appendix 5 reproduces paragraph 14 of Schedule 4 of the new Regulations, which deals with this matter.

4.7 When determining policy obligations, in addition to calculating asset shares, using the approach described above for with-profits business, there would be reserves calculated on a prudent basis for non-profit business, guarantees, options and any mismatching reserves required to support the company's investment policy. Stochastic modelling techniques would probably be used to test the robustness of the assumptions made.

4.8 The balance of the assets of the long-term business fund, after making the provisions described above, would constitute the IE as previously defined. The bases used for the calculation of the value of assets and obligations would be determined by the Appointed Actuary and reviewed by the independent actuary, whose roles are described later.

4.9 It should be noted that the quantification of the IE, as defined earlier, is not the only possible methodology. In particular, it is possible to consider some of the assets in excess of the calculated asset shares (using the above approach) and which are required only to provide investment freedom and guarantees as being part of the IE. The PRE working party report considered that policyholders could not reasonably expect to benefit directly from a distribution of these assets in the normal course of events (but see Section 8).

4.10 One of the advantages of using the asset share approach to quantify the basic entitlement of with-profits policyholders is that one is dealing with in-force policies, the bulk of which were taken out after 1974. Asset values have been available from the statutory returns since then, enabling rates of investment returns to be calculated. Detailed asset valuation data prior to that date, while not contained in the statutory returns, may be available from internal investigations. Indices would be used in the absence of such information. The errors involved in using such approximations are unlikely to be significant; it is a responsibility of

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the independent actuary to comment on the appropriateness of any approximations and the accuracy of the calculations.

5. ATTRIBUTING THE INHERITED ESTATE TO SHAREHOLDERS AND POLICYHOLDERS

5.1 The origins and growth of the IE of proprietary companies can be traced to a variety of factors, including:

(a) the injection of shareholder capital in the early years, to finance the growth of business;
(b) the retention of surplus for prudential reasons, because profit testing techniques and resilience testing were not as well developed then as they are today;
(c) earlier bonus systems were not geared to deal with volatility in market values, resulting in lower payouts to ensure solvency and preserve financial strength;
(d) the retention of profits from surrenders, non-profit business, taxation and other miscellaneous sources; and
(e) retention of surplus to finance future expansion and facilitate a wider investment policy.

5.2 In recent times, the growth of the accumulated surplus may have been reversed as a result of setting maturity payouts at levels in excess of asset shares calculated on realistic bases.

5.3 While there was general agreement within the working party on the issues previously discussed, on the question of attribution of the IE to shareholders and policyholders there were differences of opinion.

5.4 Where the division of profits was not defined in the Articles of Association, some members felt that, having made full provision, on a prudent basis, for meeting the contractual obligations and the reasonable expectations of its policyholders, reliance on the arbitrary 90:10 ratio, without proper regard to the origin and growth of the IE, was unsound. In particular, they considered that:

(a) equity was not served by transferring undistributed profits arising from policies long since terminated to those now in force and others yet to come on the books;
(b) there was often no identity of interest between the policies that generated the IE (e.g. non-profit industrial branch business) and those now being effected (e.g. personal pensions under unitised with-profits systems);
(c) profit transfers between generations should not be made, except to achieve an acceptable degree of smoothing; and
(d) with-profits policyholders, as a class, cannot have a right to the IE, because there is no requirement to distribute it.

5.5 Furthermore, while policies have a finite life, and, once terminated, cease to have any further claim on the fund, shares, on the other hand, have an

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indefinite existence; they may change hands at their perceived value from time to time, but they carry their rights to profit with them.

5.6 Members holding these views were concerned to ensure that, where the IE had been generated largely by under-distributions in the past, the situation should not recur, and that each current and future generation of with-profits policies should receive its full (smoothed) share of profits, with no undue carry forward of earned surplus.

5.7 Other members felt that the tenuous claim of policyholders did not necessarily enhance the claim of shareholders, and that the ownership of IE should, unless there were special circumstances, be in the same proportions as for distributed surplus. They believed that it was not unusual for companies to smooth returns by transferring gains and losses between generations. Generations of policyholders cannot be separated into discrete groups, because the in-force population of an office changes continuously. It is, therefore, not possible to look at one group or generation of policyholders in isolation. Moreover, if earlier generations of policyholders had made contributions to working capital that was now regarded as excessive, then it was difficult to see any a priori reason why the release of any excess should be distributed in a different proportion, between policyholders and shareholders, from other current earnings.

5.8 Part of the concern over a departure from this principle was that an underdeclaration of bonuses would increase the shareholders' share of the IE at the expense of with-profits policyholders. There was also concern that a departure from established practice, without special reasons, would result in adverse publicity.

5.9 Among the circumstances which could justify a higher attribution to shareholders would be:

(a) recognition for additional shareholder capital injected to support the business;
(b) the absence of any clearly defined participating rights in the surpluses from different classes of business, e.g. non-profit, with-profits and industrial business; and
(c) a demonstration, supported by historic valuations, that the sources of retained surplus were not attributable to with-profits policyholders. It was recognised that such information might not always be available.

5.10 It was recognised by all members that legislation (Section 45 Insurance Companies Act (ICA) 1982) confers substantial powers on the Secretary of State in determining the outcome of an application to vary the participating rights of shareholders and policyholders. A direction made by the Secretary of State may be challenged by an application for a judicial review.

5.11 Appendix 6 summarises the procedural and statutory aspects relating to the attribution of surplus assets.

6. Role of Actuaries

6.1 Where a company seeks to clarify its interest in the IE, it will, in the

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normal course, require a report from its Appointed Actuary. Before undertaking such an investigation, the Appointed Actuary should consult the Professional Guidance Committee as to whether his or her financial interest in the company is likely to create a conflict of interest, and, if so, what action should be taken. Investigations carried out by the Appointed Actuary, in these circumstances, would be subject to the provisions of GN1.

6.2 The board of the company may, in addition, seek advice from an external actuary, experienced in such matters, on the interest of shareholders in the IE. Such an actuary will clearly wish to liaise with the Appointed Actuary on a number of matters, including his interpretation of PRE in relation to the company.

6.3 The DTI requires a report from an independent actuary on the appropriateness of the proposals from the policyholders' perspective. Appendix 7 sets out our understanding of the DTI's requirement on the roles of the Appointed Actuary and the independent actuary.

7. Access and Reporting on the Inherited Estate Attributed to Shareholders

7.1 Section 30(3) of the ICA 1982 provides that, if it is proposed to reduce the policyholders' share of surplus by more than $\frac{1}{2}$%, notice must be given to the Secretary of State and a notice approved by him published. If the cumulative effect of such action were to increase the shareholders' share to levels which the supervisory authorities considered could compromise PRE, the action would undoubtedly initiate the intervention of the Secretary of State under Section 45.

7.2 In a typical 90:10 situation, shareholders would receive 10% of the surplus associated with bonus declarations, which would then be transferred to the profit and loss account from which dividends would be paid. Where, however, part of the IE is appropriated to shareholders, this would need to be quantified in monetary terms, and may be dealt with in a variety of ways.

7.3 The appropriation to shareholders could remain in the long-term fund, and be credited with the investment return earned on the fund as a whole. Alternatively, it could be invested in a separate portfolio of assets. Income from, and drawings on, the appropriated assets may be transferred to shareholder funds, subject to the Secretary of State's agreement (Section 68 ICA 1982 provides the power for such transfers). It is understood that such agreement would not be forthcoming unless he was satisfied that the remaining funds were sufficient to safeguard the interests of policyholders and provide adequate working capital.

7.4 In whatever manner the appropriated assets are dealt with, it is essential that transactions on the appropriated assets are in accordance with recognised accounting standards.

7.5 Although the attribution of the IE between policyholders and shareholders should be regarded as a 'one-off' exercise, the ability to distribute the IE is subject to constraints which will change with the passage of time. The prudent margins taken in arriving at the obligations and reasonable expectations of the

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shareholders and policyholders will change with the progress and experience of the fund. In general, margins will be released in a contracting life fund, thereby increasing the IE and the amount that can be distributed, and conversely in an expanding fund. New business plans and investment policy, as they evolve over the years, will also affect the amount of risk capital it is necessary to retain in the fund. It will be necessary to review all these factors periodically, say every five years, probably using stochastic modelling techniques. Such reviews will affect the rate at which the IE can be distributed, but should not influence the principles of attribution between policyholders and shareholders.

8. Best Estimates Variant

8.1 In Section 3 an element of prudence has been included in the definition of the IE, to ensure the protection of policyholder expectations in the widest sense. This feeds through to the assumptions used in the quantification of the IE in Section 4. A once and for all determination of the principles for attributing and distributing the IE is proposed, but it is recognised, in Section 7, that reviews of the amount of the IE will be required from time to time thereafter. Where with-profits business is declining, for example, such reviews would normally be expected to identify additions to the IE as prudent margins in the original assessment are released.

8.2 A variant to the quantification of the IE, as described in Section 4, would be to use best estimate assumptions throughout the calculation, so that, for example, assets representing the embedded value of non-profit business and assets needed to support investment freedom (but in excess of asset shares) would be added to the amount of IE identified. The attribution of this enhanced IE would follow the principles in Section 5, but, having split the enhanced IE into policyholder and shareholder amounts, there would be no further reviews. Amounts attributed to shareholders would increase with investment earnings, and would reduce to reflect any shareholder transfers. The rate at which the IE attributed to shareholders could be distributed would still reflect the need to maintain investment freedom and the other aspects, noted in Sections 4 and 7.

8.3 In certain respects this approach could be viewed as being preferable, notably the 'clean break' aspect. In other respects it is less satisfactory. Unanticipated costs arising from adverse scenarios, or otherwise, may occur, and the balance of contribution of shareholders and policyholders meeting such costs may be difficult to determine fairly, as the full attribution of the IE reduces flexibility. Under the proposals outlined in Sections 3 to 7, the impact of unanticipated costs on the IE is significantly reduced by the prudent margins in the determination of the IE as defined. Such costs would mainly be reflected in reduced amounts being recognised in the IE at subsequent re-assessments.

9. Conclusions

9.1 The subject under consideration can be viewed from a number of

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perspectives. There was general agreement on the fundamental requirement to safeguard the contractual rights and reasonable expectations of policyholders, on the definition of IE, and the principles to be adopted in quantifying and accessing it. It was not surprising that differences emerged in the rationale for determining the balance of interest of policyholders and shareholders in the IE. The essential difference is that some members favoured the concept of classes of policyholders being entitled to profits irrespective of when they were earned, a view favoured by the DTI, and others held the view that the principles of equity and reasonable expectations would be fully served by giving each generation of with-profits policyholders its full smoothed share of profits earned plus the backing of sufficient IE to ensure that policyholders' expectations associated with either normal or adverse conditions can be fully met.

9.2 The issue of ownership of the IE is largely of historic origin, and, under present day conditions, the future attribution of emerging profits should be fully determined by current disclosed information, particularly in with-profits guides and under the recently introduced regulations. Any scheme to quantify and attribute IE should therefore be 'one-off' in nature.

9.3 This report is not concerned with the minutiae of bonus declarations, but it was generally felt that the creation or increase of IE in future should be avoided, and that, subject to prudent actuarial management, there should be a full and equitable distribution of surplus to each current and future generation and class of policyholders.

ACKNOWLEDGEMENTS

The authors thank the many members of the profession for their verbal and written comments which helped to shape the paper, Ronald Fergusson and Mark Symons who acted as secretaries to the working party and Shelagh McComiskey for typing and amending the many drafts that were produced during the development of this paper.

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APPENDIX 1

THE DEPARTMENT OF TRADE AND INDUSTRY'S POSITION ON 'ORPHAN ESTATES'

(This appendix is referred to in ¶1.3.)

A.1.1 A number of with-profits life offices have accumulated amounts within their long-term funds whose allocation between shareholders and policyholders may not be clear-cut, and there has been a growing interest among relevant companies in the scope for clarifying shareholders' interest in the long-term fund.

A.1.2 The DTI is, in principle, in favour of greater clarity in the attribution of the long-term funds of proprietary insurance companies. In any such attribution, it has a responsibility to ensure that the reasonable expectations of policyholders are fulfilled.

A.1.3 The DTI considers that policyholders' reasonable expectations, in respect of attribution of surplus, are influenced by a range of factors, notably:

— the fair treatment of policyholders *vis-à-vis* shareholders;
— any statements by the company as to its bonus philosophy and the entitlement of policyholders to a share in profits, e.g. in its Articles of Association or in company literature;
— the history and past practice of the company; and
— general practice within the life insurance industry.

A.1.4 The DTI is concerned that any restructuring of funds for the purpose of clarification should preserve a proper balance of interests as between policyholders and shareholders. In this connection, it considers that the proportion of policyholders' and shareholders' interests in the surplus are unaffected by whether or not the surplus is actually distributed — that is, if, in any year, surplus is not distributed, but is retained in the fund, the policyholders, as a class, retain their interest in that element of the fund.

A.1.5 A life office may make distributions from surplus in the long-term fund, as shown by the statutory annual actuarial valuation. It is common practice to make distributions to policyholders and shareholders in the proportion 90:10. In assessing policyholders' reasonable expectations, the DTI would expect this ratio to be used as the basis of attribution between policyholders and shareholders, unless there was clear evidence, based on a company's circumstances, statements or practice, that a different proportion was appropriate in respect of the surplus arising from some particular part of the business.

A.1.6 The DTI considers that the proposal announced today by United Friendly Insurance to restructure its long-term funds is consistent with these principles. It has reached this view on the basis of information provided about the history and practice of the company, the amount of accumulated reserves to be set aside for the benefit of with-profits and other policyholders (a part of which is being used imme-

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diately to declare a special bonus to policyholders), and the intended arrangements for the future distribution of surplus arising in the long-term funds.

A.1.7 The DTI will assess any similar proposals from other life offices, having regard to the facts of the case and the principles described above. The outcome in any specific case will depend on the history and circumstances of the fund, which may differ widely from company to company.

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APPENDIX 2A

CASE HISTORY — UNITED FRIENDLY INSURANCE PLC

(This appendix is referred to in ¶1.4.)

A.2A.1 *Constitution*
Proprietary life office.
Articles of Association silent on distribution of surplus.

A.2A.2 *History*
Long-term business was first transacted in 1919.
The first with-profits ordinary branch (OB) contract was issued in 1937.
The first with-profits industrial branch (IB) contract was issued in 1979.
Non-contractual bonuses were paid on IB non-profit policies from 1947.

Transfers to profit and loss account were first taken from the IB fund in 1952 and from the OB fund in 1980. Amounts transferred varied between 0.5% and 16.0% of the total surplus distributed.

Terminal bonuses were introduced in 1982 for OB policies and in 1989 for IB policies.

Asset share techniques were first adopted in 1988 for the purpose of bonus declaration.

A common investment policy has been followed for all long-term business.

A.2A.3 *Bonus Philosophy*
Bonus rates are set in accordance with the following principles :
(1) Guaranteed benefits (sum assured plus reversionary bonus) should provide a targeted proportion of any payout. The proportion varies by duration of policy.
(2) There should be a smooth progression in payout from calendar year to calendar year.
(3) There should be a smooth progression in payout from policy year to policy year.
(4) Payouts should track asset shares.
(5) The company defines an asset share as an accumulation of the policyholders' contributions less expenses, charges for insured benefits, taxation, charges for the cost of smoothing payouts and the cost of transfers to the profit and loss account.
(6) Investment policy should not be subject to abrupt changes.

A.2A.4 *Policyholders' Reasonable Expectations*
The reasonable expectations of policyholders are considered to depend on state-

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ments made to them at the time they were sold their policies, on published statements regarding company practice over subsequent years, and on standard practice in the life industry. The bonus philosophy described above is a reflection of these factors.

A.2A.5 *Attribution of Assets*

A.2A.5.1 The initial amount of assets attributed to with-profits policyholders at 31 December 1992 comprised :

— aggregate asset shares;
— accumulated charges in excess of claims in respect of insured benefits;
— accumulated tax deductions in excess of tax paid;
— accumulated charges for smoothing in excess of smoothing losses; and
— where appropriate, an estimate of the future cost of supporting payout levels currently in excess of asset shares.

A.2A.5.2 Any application or transfer of the assets attributed to with-profits policyholders shall be made on a basis that ensures at least 90% of surpluses are applied or transferred for the benefit of policyholders.

A.2A.5.3 Remaining assets were attributed to shareholders, after setting aside prudent amounts representing non-profit business liabilities and an estimate of the potential cost of the company's smoothing policy under adverse investment conditions.

A.2A.5.4 The amount attributed to shareholders has been termed 'Retained Capital'.

A.2A.5.5 Rules have been agreed for the presentation of audited accounting information necessary for the DTI to monitor the ongoing fairness of the attributions of assets.

A.2A.6 *Access to Retained Capital*

A.2A.6.1 The company has dispensation to transfer to shareholders an amount representing a prudent estimate of the smoothed long-term investment return on the retained capital.

A.2A.6.2 The company may transfer additional amounts, subject to the Appointed Actuary certifying that the remaining long-term business assets are, in total, sufficient for the company to continue its business philosophy, as determined from time to time. In particular, the implications for bonus philosophy would have to be considered.

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APPENDIX 2B

CASE HISTORY — LONDON AND MANCHESTER GROUP PLC

(This appendix is referred to in ¶1.4.)

A.2B.1 *Introduction*

A.2B.1.1 In April 1991 London & Manchester Group plc (L&M) announced the identification of some £100m of residual value attributable to shareholders after meeting the reasonable expectations of existing with-profits policyholders.

A.2B.1.2 In June 1992 it announced a revised basis for distributing OB fund surplus, which involved an allocation to shareholders which was greater than that prescribed by Section 30 ICA 1982.

A.2B.2 *History and Background*

A.2B.2.1 Welfare Insurance was acquired in 1974, with unit-linked and non-profit business remaining segregated from the with-profits fund as part of the 'separate OB fund' or SOB.

A.2B.2.2 Prior to 1989 SOB remained segregated (and exempt from Section 30), with profits distributed on an equitable basis between shareholders and the OB with-profits policyholders; the latter also enjoyed 90% of the profits arising from the with-profits fund.

A.2B.2.3 Business developments precipitated a reconsideration of the fund structures. Growth of unit-linked business outstripped that of traditional with-profits business, leading to new business strain and profit sharing issues. Also, unitised with profits (UWP) had blurred the distinction between the funds.

A.2B.2.4 In 1989, and with DTI agreement, the funds were merged, allowing the aggregate resources to become available to support the development of the business as a whole. OB with-profits policyholder entitlement was confirmed to be a minimum of 90% of own business profits plus a reasonable share of profits from other business. This was to be evidenced, in part, by the creation of a with-profits sub-fund. The Section 30 exemption was withdrawn.

A.2B.3 *Bonus Philosophy*

A.2B.3.1 In May 1969 L&M became one of the first companies to introduce terminal bonus through its 'complete bonus' system. Entitlement to a share of any investment appreciation was calculated at the individual policy level, with that in respect of non-profit business and surrenders/lapses (which earned no terminal bonus) left to accumulate as an unallocated investment reserve with undefined ownership.

A.2B.3.2 This gave cause for concern following the Pearl takeover (which had highlighted the importance of proper stockmarket evaluation of the shareholders' proprietary interest), and given the moves towards reporting financial results in a more meaningful way.

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A.2B.3.3 Additionally, and pursuant to the 1989 exercise, L&M had committed to adopting an asset share based methodology to determine bonuses and payouts, and to ensure that any transfer of assets out of the with-profits sub-fund came from the unallocated part of the investment reserves.

A.2B.4 *Asset Shares and the Inherited Estate*

A.2B.4.1 The asset share of a policy is taken to be simply the accumulation (at the net rates of investment return achieved) of premiums less expenses and mortality costs, plus an appropriate share of miscellaneous profits, allowance being made for the shareholders' share of bonus already granted.

A.2B.4.2 Subject to appropriate smoothing, this defines the claim value, and hence the terminal bonus, being the difference between the asset share and the guaranteed amounts of sum assured and reversionary bonuses.

A.2B.4.3 Substantial calculations, using extensive historical data and a significant degree of judgement, were involved to ensure that the reasonable expectations of policyholders would (and would continue to) be met; essentially, claim values should be fair, having regard to past profits and the prevailing investment conditions, as well as reflecting a consistency of approach.

A.2B.4.4 The calculation of an asset share for each policy, and, after augmentation as appropriate, to align to payouts, left a balance of assets which L&M termed the 'inherited estate', which could be traced back to previously identified unallocated reserves and surpluses; this balance was evaluated to be some £100m.

A.2B.4.5 A review of the company's Articles of Association and relevant product literature over time revealed no limitation over ownership or constraints. Therefore, having satisfied itself (and the DTI) that in-force asset shares were at a level consistent with PRE, and that inherited estate derived from previous unallocated surpluses, the announcement was made that this was attributable to shareholders.

A.2B.4.6 Whilst required, in part, to provide investment freedom and cover for guarantees, the inherited estate was at a level in excess of that required for these purposes and the natural development of the business. Section 30 constrained its rate of distribution to shareholders in a way totally unrelated to any amount which might otherwise be regarded as surplus to the foreseeable requirements to run the business.

A.2B.5 *Section 30*

A.2B.5.1 By 1992, it was becoming increasingly clear that the application of Section 30 did not provide sufficient flexibility to distribute profits in a way which appropriately reflected the relative interests of policyholders and shareholders. This was particularly so because of the link to the increasingly less relevant cost of bonus, coupled with the realignment of the latter necessary to conform to the new era of low inflation and low investment returns.

A.2B.5.2 Accordingly, it was agreed that, for 1992 and beyond, L&M would

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be free to transfer to shareholders, in addition to profits rightly attributed to them on unit-linked and non-profit business, such part of the investment return on the inherited estate as is considered prudent and without prejudice to PRE. Further amounts could also be taken out to finance new business strain by way of a repayable 'establishment account'.

A.2B.5.3 The revised basis led to the overall proportion of surplus allocated to policyholders falling below the Section 30 limit (in fact, moving from 82.16% to 72.45%), and L&M undertook to write to all OB policyholders giving statutory notice of the changes. The opportunity was also taken to effect a 20% cut to normal reversionary bonuses and severely reduce additional (special) reversionary bonuses, eliminating them in the IB.

A.2B.5.4 Over the last two years, the policyholders' proportion of surplus has moved to 72.00%, within the Section 30 limit. Any future 'breach' will not automatically invoke a requirement to write to policyholders, subject to the DTI being itself satisfied that the proposed distribution of surplus reflects fully the agreed approach. However, a significant downward shift over time could trigger a requirement to re-approach customers to notify them of the change.

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APPENDIX 3

POLICYHOLDERS' REASONABLE EXPECTATIONS

(This appendix is referred to in ¶4.2.)

The principal points which have emerged are :

(1) In the normal day-to-day actuarial management of a life office, PRE are virtually synonymous with equity, and the almost universal method for measuring them is asset share calculations. (It is, naturally, widely accepted that there are differing ways of calculating asset shares.)

(2) In the normal course of events, any orphan surplus in an office does not form part of the reasonable expectations of (with-profits) policyholders, since they could not have 'reasonably expected' its distribution when they effected their policies.

(3) In the circumstances of a 'major change' in a life office (such as demutualisation), policyholders may reasonably expect that the proposed new arrangements do not disadvantage them as compared with the option of a closed fund. Our profession, therefore, should make the advantages and disadvantages of each option clear, and recommend a closed fund if it is in the existing policyholders' interests.

(4) For with-profits business gradual change is acceptable, particularly if communicated to policyholders, whereas sudden change is not. Changes in the company's levels of payment would be by reference both to previous levels of payment and to standing in the market place.

(5) For non-profit business, any changes should be consistent with market practice. Thus, reflecting changes in market levels of charges, perhaps due to inflation, is reasonable; increases to recoup new business expense over-runs are not.

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APPENDIX 4

DISCLOSURE OF PARTICIPATION RIGHTS

(This appendix is referred to in ¶4.6.)

A.4.1 In this appendix we summarise the results of a review of participation rights, as described in the 1994 DTI returns and 1994 with-profits guides of 14 proprietary offices and 2 mutual offices.

A.4.2 *DTI Returns*

A.4.2.1 Section 12 of Schedule 4 is required to describe "whether there is any reference to the principles on which the distribution of profits among policyholders and shareholders is made in the constitution of the company or in provisions made thereunder, in any policy issued by the company or in any advertisement by the company and, if so, a description of the principles and a reference to the document in which they are expressed."

A.4.2.2 Responses are generally very brief referring to "..distribution of profits determined by the directors in accordance with the Articles of Association.." or similar. Most proprietary offices then conclude with a statement along the lines of ".. proportion of profits allocated to shareholders is not more than one-ninth of the sum apportioned to the participating policyholders".

A.4.2.3 Four companies did not refer to their Articles of Association, with one quoting the regulations of the company and the other three failing to describe any document. Only one company included a reference to its with-profits guide as providing additional information on distribution principles.

A.4.2.4 Other non-standard features included :

- — several references to specific court agreements or similar;
- — one description of asset shares;
- — one reference to advertisements (as having no influence); and
- — a minority noting that the directors also act on the advice of the Appointed Actuary.

A.4.3 *With-Profits Guides*

A.4.3.1 The LAUTRO (now PIA) rules prescribe much of the content and format of the with-profits guides. Aspects of participation rights could be covered in:

Section C — factors influencing bonus rates;
Section F — recent bonus policy; and
Section J — other factors.

Only two companies mention their proprietary status in Section C as a factor influencing bonus rates (although most have a cross reference to later sections). The proprietary/mutual status is covered in Section F, although no company quantifies

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the impact of profit sharing with shareholders.

A.4.3.2 All guides include a reference to asset shares or an equivalent description. Only one uses the phrase 'reasonable expectations'; however, references to fairness are a common substitute, but are not used in all cases. The range of descriptions is illustrated by the following two extracts:

> "... uses asset share calculations to indicate the total amount which might be payable in respect of forthcoming maturity values. These retrospective calculations form the basis for determining the level of terminal bonus, subject to smoothing".

> "Fairness of treatment between investors holding policies issued at different times is achieved by assessing maturity and surrender payments having regard to the results of asset share calculations. Asset shares represent the accumulation of past premiums allowing for the actual investment performance, expenses, mortality costs, surrender payments and shareholders' profits, together with profits arising from without-profit policies".

A.4.3.3 The impact of free reserves on bonus prospects is generally restricted to comments regarding investment freedom, with only one (proprietary) office noting explicitly that profits from its free reserves contribute to the profits of the life fund. One further office noted that its 1993 payouts were asset shares supported by a contribution from free reserves, albeit that any such contribution is limited by the need to maintain sufficient free reserves. Explicit references to the availability of profits from non-participating business or other subsidiary operations are included where relevant.

A.4.4 *Commentary*

A.4.4.1 Given the detail on asset share methodology present in with-profits guides, it is, perhaps, surprising that only one company believes that a mention of its with-profits guide is necessary in the DTI returns. The DTI document *Updating the DTI Returns — the Next Steps,* dated July 1995, addresses this issue by proposing explicit disclosure of the principles, aims and methodology of the distribution of profits.

A.4.4.2 On questions of quantifying and attributing the IE, the DTI returns and with-profits guides are generally unhelpful. References to profits are normally distributed profits, thus giving no guide on ownership of undistributed profits. Further, the descriptions of asset shares generally leave open the question of whether earnings on free reserves are included in profits to be shared between policyholders and shareholders.

A.4.4.3 One aspect that is clearer is that there is no expectation of distribution of free reserves to policyholders in existing with-profits guides — other than to a very limited degree in one case. This is consistent with the conclusions of the PRE working party.

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APPENDIX 5

THE INSURANCE COMPANIES (ACCOUNTS AND STATEMENT) REGULATIONS 1996, PARAGRAPH 14, SCHEDULE 4

(This appendix is referred to in ¶4.6.)

14 (1) The principles on which the distribution of profits among policyholders and shareholders is based as described in any of the following documents :
- (a) the constitution of the company;
- (b) board resolutions of the company;
- (c) any policy issued by the company;
- (d) any advertisement issued by or on behalf of the company;
- (e) any document required to be issued by any regulatory body authorised under the Financial Services Act 1986(a); and
- (f) any other relevant document.

(2) A broad statement of the company's aims in relation to the distribution of profits among policyholders, including its aims in relation to:
- (a) policies which mature or are surrendered and claims arising by death;
- (b) the appropriate and equitable treatment of groups of participating policies; and
- (c) smoothing.

(3) A description of the methods used in order to ensure that the aims described in sub-paragraph (2) above are achieved.

(4) Subject to sub-paragraph (5) below, if different principles or bonus policies apply to different categories of with-profits issued by the company, the information in sub-paragraphs (1) to (3) above shall be given in respect of each category.

(5) Categories of with-profits polices which, apart from this sub-paragraph, would require separate information in accordance with sub-paragraph (4) above need only be listed under this sub-paragraph, and the information in sub-paragraphs (1) to (3) need not be supplied, provided that:
- (a) the aggregate amount of established surplus allocated to policyholders in all such categories is less than 10 per cent of the aggregate amount of established surplus allocated to all policyholders (as report at line 46 of Form 58);
- (b) the amount of established surplus allocated to policyholders in any one such category is less than 5 per cent of the aggregate amount of established surplus allocated to all policyholders (as reported at line 46 of Form 58); and
- (c) none of the categories was introduced during the report period.

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APPENDIX 6

PROCEDURAL AND STATUTORY ASPECTS

(This appendix is referred to in ¶5.11.)

A.6.1 *General Comments*

A.6.1.1 Insurance supervision in the United Kingdom does not rest upon a 'trustee' relationship between the company and its long-term policyholders, although, in practical terms, the controls which are imposed by the Insurance Companies Act 1982 (and in the past by its legislative predecessors) create a relationship which is similar to that between a trustee and beneficiary.

A.6.1.2 However, the individual long-term policyholder is not entitled to assert a legal or beneficial interest in the assets in the long-term fund other than in his ordinary capacity as a creditor of the company.

A.6.2 *Relevant Statutory Aspects*

Unless otherwise stated, the sections referred to in this appendix relate to the Insurance Companies Act 1982. The following summarised sections of the Act are the most relevant to this topic:

Section 28 requires the maintenance of separate accounting and other records in respect of long-term business, and, in particular, the establishment of a separate long-term insurance fund to hold all receipts of money applicable to long-term business. Separate funds must be maintained for industrial assurance and ordinary long-term business.

Section 29 provides, *inter alia,* that, apart from the reimbursement of expenditure borne by other assets and the distribution of valuation surplus determined according to the provisions of Section 18 of the Act, the assets representing the long-term fund may not be used for any other business of the company. The surplus disclosed may be allocated to with-profits policyholders, transferred to shareholders' funds or retained in the long-term fund.

Section 30(3) provides that, if it is proposed to reduce the proportion of surplus allocated to policyholders by more than 0.5% by comparison with the proportion of surplus last allocated, then notice must be served on the DTI, and an approved statement must be published in such ways as directed by the DTI. Not less than 56 days must have elapsed after publication before the proposed allocation is implemented. Section 30 does not confer any rights on a policyholder on receipt of the notice. However, he could make representations to the DTI to exercise its powers of intervention.

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A.6.3 *Articles of Association or Regulations*

A.6.3.1 The Articles of Association or regulations of the life insurer may specify that policyholders and shareholders will be entitled to participate in profits declared by the directors in specified proportions — frequently 90:10. However, the Articles may specify no such percentage, and it is common for the directors to be given a power prior to apportionment to carry forward such sums as they see fit. In its statement of 24 February 1995, the DTI states that it considers that "the proportion of policyholders' and shareholders' interests in the surplus are unaffected by whether or not the surplus is actually distributed — that is, if in any year surplus is not distributed but is retained in the fund, the policyholders as a class retain their interest in that element of the fund." It has not been conclusively established that, in all cases, *undistributed* profits are necessarily 'owned' by policyholders and shareholders in the same ratio that applies to *distributed* profits. Some legal opinion takes the view that policyholders have no special rights or interest in respect of undistributed surplus. If the articles do not specify a percentage for the split, the DTI has said that it would expect a 90:10 proportion to be adopted, "unless there was clear evidence, based on a company's circumstances, statements or practice, that a different proportion was appropriate in respect of the surplus arising from some particular part of the business".

A.6.3.2 There would be no statutory constraint (subject to the powers of the DTI to intervene, mentioned below) on a company changing its Articles of Association so as to adopt a different ratio for distribution of surplus.

A.6.3.3 Such a change would necessitate, however, a consideration of the contractual rights of policyholders.

A.6.4 *Contractual Position*

A.6.4.1 The Articles of Association may give rise to an implied term of a policy, insofar as they have been referred to in marketing literature or a with-profits guide. However, it appears clear, as a matter of law, that, even if the division of declared profits set out in the Articles is an implied term, this, of itself, would not prevent the Articles from being changed without the consent of individual policyholders. However, the company could be liable to damages to a policyholder if it sought to give effect to a change which gave the policyholder less than that to which he would otherwise be entitled.

A.6.4.2 Quite aside from the Articles of Association, policy literature of itself, or other representations made by the company or its agents, may give rise to a term in the policy or constitute legally enforceable representation as to the distribution of profits which could create legal rights on the part of the policyholder. However, in order to recover damages in respect of these rights, it would be necessary for a policyholder to establish that a change in the Articles or a reorganisation of the long-term fund (for instance into with-profits and non-profit sub-funds) caused him actual loss or damage.

A.6.4.3 In the normal case these rights will arise in respect of *distributed*

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profits, and will not have a bearing on ownership of the surplus, unless specific references have been made to it in policy terms or marketing literature, which is unlikely.

A.6.4.4 However, the contractual position is not all that has to be considered; the DTI has a responsibility to safeguard PRE, which is a factor every bit as significant as the purely contractual rights of the policyholder. The DTI takes the view that the Articles of Association are an important reference point for PRE, and any change in the Articles which adversely affected the balance of interests between policyholders and shareholders could be considered to breach PRE if applied to existing policyholders.

A.6.5 *Policyholders' Reasonable Expectations*

A.6.5.1 *Section 37(2)(a)* confers grounds for intervention by the Secretary of State if he considers that an insurer will be unable to fulfil the reasonable expectations of policyholders or potential policyholders.

A.6.5.2 *Section 45* contains a direct power for the Secretary of State to require a company to take such action as appears to him appropriate "....to fulfil the reasonable expectations of policyholders or potential policyholders."

A.6.5.3 PRE is not defined in the legislation, and has not been the subject of construction proceedings in the court.

A.6.5.4 The working party on PRE (whose conclusions are contained in Appendix 3) considered whether policyholders have a reasonable expectation to share in the inherited estate :

> "It has been suggested that the reasonable expectations of with-profits policyholders in a proprietary company do not extend beyond their asset shares. This implies that if such a company decided to restructure its operations (for example by creating a separate fund for with-profits business) the balance of the Orphan surplus would fall wholly to the shareholders. The existence of such a possibility could lead to serious conflicts of interest in the operation of with-profits business within a proprietary company which are unlikely to be understood by policyholders. The working party considers that the profit sharing arrangements described in the Articles of Association may form an important part of PRE. However their expectations may be based on the actions of the company, perhaps over many years."

A.6.6 *Supervisory Powers of the Department of Trade & Industry*

A.6.6.1 The DTI does not have any specific power to compel distribution of the inherited estate or any specific power to intervene to prevent such distribution.

A.6.6.2 *Sections 38 and 41 to 45* contain specific powers of intervention for the DTI, which are exercisable on various grounds, including that the DTI considers it to be desirable to intervene for the purpose of "protecting policyholders or potential policyholders of the company against the risk that the company may be unable to meet its liabilities, or, in the case of long term business, to fulfil the reasonable expectations of policyholders or potential policyholders"; or that any of the criteria of "sound and prudent management is

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not or has not been or may not be or may not have been fulfilled" with respect to the company.

A.6.6.3 *Section 11* gives the Secretary of State the power to withdraw authorisation to write new business by reference to the criteria of sound and prudent management, or, more likely in these circumstances, for failure to satisfy an obligation to which the company is subject by virtue of the Act. The latter would include obligations placed on the company by the Secretary of State in the exercise of his intervention powers.

A.6.6.4 Where a restructuring of the long-term fund is to be accomplished by way of a scheme under Schedule 2C to the Act (previously contained in Section 49), then the scheme will require the sanction of the High Court, and the DTI will have the right to object to the scheme. In practice, its views will carry considerable weight.

A.6.7 *Could the View of the DTI be Challenged?*

A.6.7.1 The only practical way in which the exercise by the DTI of its regulatory powers could be challenged would be by way of an application for judicial review in respect of an intervention by the Secretary of State under the powers mentioned above. The courts are not prepared to become involved in hypothetical cases, and so it would be necessary for a challenge to be mounted in relation to an actual regulatory decision.

A.6.7.2 Judicial review is a notoriously unpredictable area of the law. The classic grounds for judicial review are :

(1) *Illegality.* Has the decision maker understood correctly the law that regulates his decision making power and given proper effect to it?
(2) *Irrationality.* The court will not take it upon itself to decide whether the administrative decision is itself a reasonable one on an objective basis. Instead, it will ask whether the decision is so irrational that no reasonable decision maker who applied his mind to the question to be decided could have arrived at it.
(3) *Procedural impropriety.* Have the rules of natural justice, procedural fairness and the obligation to observe procedural rules laid down in the statute been complied with?

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APPENDIX 7

THE ROLES OF THE APPOINTED ACTUARY AND THE INDEPENDENT ACTUARY

(This appendix is referred to in ¶6.3.)

A.7.1 The DTI is strongly supportive of the important role that the Appointed Actuary plays as impartial adviser to his board on any proposals under consideration by the company which may have an impact on PRE, such as the clarification of the policyholders' and shareholders' interests in the inherited estate. However, the DTI is also aware that the Appointed Actuary has a duty under GN1 (paragraph 2.3) to consider any material conflict of interests (for example, the ownership of shares and share options) which would seem to arise in special situations, such as exercises of this nature. It is also normal practice for a company that is undertaking such an exercise to employ the services of a consulting actuary to advise the board on the shareholders' interest in the inherited estate. The DTI also considers that it has a duty to ensure that such high profile exercises are demonstrably seen to take full account of policyholders' interests.

A.7.2 Consequently, the DTI has decided, in such cases, to require a report to be commissioned from an independent actuary, addressed to both the company and the DTI, on the effect of the company's proposals on policyholders' interests. It is intended that the full report, subject to the exclusion of certain information on the grounds of commercial confidentiality, should be available to policyholders. The DTI considers that these requirements will ensure that the process is conducted in a way that preserves an appropriate balance between the interests of policyholders and shareholders. The approach has the advantage that it ensures openness and clarity, and avoids any impression that the DTI is doing deals behind closed doors, and closely parallels the arrangements for Schedule 2C (Section 49) transfers.

A.7.3 The terms of reference set for the independent actuary will vary, dependent upon the particular circumstances of each exercise. However, the independent actuary will be expected to adopt a pro-active role, by researching the past records of the company and statements made to policyholders, in order to prepare a report on the interests and reasonable expectations of policyholders of the company. The independent actuary will be expected to report on the influence of the following factors on PRE:

- the fair treatment of policyholders *vis-à-vis* shareholders;
- any statements by the company as to its bonus philosophy and the entitlement of policyholders to a share in profits;
- the history and past practice of the company; and
- general practice within the life assurance industry.

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A.7.4 The report of the independent actuary will also be expected to include statements of his or her views on the appropriateness, from the policyholders' perspective, of:
— the proposed arrangements of the company;
— the methodology and assumptions which the company has used;
— the accuracy of the company's calculations; and
— the extent to which the company has met the requirements of the Department's policy statement on 'Orphan Estates', dated 24 February 1995.

A.7.5 In addition, the independent actuary may be asked to consider the initial implementation of the company's proposals, and the manner in which the implementation might be monitored in the future.

A.7.6 The role of the Appointed Actuary in the project is as set out in paragraph 3.3 of GN1. The Appointed Actuary has a duty to advise the company of his or her interpretation of PRE, and to ensure that the company appreciates the implications for the reasonable expectations of its policyholders of the proposed arrangements. The Appointed Actuary would be expected to provide the board with a balanced interpretation of the reports produced by the independent actuary and the actuary advising the company on the shareholders' interests.

A.7.7 Similarly, the DTI will reserve the right to form its own view on the merits of any proposals put to it, in the light of advice from the Government Actuary's Department, as well as the reports and opinions of the other parties involved.

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ABSTRACT OF THE DISCUSSION

HELD BY THE INSTITUTE OF ACTUARIES

Contributors to the discussion were requested to state their views on the following specific questions:

Question 1. Ignoring the smoothing of investment returns, are the reasonable expectations of current with-profits policyholders affected by the level of payouts to former with-profits policyholders?

Question 2. Ignoring the smoothing of investment returns, are the reasonable expectations of future with-profits policyholders affected by the level of payouts to former with-profits policyholders?

Professor S. L. Smaller, F.I.A. (introducing the paper)**:** In the paper the members of the working party attempted a broad coverage of the main areas involved, avoiding such matters as the philosophy of bonus declarations or being prescriptive on actuarial bases to be used in particular circumstances. Had time allowed, we would have liked to have explored in detail the effect on shareholders and with-profits policyholders of closing the fund to new business, and, conversely, the effect of expanding the with-profits portfolio. Depending on the size of the inherited estate (IE), the former scenario could benefit existing with-profits policyholders possibly disproportionately, while the latter generally would favour shareholders. Fundamental to our deliberations was the concept of policyholders' reasonable expectations (PRE) — an expression enshrined in legislation, but yet to be interpreted by the courts. Here we relied on the conclusions of the working party on PRE and on the interpretation and implications in the published literature of life offices.

There was general agreement on most of the issues involved, but it was accepted that other approaches were possible on some questions, such as the identification and quantification of the IE.

Mr C. J. Hairs, F.I.A.: The office for which I work is one of those referred to in ¶1.3, and my comments may be helpful as a supplement to Appendix 2.

Our starting situation was unusual. We only began to write with-profits business, in the full modern sense of the term, just over 40 years ago, in spite of having been in existence for 160 years. At that time, 1954, the articles were changed to establish rules for sharing the profits derived from this (for us) new class of business, viz. with-profits. The rules were simple. The division was a strict 90:10 on profits as they were distributed. Other profits, it was made clear, were for the benefit of shareholders. However, with a new line of with-profits business to finance, the revised articles also provided directors with the power, at their absolute discretion, to make parts of these other profits available to support the with-profits business.

For the next 20 years the directors made use of that discretion, transferring across to the with-profits side amounts which averaged more than 40% of the cost of bonuses over the same period. After that period this support dropped to around 5% of the cost of bonus on average, but the accumulated value of the first 20-years support was considerable.

Also, after about 20 years, an event happened which could not possibly have been foreseen when the articles were changed, namely the introduction, through the 1973 Insurance Companies Amendment Act, of the $\frac{1}{2}$% rule. This meant that, unless they went through a certain potentially onerous procedure, directors could not, at any declaration, increase the shareholders' proportion of profits by more than $\frac{1}{2}$% from what it had been a year previously. The limitation applied to all profits in which policyholders were eligible to participate. Because, in our case, directors had the power to make non-profit profits available, even though only at their absolute discretion, this meant that *all* our life and annuity profits were subject to the $\frac{1}{2}$% rule. This was to become a material limitation on our

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ability to provide *shareholders* with a proper yield on *their* investment in our non-profit business, even after the strength in the with-profits fund had built up to the point at which further support from the non-profit fund was unnecessary.

We thus approached the DTI, and agreed that we would appoint an independent actuary to consider and report upon our emerging proposals from the perspective of policyholders. Of course, as Appointed Actuary, I would already be reporting, and did indeed report on behalf of all stakeholders in the fund.

We decided that, for our company, the right way to tackle the problem of the ½% rule was to go to the source of our difficulty and amend the wording of our articles. Within our corporate structure this could have been achieved wholly internally. However, it was of paramount importance to retain the confidence of our policyholders. We therefore agreed with the DTI that we would circularise all 1½ million of our with-profits policyholders with information about the proposals.

In order to provide comfort and externally evidenced facts to all interested parties, we undertook extensive internal financial investigations of both a retrospective (mainly asset share-based) and a prospective nature, building upon work that we had already announced several years earlier, in 1991. We also made a thorough review of the many items of literature that our policyholders had received over the years. All five of areas (a) to (e), given in ¶4.1, were considered at length.

These investigations confirmed and quantified several important points:

(1) On a wide range of interpretations of the expression PRE, we confirmed to ourselves and to the independent actuary the adequacy of the with-profits part of the fund to meet PRE without reliance on future further support from the non-profit fund. In due course we published our view that there was an estimated margin in the with-profits part of the fund of some £1.2 bn to £1.5 bn beyond the amount necessary to meet PRE for existing policyholders, together with associated shareholder transfers from the with-profits side.

(2) We were able to satisfy all parties that this margin came, *not* from withheld surpluses from past with-profits policyholders, but was part, but only part, of the accumulated value of the support that had been provided from non-profit sources, that is from profits that otherwise were fully and properly available 100% to shareholders. In terms of ¶5.1, all of our IE on the with-profits side came from source (a). Although undoubtedly, within the normal with-profits process, there is a cross-sharing of profit between policyholders, we considered it very important to be able to confirm to our policyholders that the declared strength of the with-profits fund was referrable fully to this external support; external to the with-profits fund, that is.

(3) Thirdly, and importantly, we took the view, in the context of the wording of our articles and what we felt was implicit in our approach to with-profits business, that this strength of the with-profits fund was definitively part of that fund. We were not seeking in some way to extract the £1.2 bn to £1.5 bn for shareholders. We confirmed that it was still within the with-profits fund and still subject to our 90:10 article.

A further feature of finalising our articles' changes was that we made the important adjustment of converting 90:10 to the 'at least 90: not more than 10' form, and additionally identified a sub-fund within the non-profits fund from which, if directors ever so chose, further profits could be made available for bonus. We also, as tangible evidence of the strength of the fund, declared a special bonus for our policyholders.

I add, for completeness, that, in addition to the IE on the with-profits side, we also have another IE in the remaining non-profit part of our long-term fund. In our view, the source of this other IE is retained surpluses from our non-profit past, and so this other estate is properly to be regarded as owned wholly by shareholders. This, however, is not a new conclusion.

At the end of our investigations the DTI confirmed to us its support for our proposals. We wrote to our with-profits policyholders outlining what we were proposing. We offered further details in the form of a 27-page booklet, and eventually sent out over 30,000 copies. We invited comments, which were all (a few hundred) reviewed by the independent actuary as well as by ourselves, and reported upon to the DTI. Most of the comments were either questions or misunderstandings. None of the

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comments raised issues that had not already been considered, and our new articles became effective on 1 February 1996.

I worry about questions such as the two that have been asked of us, because I worry that, in seeking to strengthen and closely define the PRE concept, the value and purpose of the concept will be undermined. Paragraph 4.3 refers to PRE as an *obligation*. This seems particularly dangerous, given the strong contractual overtones that attach to the word obligation. In this context, I also point out that I believe that the statement in ¶A.6.5.2 is *wrong*. The Section 45 power of the Secretary of State, as I read the Act, is to take action against the risk that the company *may be unable* to fulfil PRE. This is not at all the same as a power to require the company to fulfil PRE.

If it is possible, against this background, as to the status of PRE to make comments that will not be misunderstood, I contribute the following:

(1) A company should strive to preserve both solvency and fairness, and policyholders should expect this.
(2) Policyholders should expect a good degree of consistency of behaviour over the years, but not such as to lock the company into past practices. Generally change should be smoothed.
(3) Companies should be expected to stick by what they have said to policyholders, especially what they have said in writing, which is less likely to be misunderstood. However, reasonable policyholders should be expected to have read material provided to them (including caveats like 'the past is not necessarily a guide to the future', and 'bonus rates can go down as well as up').
(4) To expect to be able to separate out the operation of smoothing in judging PRE seems to me an impossible question, or pair of questions.

So, I think that my answer to both questions is "yes, sometimes, but only a bit amid a number of other factors and not in a locked-in sense". Others might interpret that as 'no'.

Mr R. E. Brimblecombe, C.B.E., F.I.A.: My comments are made primarily from the point of view of the independent actuary.

An unfortunate myth, that PRE need to be considered almost entirely in terms of asset shares, appears to be growing, but I believe that asset shares should be considered as a base point, and I believe that there are other issues which need to be taken into account. In relation to market comparisons on maturity values; rightly or wrongly the company's past performance on its with-profits policies is compared with the office's peer group, and, if it has been the practice of the company to ensure that with-profits policyholders receive competitive pay-outs, this has, in my view, created a PRE possibly in excess of asset values. Then there is the question of surrender values, which, whilst not technically guaranteed, may have been pre-quoted in a manner which might lead policyholders to believe that surrender values could not be reduced. This again is a PRE issue, as the cost of meeting any apparent guarantee should not be debited against asset shares.

Considering financial strength, it has been market practice for with-profits business to be sold on the basis of free asset ratios, particularly since the introduction of the Financial Services Act. Although this is, perhaps, more prevalent in the independent financial advisers' market than in direct sales, nevertheless references in the financial press and, no doubt, by direct salesmen to this issue are likely to have been a material factor when sales have been made. Offices which, traditionally, have had substantial free asset ratios are likely to have had business attracted to them because of it. One reason for this is that high levels of free asset ratios indicate substantial financial strength; another is that it enables life offices to have substantial investment freedom, with particular emphasis on equity investments which, in the long run, should lead to higher levels of bonuses. I am, therefore, of the view that high levels of free asset ratios have created PRE which have to be taken into account, as they are, by definition, likely to be reduced in any exercise to apportion the IE.

I now consider the office's philosophy on how the level of reversionary bonus, as opposed to terminal bonus, is determined. This has led to a policyholders' expectation as to how much of the surplus is declared by way of reversionary, and how much by terminal, bonuses, and the ability to maintain this split is an important factor to be taken into account.

Reference is made, in ¶5.4, to the arbitrary 90:10 ratio being 'unsound'. While this may be correct

https://doi.org/10.1017/S1357321700004906 Published online by Cambridge University Press

in relation to long past history, I would need a lot of convincing that 90:10 is not the *de facto* position for ordinary business for many years and for industrial business for the last 30 years or so. Policyholders' interests would be ill-served if custom and practice in the industry over a number of years were to be ignored.

As far as asset shares are concerned, the key issue is whether, if bonuses in the past have been declared in excess of asset shares, this has created PRE in the minds of with-profits policyholders; that is that the IE will be used to maintain payouts of that level. The paper refers to the fact that many offices have been realigning downwards where bonuses have been declared in excess of asset shares, and ¶4.5 refers to the lower level satisfying PRE. However, unless a statement has been made publicly that this is to be the case, then the higher level of pay-outs has created a PRE and should be maintained.

To that extent I answer the specific questions that we have been asked to address as follows. I believe that where payouts have consistently been made in excess of smoothed asset shares, a continuance is almost certainly necessary to meet the reasonable expectations, certainly of current policyholders, and, unless a separate bonus series or different type of contract is to be introduced, probably of future policyholders as well.

Mr P. J. Nowell, F.I.A.: It is stated, in Appendix 3(3), that PRE include consideration of a closed fund alternative whenever a major change in a life fund is considered. I find it hard to see why this should apply in a proprietary office where policyholders have no say, even theoretically, in a decision to close a fund. Certainly other tests would pick up any unfairness — for instance, where a small strong office was being merged into a weaker large office, the difference in free assets would be remarked on. The difficult situation is the case of a strong, efficient mutual. Triggered by some event that causes the office to consider a 'major' change, it is proposed that the office must consider a 'closed fund' alternative. I would think that present policyholders of any strong mutual would, almost without exception, be better off if it closed to new business and shared out the estate over the lifetime of existing policyholders. Provided policyholders got their fair share of the estate, even through a demutualisation, those policyholders who are members, and hence owners of the company, might be still better off if new business can be written profitably and expenses per policy kept low. In other words, present members would gain both the IE and the value of future new business. Therefore, if we were to accept Appendix 3(3) as correct, then all mutuals should be actively considering demutualisation.

I find this a rather depressing conclusion, in that current policyholders will be gaining the benefit of the amounts prudently and necessarily built up from previous generations of policyholders, and ending a tradition that often dates back a century or more. I am sure that the founders of these mutuals would not regard this windfall as in any way reasonable.

It seems to me that a good starting point in working out who 'owns' the IE is to find out where it comes from. This is, I think, the general approach of the paper, and of the Department of Trade and Industry (DTI). In ¶5.1(a) and in ¶5.9(a) reference is made to one possible source of IE as the injection of capital by shareholders. I suggest that not taking earnings out is an equally valid source. This is especially true, as in ¶5.1(b) reference is made to "the retention of surplus for prudential reasons".

It seems to me that, if you can trace IE to shareholders injecting capital or forgoing part of their share of surplus, then, at least prima facie, shareholders have a good claim to ownership. This would also be consistent with the DTI's statement that, failing all else, they start from a 90:10 split of the IE. In that context, it is interesting that the last two lines of ¶A.1.4 read, "if, in any year, surplus is not distributed, but is retained in the fund, the policyholders, as a class, retain their interest in that element of the fund."

I am sure that the main thrust of this comment from the DTI is to say that shareholders cannot plan to appropriate surplus from one set of policyholders by not paying out their reasonable entitlement, and that policyholders, over time, should receive 90% of surplus. I support this argument fully. However, a logical corollary is that the amount of surplus attributed to shareholders should not be

https://doi.org/10.1017/S1357321700004906 Published online by Cambridge University Press

influenced by whether or not it is extracted in any year. In either case, of course, account needs to be taken of investment earnings on any amounts retained in the funds.

I believe that the paper sets out the issues surrounding the attribution of the IE, and will be used as a check list and position paper on which discussions about each particular office can be based. In each case it will be important to think through the logic of the points made from the shareholders', as well as the policyholders', point of view. There should be fairness to policyholders as a class. An approach which, as far as PRE are concerned, would seem to me to be fairer than the closed fund test would be to consider the policyholders' class as including past, present and future policyholders. If we think of fairness and reasonable expectations as including the continued introduction of new policyholders, we could avoid the unfairness of present policyholders gaining a windfall benefit from past policyholders. For a mutual, however, there remains the issue of membership rights, which can, theoretically, include insisting on a closure to new business, but this should not be confused with PRE.

My answers to the two specific questions are:

(1) 'no', except in the short term, because of smoothing rules; and

(2) at the absolute level 'no', but at the relative, league table, level 'possibly'.

Mr N. J. Dumbreck, F.I.A.: There is much potential for conflicts of interest between policyholders and shareholders in a proprietary life company writing with-profits business. These potential conflicts are much reduced if interests are aligned by fixing the proportions of distributed surplus allocated to policyholders and shareholders, such as in a typical 90:10 company. Shareholders can only get more for themselves by giving more to policyholders. If, on the other hand, shareholders can ultimately benefit from the under-distribution of surplus to policyholders because they will get what is left over, there may be a temptation to be less than generous, and the identity of interest between policyholders and shareholders will break down.

There is agreement within the working party that this should not be allowed to happen in the future, but there seems to be some implied support, in ¶¶5.4-5.6, for the view that shareholders should be the main beneficiaries of past under-distributions. I have some difficulty with such a distinction, and tend to support the views in ¶5.7. However, I accept that there are a number of companies in which special circumstances apply, and agree that a clear understanding of the origin of the IE is an essential prerequisite to determining its ownership.

Having said that, I am not convinced that the legislative framework is quite as helpful to the authorities, as is suggested in ¶5.10. Section 30 of the Insurance Companies Act 1982 requires policyholders to be informed of any significant change in the proportionate allocation of profits, but it does not provide any means of blocking a change to which policyholders object. This is left to the Secretary of State's general powers of intervention under Section 45, but the main ground for such action is to protect the fulfilment of PRE. Since, according to the definition in ¶3.1, the IE clearly falls outwith PRE, the case for intervention may be relatively weak.

This is, though, an over-simplification of the position. The presence of the IE may be necessary to meet PRE because of the additional security and investment freedom it provides, even if the policyholders have no claim to share in it when it is ultimately distributed. This creates the interesting possibility in some companies that, if shareholders can establish a claim to a substantial part of the IE, it may be in their interests to close the with-profits fund to new business to accelerate the distribution of the windfall.

I believe that it is highly desirable to clarify profit sharing entitlements wherever they are uncertain, both to help with-profits policyholders know where they stand and to prevent predatory action aimed at unlocking orphan assets. It is also helpful for realistic financial reporting. However, there is a possibility that, as existing uncertainties are being resolved, new ones are being created. A common arrangement in a demutualisation is for a with-profits sub-fund in which shareholders are entitled to a 10% share of surplus distributed to conventional with-profits policyholders, but none of the surplus distributed to unitised with-profits policyholders. It seems fairly clear that the shareholders' interest in the IE cannot exceed 10% in such a situation, but it might be zero or somewhere in between. There

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are perfectly sound reasons for choosing this type of structure, but it may be desirable to have some ground rules covering what would happen if the IE were no longer needed.

I think that I have said enough for you to be able to deduce my answers to the two questions, although I believe that they depend, to some extent, on the circumstances.

Mr J. T. Young (a visitor): It is very important, when discussing a topic of this nature, to be rigorous about separating the philosophical aspects of the discussion from a clear analysis of the strict legal rights. Normally the latter should follow the former — and may, of course, include proposals for amending the relevant law. The emotive nature of the subject under discussion means that this subject is particularly prone to the philosophical approach underlining the legal analysis.

I broadly agree with the summary of procedural and statutory aspects set out in Appendix 6. However, I believe that the law has more to say on the subject. There are common threads running through the law relating to corporations which distinguish clearly between the rights of the proprietors of a corporation (the shareholders in the case of a proprietary life office), the rights of those who contract with the corporation (including policyholders), and those whose rights derive from statute or from some other branch of the law (such as regulatory authorities). An individual may have rights under two separate heads, and this is a fertile area for confusion. Thus, for example, in a mutual life office an individual may typically have a basket of barely distinguishable rights both as a policyholder and as a member. In a proprietary company the rights are much more distinct, and the example of the windfalls currently available to members of mutuals must not over-influence the analysis of the proprietary company.

One of the most important rights attaching to the proprietor of a corporation is the right to receive the surplus assets of the corporation on a winding up. In this regard, a with-profits life office is legally in a position no different from any other corporation, save insofar as that position is modified by statute. The law has, of course, indirectly imposed certain modifications to this rule, *inter alia* in the form of Section 30 of the Insurance Companies Act 1982 and the sections permitting regulatory intervention in order to safeguard PRE. However, these sections are regulatory tools — they do not award new rights to policyholders. Section 30 did not exist before 1973. I believe that Section 30 was designed to enable regulators to enforce a fair allocation of the income of a proprietary life office. For Section 30 to be used so as permanently to divert a significant proportion of IE to policyholders is, in my view, confiscatory and a misuse of the section. It may not universally be regarded as 'fair' that such assets should be attributed to the proprietor, but any diversion of surplus assets from the proprietors should be a question for a change in the law. To regard such diversion as part of PRE is a dangerous leap in logic from the much more complex legal situation applying to mutuals.

Nor is such an attribution necessary to look after the proper interests of policyholders. The proper interests of policyholders require the existence of a healthy estate available to ensure the maintenance of a healthy equity backing ratio in the life fund. Such segregation may properly be expected to last the life of the fund. However, once the last policy has expired, the surplus assets properly revert to the proprietor. This is similar in kind to the mortgage of an asset of large value in order to secure the repayment of a small loan. The asset is tied up for a long period, but then reverts to the owner when the loan has been repaid. By contrast, the permanent attribution of a large proportion of the IE to policyholders as a class logically results in a tontine in the case of a closed fund, which is neither morally nor, in my view, legally defensible.

Thus, from what I have said, I wholeheartedly support the analysis set out in ¶5.4.

Mr P. J. Turvey, F.I.A.: I start with my conclusions:

(1) PRE require comparable treatment from proprietary and mutual offices. The key difference is the 10% charge on distributed surplus.
(2) PRE establish a floor to policyholders' expectations, not a ceiling. If benefits would exceed PRE, then this is not an argument to deprive policyholders of assets to which they would otherwise be entitled.
(3) Shareholders should never receive more than 10% of distributed surplus, unless they have historic rights that were documented at the time those rights are alleged to have been established. Rights

https://doi.org/10.1017/S1357321700004906 Published online by Cambridge University Press

that have been ignored for decades wither from disuse. It becomes a policyholder's reasonable expectation that they will never be used. They cannot suddenly be rediscovered.

(4) The existing procedures for approval of reconstructions of this kind need to be strengthened. Someone should have a duty to promote the interests of the policyholders as strongly as we expect shareholders to promote their own position. Also, policyholders should have a better opportunity to be heard.

We can learn important lessons by comparing with-profits proprietaries and mutuals. Paragraph 5.1 lists five sources of IE. Four of these apply equally to mutual offices. It would be wrong to treat proprietary life funds in a way that was materially different from what would happen in a mutual. A mutual can be thought of as the limiting case of a proprietary with a 100:0 fund instead of a 90:10 or a 95:5 one. Only the policyholders' proportion is different. There should be continuity of treatment.

Any rule which applies to a proprietary fund should continue to make sense as the shareholders' proportion diminishes from 10% to zero. There should be no discontinuity. Surplus should not be removed from the fund without going through the 90:10 gate. This consideration outweighs all the other factors that determine PRE. Where there is a conflict, the principle of continuity must reign supreme. If, in some circumstances, this produces payouts in excess of PRE, so be it. We should not be distracted by arguments that the with-profits guide gives the policyholders no right to the IE. If it is distributed, they should get 90%. PRE set a floor, not a ceiling.

Comparison with mutuals also encourages us to regard the IE as the accumulated effect of smoothing, arising from systematic under-distribution in the past. The smoothing arose because directors did not feel that it would be prudent to declare higher bonuses. The accumulated funds should only be used for further smoothing, albeit over a longer period than normally envisaged.

If we accept the principle of continuity, or the smoothing concept, we have no further need to consider PRE; but, if we must try to work out what PRE is, a proprietary with-profits fund poses all sorts of problems, which the profession is still only beginning to address.

These arise because we are trying to deal with a curious financial animal. A proprietary with-profits fund is a historical accident, and would not be invented today if we were starting with a clean piece of paper. We would not permit a situation where there was uncertainty about the ownership of very significant sums of money, or where the amounts paid to policyholders depend to such a large extent upon the discretion of a board of directors.

There are a number of difficult issues relating to establishing PRE in a proprietary company. For example, when I took out my first with-profits policy with a proprietary company, the portion of surplus distributed to policyholders was 93%, with only 7% going to shareholders. This was a long-established practice, and I think that the company referred to this in its marketing material. I naturally assumed that this would continue for the duration of my policy, but I was wrong; it was changed to 90:10. Was continuation of 93:7 a reasonable expectation?

In nearly all proprietary companies the shareholders receive 10% of the cost of bonus valued on the statutory basis. This overstates the true cost of bonus. The shareholders' share of the actual cost will always be larger — perhaps around 15% — depending upon a number of factors. This feature is well known to actuaries, but little discussed in public. I have never seen any reference to it in DTI Returns or in with-profit guides. In terms of orders of magnitude it is potentially very significant. I wish that it was referred to in the paper. Is it the PRE that this is established practice throughout the industry, even if not understood by the man in the street, or are PRE what a reasonable man would understand, namely that shareholders received 10% of the realistic cost of bonus?

In past years proprietary offices have often offered similar or better overall returns than mutuals. To the extent that the bonuses were enhanced by using the earnings on the IE, it could be argued that PRE are for a continuation of this practice, so perhaps the IE is already spoken for.

I now look at the interests of the shareholders. Not so long ago it was generally accepted that it was uneconomical to start a new with-profits fund, because any shareholders' funds injected as seed capital would be subject to the 90:10 gate on both investment earnings and capital repayments. The only time when shareholders may have an exceptional interest in the IE is when they have put money into the life fund under terms that made it clear that they planned to recover it when it was no longer

https://doi.org/10.1017/S1357321700004906 Published online by Cambridge University Press

needed; moreover, that they expected to recover it in some way other than through a share in the cost of bonus.

Where capital is repayable, it is also necessary to consider whether the shareholders are entitled to compound interest on any such injection, and, if so, at what rate. One extreme would be to argue that they have already been remunerated for the opportunity cost of the funds — through their share in cost of bonus — and are only entitled to a recovery of capital. At the other extreme, it might be argued that their money was invested in a notional pot of equities, and should now be returned together with reinvested dividends. In either case it would be necessary to enquire as to whether the investment policy of the life fund had been consistent with such an approach.

I am not impressed by arguments based on the fact that the majority of current business may be non-profit or unit-linked, from what the profits should accrue to shareholders. Look back to the origins of this business. When companies started unit-linked business, they made a conscious choice either to write it in a shareholder-only fund, or in the 90:10 with-profits fund. Where the with-profits fund was used, there were presumably good reasons, such as access to the free assets of the life fund, to finance the business. The with-profits policyholders financed the business, took the risks, and are entitled to the rewards.

Probably the worst argument quoted in the paper, supporting the attribution of part of the IE to shareholders, is that equity is not served by systematic transfers from past policyholders to current policyholders. Equity is served even less well if the IE benefits the successors of shareholders who paid exiting policyholders too little, albeit without malice aforethought. If exiting policyholders had received their asset share, shareholders would have received 10% of the what is now the IE. This must represent the ceiling on the shareholders' interest.

I have one question for those who think that shareholders are entitled to money representing past systematic under-distributions. Even if it were accepted that shareholders could benefit from past under-declarations, there is an obvious corollary. If shareholders are entitled to the benefit of under-distribution (other than for smoothing reasons), they should also make good any *future* over-distribution. Consider the problems that could follow. If it turned out, with the benefit of hindsight, that a whole generation of policyholders had received more than their asset shares — which could not be established until years after the event — someone would have to decide whether this was legitimate smoothing or a mistake, because this would determine whether the loss should be borne by shareholders or by other policyholders. In practice this would be an insoluble problem, and I cannot imagine shareholders ever accepting the responsibility — even if they could afford the huge sums that might be involved. Also, if the threat were real, directors would be tempted to become very conservative again, and start another cycle of under-declaration that would be in no-one's interest.

The DTI's stated position, shown in Appendix 1, implies that (subject to safeguards) any IE in excess of that needed to fulfil PRE can be attributed to shareholders. The company will naturally be a protagonist to maximise its own interests, and a proper hearing of the argument requires that someone should represent the interests of policyholders with equal vigour. The shareholders are supported by the directors, the management, the professionals employed by the company, their lawyers and their consulting actuaries. In contrast, support for the policyholders comes only from the Appointed Actuary and the independent actuary, whose briefs are limited to ensuring that the policyholders receive their reasonable expectations.

The Appointed Actuary has two masters and a conflict of interests. Neither he nor the independent actuary is asked to maximise the interest of the with-profits policyholders, but only to ensure that they get their PRE. They are not expected to argue strongly for maintenance of the 90:10 status quo. Individual policyholders cannot possibly mount a concerted defence against the shareholders. Whilst the DTI will, no doubt, be conscious of this imbalance, and perhaps seek to give the benefit of any doubt to policyholders, it cannot be expected to adopt a partisan or adversarial stance versus the insurance company; its role is that of an umpire, to see that the proper procedures and guidelines are followed. Policyholders should not have to rely upon the DTI to promote their interests.

In reconciling the claims of policyholders and shareholders there should be a level playing field. Policyholders and shareholders should have equal expertise and resources to defend their interests. The best way to do this would be to appoint a policyholders' actuary to promote their interest, and

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his costs should be a charge on the fund. Arrangements could be made for him to report to a representative body of the policyholders. The policyholders' actuary must have sufficient time to deal thoroughly with any proposals emerging from the company, and have full access to the supervisory authorities. The independent actuary — if we still needed one — could then act as an expert arbitrator in the event of disagreement.

Negotiations regarding any major change to the status of a with-profits fund are conducted between the company and the DTI/GAD in conditions of secrecy, and only the final conclusions are exposed to the light of day. The policyholder has no option other than to rely upon the professionals involved to protect his interest.

The paper is not clear about the distribution of the report of the independent actuary. It should be sent automatically to all with-profits policyholders. It should be in sufficient detail to satisfy an actuary knowledgeable in these matters, and there should be sufficient time for the reader to consider the points involved, and an opportunity to make representations. As the paper points out, a judicial review of the DTI's decision is neither the time nor the place to influence thinking. The long stop should be an open hearing — like the court hearing in a transfer — where aggrieved policyholders can be heard, but even this is much too late in practice.

With respect to the two questions posed, they are the wrong questions, but I would say 'yes', 'yes', if you insist. As I said before, PRE are the floor, not the ceiling; we have to accept that any attempt to distribute the IE will lead to payments in excess of PRE.

Mr C. D. Daykin, C.B., F.I.A.: Proprietary offices are remarkable structures. Their with-profits contracts are unusual, since the company has agreed to share profits with a particular set of its customers without, in general, any clear formula having been set for the individual entitlement. The concept may well be unique to the insurance industry.

In recent years asset shares have come to the fore as a favoured method for considering issues of equity in the treatment of different generations or classes of policyholders. However, an asset share, as usually used, is merely a retrospective reserve. Provided that they include all the wider sources of profit in which the policies could share, asset shares provide a valuable guide to the reasonableness of payouts in normal circumstances. They cannot be said, on their own, to determine PRE, particularly in the event of a significant restructuring or other change. This is recognised, in practice, even by their strongest advocates, with the inclusion in their calculations of various adjustments, for example contributions to the security provided by the estate, smoothing charges and charges for guarantees. Asset shares are useful tools, but cannot be regarded as a complete representation of PRE, which cannot be quantified in a simple, mechanical way. If PRE mean anything, they must include the concept of equity or fair play, and this inevitably involves actuarial judgement. Under-distribution, either now or in the past, cannot automatically change the policyholder/shareholder split of interest in the fund which has been established by custom and practice or by rules within the organisation of the company, even though it may lead to a developing gap between retrospective reserves and the total assets.

I am quite unimpressed with arguments that, if surplus arose from old long-matured policies, it must belong to shareholders, since current policyholders did not build up the surplus. This moves away from the partnership principles which underlie the traditional relationship between proprietor and policyholder in a with-profits office. In general terms, I would agree that policyholders do not expect the estate of a life office to be distributed to them. All other factors being equal, they are likely to expect that a strong office which they join will endeavour to remain strong, and will still enjoy a significant estate when they come to draw their benefits. In considering issues of PRE, as long ago as 1976 the then Parliamentary Under-Secretary for Trade said, in addressing a meeting of the Faculty, that the DTI did not "envisage any general intervention in ... the manner in which (surplus) is distributed between policyholders of different generations or classes. We would hope that this could be left to the directors acting on the advice of their Actuaries". This remains as true today.

Policyholders may have no reasonable expectations to receive a share-out of the estate, but, if there *is* to be a distribution from the estate, it is incumbent on the DTI and upon the actuarial profession to ensure that policyholders, as a class, receive their equitable share. This is particularly so where the

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terms of the partnership between shareholder and policyholder are not written down clearly. Nonetheless, the passage of time and unbroken trends by companies and the industry at large have established certain understandings between policyholders and shareholders which need to be borne in mind. There has been criticism in some press articles of the role of the actuarial profession in allowing these assets to accumulate. Our collective reputation is threatened, and it is important that the profession applies its traditional principles in seeking an answer to this challenge. It is incumbent on our profession to support the policyholders who have, for so long, looked to us to protect their interests, and whose interests we claim to represent. The independent actuary required by DTI in these cases has a particular obligation to consider the interests and reasonable expectations of policyholders, and owes a duty to the entire profession to ensure that the perspective of policyholders is properly aired.

I think that the answer to both questions is 'yes'.

Mr S. Creedon, F.I.A.: The reasonable expectations of both current and future policyholders with participation in profits are affected by the amount and allocation of distributed surplus in the past. I am disinclined to accept the caveat "ignoring the smoothing of investment returns", since I think that our efforts to do this are part of what has created the quandary in which we find ourselves. However, I believe that the profession will, before long, find the concept of PRE being underpinned and determined by the legislature or the judiciary or both; thus it will not just be our views that are important.

In preparing for this discussion, I reviewed some of the past literature on the subject, and I was surprised that what I found did not lead conclusively to acceptance of either of the alternative views set out in ¶9.1. I did find it stimulating to read of the continuous search, over 200 years, for the goal of equity. Three definite conclusions were suggested by the review: equity is not only a quantitative concept; changes in the environment tend to upset any theory very quickly; and no material distinction was made previously by our profession between mutual and proprietary offices in the pursuit of equity.

I conclude that the circumstances which may, for any particular office, have resulted in what might potentially be regarded as an IE are quite likely to be unique to that office, and that no general prescription can be appropriate. The DTI clearly recognises this, and I find myself in positive agreement with most of Appendix 1. However, I do believe that this position needs to be extended to embrace undertakings as to how participation in profits is to be allowed prospectively, in terms, at least, of the flow of future entrants to the fund and of the means by which the laudable objective in ¶9.3 is to be achieved. I also feel that ¶A.1.4 of the DTI position is subjective, and that, provided agreements have been reached which effectively preclude a recurrence, there can, in certain circumstances, be a case for distribution on a basis other than 90:10 in the mutual interest of both shareholders and current policyholders. This should be able to be confirmed by the independent actuary.

Mr J. Goford, F.I.A.: I first answer the two questions:

(1) I think that the current level of bonuses can be temporarily high relative to ongoing PRE for reasons other than smoothing and investment returns. It was apparent in the late 1980s that perceived competitive forces persuaded some companies to maintain bonuses at a high level for some time during a period of reduced expected future investment returns, and are now seeking to match asset shares rather more closely with normal smoothing. They felt able to hold bonuses high for a period, in part because of the accumulated amounts from relative under-payment to former with-profits policyholders. Even in these cases the strict answer to the question is still 'no'. Holding bonuses up because of an accumulated prior underpayment should not create PRE of future excessive payouts to current policyholders. Current payouts in excess of asset shares are not intended to establish a PRE in excess of normally smoothed asset shares. The fact that over-payments are currently being made does not inhibit the office from the intention of reverting to normally smoothed asset shares, and it is that intention which dictates PRE, not the fact that over-

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payments are currently being made. Current over-payments are a one-off windfall, which should not raise PRE above smoothed asset shares.

(2) My answer is also 'no'. If it were 'yes', how would you decide which with-profits policyholders to affect, and how? Presuming that 'affecting' means paying out more than smoothed asset shares, if you decide on some future PRE to affect, would that not establish a PRE for all, and, by definition, you run out of estate?

I have answered 'no' to both questions relative to asset shares. The asset shares themselves may be expected to be higher for companies with demonstrated superior investment performance and expense history.

I now address the issue of the importance of asset shares in PRE and bonus declarations. Historically, bonuses were determined using projections of the fund, bonus reserve valuations, projections of the free asset ratio and an input from the marketing department. Since the advent of asset shares, PRE and bonus declarations have had much more attention paid to them, to the point of including reference to asset shares in with-profits guides. Nowadays PRE and bonuses are determined much more at policy level than at fund level. We also see some intrusion from an expectation of shareholder support, particularly, for example, with the costs of mis-selling of pensions opt outs and transfers, and European experience is also relevant here in demanding shareholder support.

All this leads me to believe the following six statements:

(1) The fund is becoming less relevant.
(2) PRE and bonuses are determined more through asset shares at policy level.
(3) PRE does not include any expectation of windfall additional bonuses as a result of closing the fund.
(4) It is a shareholder's responsibility to satisfy the terms of its contract with its creditors and policyholders, including satisfying guarantees.
(5) The balance of the fund only remains relevant as an identification of assets currently available to support guarantees, given the equity backing ratio of the assets.
(6) Once assets become free, because they are not needed to satisfy fully PRE or support guarantees, they may be allocated to shareholders.

I would rather have a large bonus arising from an efficiently run office giving me a smoothed asset share than a smaller one including a contribution from the estates being eaten up by expense over-runs.

Mr J. A. Jenkins, F.I.A.: There are many possible reasons why orphan assets may have arisen within an office — proprietary or mutual — which has written with-profits business over many years. One of the possible reasons is that of under-distribution to past maturing policyholders, and it is this situation that I now consider.

In considering why past under-distributions have occurred, we need to bear in mind that many of the actuarial tools and techniques which we now use have not always been available. The computing power which now enables us to calculate retrospective asset shares was not available decades ago. Actuaries had to err on the prudent side. Having said this, the lack of the current level of intense competition between offices during those times did, I suspect, lead to deliberate under-distribution in some cases, and to unnecessary levels of prudence in others.

As to who owns orphan assets generated by past under-distributions, my view is that, leaving aside the issue of the short-term smoothing of investment returns, the reasonable expectations of both current and future with-profits policyholders are not affected by the level of payouts to former with-profits policyholders. I would thus answer 'no' to both of the questions that we have been asked.

The implication of this view is that, where there are orphan assets in excess of those required to meet a full quantification of PRE, current and future policyholders have no interest in them. In a proprietary office, I thus have no difficulty with 100% of the orphan assets being attributed to shareholders, nor do I have any difficulty with the concept of a reasonable rate of return on all these orphan assets being withdrawn from the fund. I would, however, have difficulty with the orphan

https://doi.org/10.1017/S1357321700004906 Published online by Cambridge University Press

assets capital itself being withdrawn. This is because so many offices, these days, are experiencing expense over-runs, large-scale compensation bills and other significant re-structuring expenses of one sort or another, and I think that this will continue for some time to come. Where sufficient orphan assets exist, they are an obvious source of finance to meet such expenditures, without impairing PRE and without causing shareholders undue pain.

The same principle to that which I have just outlined can easily be applied to orphan assets within mutuals.

This view, that of 100% of orphan assets being attributed to shareholders, is, of course, not in line with that expressed by the DTI. One issue which the DTI may well have had in mind in formulating its view is that of future under-distributions being used to generate new orphan assets. However, if this is an issue, then the DTI, in conjunction with the profession, should be looking to monitor and supervise it directly, rather than indirectly through its approach to orphan assets.

Mr M. R. Kipling, F.I.A.: As Professor Smaller and Mr Nowell have said, the key public interest question raised by the presence of IE is by whom they are to be consumed. Critical to the answer is their origin. The working party identify five possible sources in ¶5.1. I do not disagree with any of these. However, I prefer the broader categorisation hinted at in ¶¶5.7 and 5.9. As to the first, it is difficult to see any sustainable objection to surplus that has arisen out of activities in which with-profits policyholders' moneys have never been involved or been identified as belonging to the shareholders. Nevertheless, it would have been interesting to have been told, if it is now recollected, how, in 1937, the directors of the United Friendly first determined bonuses, and what they told incoming with-profits policyholders at that time.

I disagree with Mr Nowell that the failure of shareholders to withdraw their entitlement necessarily equates to an injection of capital. It all depends upon whether marketing advantage was sought from the policy of under-withdrawal at the time.

My second category of IE is that which arises if the surplus that remains after deducting the IE of my first category exceeds the aggregate asset shares plus the other items listed in ¶A.2A.5.1. This will have arisen from past underpayment to with-profits policyholders. The ownership of this amount is less clear to me.

One reason for underpayment is underdistribution of surplus. This was an issue raised by Redington in his 1981 essay, 'The Flock and the Sheep'. He was referring to the period between 1955 and then, when equity prices first began to climb and the industry failed, in retrospect, to recognise the permanence of these movements and to pass on the benefits to the policyholders at that time. Further under-distribution, only recently reversed, is likely to have occurred since then.

Another source of underpayment may have been the payment of less than asset shares on early surrender of with-profits policies. The PRE working party, in its paper to the 1992 CILA seminar, specifically refers to the reasonable expectations of surrendering policyholders, and states that these often fail to be met. However, it did not go so far as to define them by reference to asset shares as it did for maturity values. Thus, except possibly for policies sold since disclosure of sample surrender values became compulsory, I cannot see why asset shares should not be the base for determining surrender values.

The inclusion of surrender surpluses in asset shares can also potentially mislead both existing and new policyholders as to their expectations. To avoid this, and to arrive at the expectations suggested by Mr Goford, prominence needs to be given, when displaying these figures, to the contribution from miscellaneous sources and the conditions which would have to recur in the future for them to be repeated.

Therefore, I see actual and potential IE treasure chests as likely to consist of a mix of the true fruits of the shareholders' sweated labour and the, albeit unwitting, plunder of past generations. The former part the shareholders can claim with pride. The latter, too, they well may prove a legal right to, but have, I feel, a rather less certain moral entitlement. On the other hand, for the reasons advanced in ¶5.4, I cannot see why current and future generations of with-profits policyholders have title to any part of the IE either. To resolve this ethical dilemma, might it not be fairest — and do the image of the life insurance industry, and perhaps our profession, some good — if any morally questionable

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parts of the IE were, in part at least, voluntarily sacrificed for the benefit of the community as a whole?

Mr R. E. Allen (a visitor): The DTI's own position on the IE was set out in a statement to Parliament by the then Minister for Corporate Affairs in February 1995. This statement remains the basis for DTI consideration of any particular proposals which are put to us. Our examination of particular cases has confirmed our confidence in the broad principles set out in the statement, and has given us the opportunity to refine their application.

The main area in which our thinking has moved on since publication of the ministerial statement is that of procedure. As the paper makes clear, we have adopted the policy of requiring a report on any exercise to clarify or restructure the estate from an independent actuary, to be appointed by agreement with us, and working to terms of reference agreed with us. This arrangement has two important advantages in our view. First, it reduces, and possibly removes, any problem of conflict of interest which the Appointed Actuary to the company might face (though the normal professional guidelines remain in place); and it also ensures that the proposals will be examined from an additional perspective, which takes particular account of the policyholders' interests. The DTI is then able to take account of the independent actuary's report before reaching its own conclusion in the light of advice from the GAD. This arrangement helps to ensure that any proposal is not only fair to all parties, but can be seen to be fair.

Another point to which the DTI attaches importance is the need for clarity in the future. Exercises to attribute IE are complex, difficult and time-consuming. There is no precise, mathematically correct answer, and a large element of judgement, commonsense and goodwill is required to reach a mutually acceptable arrangement. The DTI regards it as important that any arrangement should include firm provisions for a clear and transparent basis for future distributions of surplus. Future generations of policyholders would not be well served if the effect of a restructuring today was to sow the seeds of another IE problem in the years ahead. I am, therefore, glad that the authors took the view (in ¶9.3) that "the creation or increase of IE in future should be avoided, and that, subject to prudent actuarial management, there should be a full and equitable distribution of surplus to each current and future generation and class of policyholders." I would add to that that, not only should the distribution be full and equitable, but that the basis for it should also be clear and transparent. Indeed, without this clarity, the future of with-profits business must be in doubt. The customer expects to know what he is buying. If he does not, he is likely to take his custom elsewhere.

Mr D. E. Purchase, F.I.A.: My answers to the two questions given are 'yes' and 'yes'. I strongly support the views set out in ¶5.7, and suggest that, unless there are clear and publicly known reasons for doing otherwise, any surplus that is identified and allocated should be split in the standard proportions. Of course, that is not to say that a fair scheme cannot be devised to rearrange things for the future.

There are two reasons for this. The pragmatic reason is that, if we do otherwise, one of these cases is going to go badly wrong, and the statements of the directors will be publicly paraphrased as "Because our predecessors were clever, or maybe ignorant, enough to underpay past generations of policyholders, we are now going to give all that extra money to the current shareholders". However, the important reason is that it is right to do so. With-profits policyholders in a proprietary office should be regarded as similar to participants in a mutual fund, albeit that they know that only 90%, and not 100%, of the profits that are identified accrue to their fund. That is the way that the relevant literature from most offices would be read by the intelligent layman. The 'generation' issues then fall away.

I think that our profession should be clearly seen to be protecting the interests of those who do not have the knowledge or influence to look after themselves — the ordinary policyholders. Apart from the regulators, we seem to be the only body that can, although I accept that our influence may not be as great as we would always like it to be. However, I do not wish to see our profession risking an episode where we can be accused — justly or unjustly — of failing the public interest.

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Mr D. H. Craighead, F.I.A.: I have been disappointed with this paper. No doubt it was well intentioned as the consensus of opinion of a number of actuaries working in a variety of offices defining generally accepted attitudes within the profession as to the correct technical profit distribution of a life office. What has emerged seems to me to be more of a lowest common denominator which fails to argue any one thesis fully. It is, of course, a discussion paper, and perhaps some of the speakers have gone much further in answering the questions posed, but, as they stand in the paper, I do not think that those questions have been answered.

Let me explain in more detail by mentioning some history as to how a life office may begin. As a young actuary many years ago, I found myself as the then equivalent of the Appointed Actuary, in a different country, to a young, rapidly developing composite office. Since the amount of life insurance written was increasing substantially, there was a deficit, even though no bonuses had been declared. The directors, who were also the sole shareholders, were very perturbed. There was a statutory minimum basis of valuation requiring a net premium valuation with Zillmer allowance of one year's premium limited to 15‰.

At the time I explained the concept of new business strain, but lack of computing power meant that I was unable to follow up by depicting a possible scenario for the next 10 to 20 years, assuming, perhaps, a pattern of development that slowed down after some years. Conditions subsequently changed greatly.

Identification of the quantum of the IE must refer back to its establishment over a period of time from the early days of an office's life. What I should have liked to see with this paper is, perhaps, two separate analyses: the first analysis being of a life office's operations commenced after the war, some 50 years ago, taking into account the level of premiums actually charged by competitive offices during that period, the subsequent effect of a considerable degree of inflation, with resultant relatively high investment returns, expenses controlled below inflation levels by the advent of mechanisation, considerable improvements in mortality and relatively low surrender values. What the analysis would show is what surpluses would have emerged over the years, and how they would have related to the levels of bonuses declared by most offices.

Then I should like to see the exercise repeated for a life office commencing operations today, assuming a reasonable control of inflation by governments in the future, some improvements in mortality, but not as great as has occurred in the past, surrender values relatively high and bonuses determined by the reasonable expectations of policyholders being met by bonus declarations from inception. The result after 50 years would obviously differ greatly from that emerging from the first exercise.

The results of both exercises would be useful as illustrating the amount of IE that could have been expected to emerge at various stages of the development pattern.

Mr W. M. Abbott, F.I.A: Two specific questions were asked. The answer to both should be a resounding 'no', at least to the extent that the profession as a whole should have a view on the subject.

The relationship between a participating policyholder (or possibly the collective of participating policyholders) and the shareholders is in the nature of a joint venture agreement. We are where we are after 200 years of happenstance development, but, by the standards of today, any legal draftsman drawing up such a joint venture agreement on its current basis would be exhibiting gross incompetence.

I have a similar view on the draftsman of the insurance legislation which introduced the imprecise concept of PRE without the level playing field of shareholder reasonable expectations. This, alongside the one sidedness of the 'no less than' fair concept, introduces a source of bias which more than compensates the requirements for directors to act in the interests of their shareholders. As a result, companies and actuaries have to work in an environment where the law is what it is, and equity between the joint venture partners must respect that law. The issue of sharing the returns from the joint venture on a fair basis, which reflects the capital provided by the partners and the risks borne by them, should be a separate issue, and actuaries should be able to give a perspective on this. Inevitably, in practice, the issue is not seen in this pure light, and, where there is a conflict with the

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legal reality, then the result may not lead to a fair sharing of the returns. As actuaries, we should try to ensure that the reasonable expectations of both partners are met. To give one partner more than their reasonable expectation must be at the detriment of the other partner. This would lead me to add some caveat to the observation of the PRE working party, as set out in ¶4.3.

Now, referring back to the two questions, policyholders' expectations may be affected by representations actually made as to the future. It does not appear rational that current payout levels lead to an expectation that such levels will continue into the indefinite future. If this interpretation were to be adopted, it would impose substantial shackles on the ability of a company to give its current policyholders a reasonable return.

A previous speaker suggested that further legislation might be needed in this area. Quite often legislation has the opposite effect from the one intended. Any future legislation should bear that in mind.

Mr M. N. Urmston, F.I.A.: My answers to the questions are: "yes, to some degree, given that sudden changes are unlikely", to the first one; and "yes, to some degree, but subject, perhaps, to the length of time to maturity", to the second one.

PRE is one of those subjects that the more you try to define it the more elusive it becomes. Mortgage endowments are a case in point. In my office we have been very careful not to create PRE that mortgages will be repaid. To do so is the slippery slope to a commitment to policyholders, to reserving requirements and to guarantees. Offices are now writing to policyholders advising them to make further provisions to repay their mortgages. This is very admirable, but creates a problem, not only for those policyholders that they do not write to, but for those offices that are not actually writing to policyholders.

I question the somewhat undignified digging in dusty cupboards to change past decisions about the allocation of profits between shareholders and policyholders. I do not believe that this was a critical issue at the time. What, perhaps, should be the issue is the size of the surplus at the time when, principally, the actuarial profession underestimated and underdistributed. The DTI appear to have drawn an artificial distinction over those offices where the articles and past practice were unclear and those where it was comparatively clear. I believe, given that the issue is the same — underdistribution — then the approach taken is unfair to those companies who defined their articles clearly in the first place.

Arguing too much about the ownership of an IE is unproductive. The key thing is the way that the estate is used. There are plenty of legitimate opportunities for companies to use the power that the IE brings, and give more value to both shareholders and policyholders.

Mr M. H. Field, C.B.E., F.I.A.: A reference that I made in my Presidential Address in 1986 (*J.I.A.* **114**, 1-14) to a warning given by Frank Redington is pertinent to this paper. Frank, in 1952, had pointed to the danger of going too far in building up strong reserves to be held specifically against liabilities. This paper is, in part, about dealing with the consequences of not taking heed of Frank's warning.

I agree that IE is a better term than its predecessor — it carries with it the concept of who should inherit it. I also agree that, before passing to shareholders any of the IE beyond their normal share, it must be demonstrated that policyholders have no reasonable expectation to it. Indeed, I would go further. I consider that it should also be demonstrated positively that the shareholders have some right to it. If the IE is merely the consequence of past prudence, I become very nervous for the profession and the industry.

The asset shares technique is aimed at determining the proportions of surplus to be distributed to different classes of participating policyholders and to different generations of policyholders. It does not help in determining the quantum of surplus for distribution.

I heard comment, echoed in the paper, that, if policyholders have received asset shares in full, they have no cause for complaint. To my mind, this belies the very concept of with-profits life assurance, where policyholders enter into a mutual (or quasimutual) fund with the expectation of owning a share in its totality.

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If there have been under-declarations in the past, this actuarial error is permanently to the detriment of policyholders who departed at that time, but it is, therefore, to the betterment of those that remain. That is how it works; that is how it is perceived to work; that is how the Appointed Actuary should see that it works. To interfere with that concept would, or should, have serious public relations consequences for the already hard-pressed industry.

I am, therefore, a 'yes' man, unless there have been consistent under-distributions in the recent past.

It might be that there is a quantum of surplus to which the current policyholders have no reasonable expectation, but that does not, of itself, give the shareholders a right to it. Such a truly orphan estate seems to be analogous to treasure trove. I do not suggest that it should be passed to the Crown or even the DTI, but there are several charities that would be more appropriate recipients than the shareholders. The overriding message is, however, that, as recognised by Redington, we must be on our guard not to let these actuarial accidents happen, or, where they have occurred, to rectify the situation before it is as late as it has become in some instances.

Mr T. A. Sibbett, F.I.A. (in a contribution that was read to the meeting)**:** In my view, an ethical problem arises if money is transferred to shareholders in the absence of clear evidence of their ownership. The better practice is to continue to distribute surplus on the principles established by the past, which accepted that there was some unavoidable transfer of money between different generations of policyholders.

Further, if the profession does not agree with this view, the practice of passing the IE to shareholders, as has been done in the recent past, needs re-examination in some aspects. Most offices have policyholders with policies several decades old. Old-established policyholders' claims to some part of the IE have not generally been taken into account. That seems to be inequitable. Also, some form of policyholder consultation, short of a judicial review, needs to be set up so that policyholders' concerns and expectations can be addressed. The area can be wider than the purely actuarial field.

Margins of solvency are under examination at European Union level, and new margins are expected to be set early next century. There are some contracts, such as permanent health insurance and annuities, where no margin of solvency for risk is currently prescribed, but where the risk may be significant. Money should not be passed to shareholders without there being enough retained to cover the likely new margins in the amended regulations for business existing at the point of transfer.

Mr N. B. Masters, F.I.A.: I welcome the approach in the paper, but I feel that in ¶8.3, which is the part rejecting the use of best estimates rather than prudent assumptions, is less convincing. I believe that the assumptions should be based on best estimates, albeit prudent best estimates. The reason is that the IE will drive accounting issues, as is said in ¶1.2, and, to be consistent with other standards of financial reporting, I believe that the number should be based on prudent best estimates. Paragraph 8.3 implies that the use of best estimates is appropriate for a one-off decision, but this is precisely the nature of the decision required if financial statements are to give a proper view of the progress of the office to all concerned. This is not to say, as the paper seems to imply, that contingent reserves should not be held with regard to PRE, but need not be added to PRE.

To answer the two questions, I believe the answer to both is 'no'. I think that the public interest is perfectly well served by asset shares, and I think that it also should avoid some of the unseemly 'carpet baggery' from transient investors that we have seen of late.

Mr P. D. Needleman, F.I.A.: It is not surprising that the issue of IE has emerged over the last few years. Not only do we have better tools for analysing the inner workings of a with-profits fund, but the industry is undergoing radical changes which necessitate an efficient flow of capital within the industry.

The rather blunt tools available to manage the with-profits business prior to the 1980s and the natural prudence of actuaries may, in part, have led to the size of the IE that we see today. The current changes in the industry, which have led to reductions in the growth of with-profits business written by some companies and diversification into new lines of business, are other reasons. All of this has resulted in the need to ensure that capital is not locked up and used inefficiently in with-

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profits funds where it is no longer required. To ensure a competitive and efficient industry in the future, we need to unlock these estates and ensure that they are fairly and clearly attributed going forward.

In considering ownership of the IE, the DTI considers that policyholders' and shareholders' interests in the surplus are unaffected by whether or not the surplus is actually distributed — so policyholders, as a class, retain their interest in the undistributed surplus in the fund.

Whilst I agree with the DTI's concern that a company should not deliberately underdistribute so as to boost shareholder profits, it is far from clear to me that policyholders, as a class, do retain any rights to undistributed surplus other than sufficient to meet their security and reasonable benefit expectations. The articles usually provide for the directors to determine 'divisible surplus' and to take any balance to reserves. The respective interests of policyholders and shareholders, even if defined, will only be specified in relation to distributed surplus.

If the DTI's position were correct, it would rarely, if ever, lead to the conclusion that all undistributed surplus should be attributed in proportion to the current allocation of surplus. That approach would force one to consider the practice and appropriate split at the time the surplus arose, and to preserve the respective interests in undistributed surplus, going forward. This could result in a significantly different attribution of the surplus carried forward than the 90:10, or any other split currently used.

To attempt to identify how much, if any, of the IE may be attributed to shareholders, it is, therefore, essential to identify, as closely as possible, the various sources of the estate, so that the principles of ownership can be ascertained in respect of each major source at the time. The three main sources of the IE are:

(1) contributions from the current generation of with-profits policyholders, (including surrender profits arising during their lifetime and any charges from asset shares to the estate);
(2) non-profit and other miscellaneous surplus earned during the lifetime of the current business; and
(3) surplus which emerged prior to the current generation of in-force policies (and the investment earnings thereon).

The surplus arising from current with-profits policies can be dealt with most easily, and would be governed by the appropriate allocation rules or practice at the time. Similarly, an appropriate treatment of non-profit surplus can usually be inferred from past practice, literature or the articles of the company. The most difficult aspect to deal with is surplus which has arisen before the current generation of policyholders' policies were in force. In some cases this may clearly have been provided by, or accrue to, shareholders, but in other cases no obvious 'ownership' exists, and it is a true windfall. In the latter case, provided the position of current policyholders has been secured, I see no reason why shareholders should not benefit, perhaps in conjunction with a windfall distribution to policyholders.

In answer to the two questions posed — I believe that the answer to question one must be "yes, to some extent — if only because changes in practice must be gradual", and to question two, it is surely 'no'. To answer 'yes' would be akin to forcing building societies to charge the same rates, or offer the same discounts, to new borrowers in the future as they may have charged or given to borrowers in the past.

Mr H. D. White, F.I.A.: My answers to both questions 1 and 2 are 'yes'; reasonable expectations of all policyholders are affected by what has been paid out in the past.

I work for a company which has had asset shares in place for many years. Even though our asset shares are built to include surrender profits, we found that assets exceeded asset shares, and over a number of years the level of this excess has increased, despite some enhancement to bonus rates to correct this. We recently conducted a study, and found that, even without any further contributions of profit from non-profit business, this level will continue to grow and eventually reach very high levels.

My conclusion is that my earlier understanding of the dynamics of asset shares and the with-profits fund was inadequate, and I suspect that this is true of many members of the profession. I will now explain. In ¶5.1(d), there are two other miscellaneous sources of profit of real significance. Firstly

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there are maturity differences — unintentionally in the decision-making process we may tend to take a series of small margins in determining the next year's future, and this year's current, investment performance, resulting in too conservative a level of final bonuses. As a result, without trying, we may retain surplus which does not get recycled back into the asset shares, as there is never anyone left in the tranches of matured business to give it to. Thus the IE grows larger.

Another source of profit is mortality profits. Although whole-life policies may be a small proportion of new business, they can become a significant proportion of the in-force liabilities, because policies do not mature. When people die at an old age, the mortality rates may be a fraction of those assumed in the premium basis. When we start to reflect this in higher bonuses, this immediately reduces asset shares to survivors, so tending to reduce bonuses. If asset shares are then the base of future bonus decisions, it is difficult to pay any surplus in excess of the basic policy asset share to whole-life policies. Eventually they all die, and most of the surplus rolls back into the estate. Also, if a claim is a death or a surrender, the asset share process rolls round any surplus to the next generation, and even on maturities this process can inadvertently happen to some extent. Asset share methodology thus encourages the IE to continue to grow.

Thus, we must deliberately pay out more than the amounts generated by the asset share process to avoid generating an excessive IE.

Mr T. A. Roff, F.I.A.: The authors remark, in ¶9.3, "that the creation or increase of IE in future should be avoided". I assume that they would, however, allow the prudent margins for guarantees, options and mis-matching, which they have included in the assessment of policyholders' obligations, to increase in line with the growth in those obligations. I also assume that their remarks are directed at all with-profits offices, both mutual and proprietary, and not just those currently embarking on an IE investigation.

Whilst I broadly agree with the statement that the IE should not be allowed to increase, assuming that the current strength of the fund is adequate, in my experience actuaries have some way to go in demonstrating that we are complying with this statement. Our recent survey of asset share techniques showed that only 60% of with-profits offices quantify the size of IE, and only 60% of offices calculate the cost of over or under payment compared to asset shares on maturity. Thus, there appears to be a sizeable proportion of offices which may not have the necessary financial reporting systems in place. With many offices having to formalise bonus philosophy as part of a reconstruction, or having to make more detailed public statements of policy in the with-profits guide and through illustrations of future benefits, the information systems need to be able to demonstrate that the stated policy is being rigorously followed. This involves quantification of the profit or loss arising from principal sources, such as non-profit business, expense performance, surrenders, taxation and interest on the IE, and a demonstration of how this has been allocated between policyholder obligations, IE and shareholders.

Probably a greater challenge in respect of reconstructions is in reassessing, from time to time, the proportion of the IE needed to meet guarantees, options and mis-matching, and explaining why this has changed since the previous time that it was considered. Stochastic techniques may well have been employed initially in determining the proportion to be set aside, and if these techniques are to be used again, consideration needs to be given as to how changes in market conditions would be reflected in the parameters of the stochastic investment model or the choice of the risk of ruin.

A significant challenge for actuaries would be, not only to develop a sound approach, but to communicate, in simple terms, the result of this complex process.

Concerning the two set questions, in my view the reasonable expectations of current policyholders are not affected by the level of payouts to former policyholders. However, their expectations are affected by the past methodology used to determine payouts. It is the application of the consistent methodology that is important, not the level of payouts. My answer to the second question is the same, it is a 'no'. The reasonable expectations of future policyholders are not affected by the level of payouts to former policyholders.

Mr J. W. O'Shea (a visitor): This debate has its roots in the success of the insurance industry since

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the 1970s, when a regime was created to look after the interests of policyholders following problems that had arisen. It was essentially a proscriptive regime rather than a prescriptive one. The regulator has not sought to tell you how to run your industry. When what became the Insurance Companies Act 1974 was being debated in Parliament, Lord Limerick said, "fundamentally, we set out to tell insurers what they may not do; whereas in many other countries the insurer has to obtain specific approval for what he does. There is a wealth of difference between these approaches, and it is not an accident that our insurance industry is so vigorous." That approach has been successful, and the number of life companies that have become insolvent since 1975 is minuscule.

The increased sophistication of the actuarial profession has also allowed you to define, through the technique of asset shares, much more precisely what the orphan estate actually is. However, there is a problem in that the approach which has been adopted means that there is a vacuum at the heart of regulation. That vacuum exists in determining the actual reasonable expectations of policyholders.

Two clear expositions of the orphan surplus are in the paper and have been expressed in the discussion. On the one hand there is the analysis that essentially sees an insurance company as being like any other company. There are creditors and there are liabilities. Once those can be discharged, there may be surplus left over and that can go to the shareholders. On the other hand, we have heard the approach that has been put forward by others, most notably the DTI, that there is an ethical and moral dimension to the maintenance of the orphan surplus, that it is something that is passed on from one generation to the next. Speaking as a lawyer, I do not think that it is for the actuarial profession in any way to discount that ethical and moral dimension.

Mr Allen referred to judgement, commonsense and goodwill, and that is the way in which this issue is evolving. The DTI has given us a prescription. It has given us the 90:10 formula, but it is a formula which is leavened by reference to history, to the public perception in terms of PRE, and also to industry practice.

However, it comes back to individual directors of insurance companies and their advisers, including, primarily, the actuaries, to make decisions. That is exactly as it should be. That is why this debate within the profession is important, and it is very welcome. These are issues which should be determined by the profession and by individual companies rather than by a wider regulator who sets out to prescribe the way in which the industry should conduct its affairs.

Mr I. P. McKeever, F.I.A.: In the paper there are many references to PRE, but these centre on the reasonable expectations of current policyholders. However, only a very cursory reading of the paper is required for it to become clear that we are discussing surplus that arose on previous generations of policies, but which was not distributed. If one accepts this, I feel that we must also consider what might have been the reasonable expectations of those policyholders.

It would be generally accepted that the larger the volume of business written by an office, the larger the estate that is required to provide a given level of security to policyholders. Those previous generations of policyholders may have thought it to be acceptable that a small element of their surplus might be used to provide future generations of policyholders with the same security that they enjoyed.

However, I think that those previous generations of policyholders may have had some difficulty with the idea that shareholders should still receive 10% of the surplus, despite the fact that the majority of the new business being written was financed out of surplus arising from previous generations of policyholders rather than from shareholders. After all, the justification for shareholders getting a share of surplus has always been the shareholders' role as providers of capital. However, this might have been acceptable, as that was the way the system worked at the time. If, however, those policyholders were informed that once this undistributed surplus was no longer needed by the company, it would be distributed to shareholders, I think that they would cry foul.

When I was training to be an actuary, an important consideration for an insurance company actuary was the matter of equity between different generations of policyholders. The existence of this IE is evidence that, as a profession, we have failed in this objective.

I think that the public would forgive this failure. However, we are also charged with the task of maintaining equity between policyholders and shareholders in proprietary companies. I think that, if the insurance industry and the actuarial profession are to use their own failure to maintain equity

https://doi.org/10.1017/S1357321700004906 Published online by Cambridge University Press

between generations of policyholder as an excuse for failing to maintain equity between policyholders and shareholders, the public may, with some justification, ask whether Appointed Actuaries are properly fulfilling their function.

The other question that we need to ask ourselves is what would have happened if inflation had continued and the structure and the business had remained unchanged. Would the proprietary offices have made a series of rights issues to finance the growth in the business or would they have obtained that finance from current generations of policyholders? Unless we can provide some justification for the view that these companies would have changed their practice, I think that we are not justified in distributing more than 10% of the surplus from previous generations of policyholders to shareholders.

The profession has established a system which, for more than a century, has given policyholders less than their rightful asset share in order to finance a growing volume of business. This has benefited shareholders, because they have shared in surplus from that larger volume of business without having to finance that growth. Whereas the public might accept the rationale behind asset shares, I think that they might, with some justification, ask whether it is right to change the system precisely when, for the first time, that system is starting to operate for the benefit of policyholders rather than shareholders. For existing policyholders an additional allocation to shareholders may be particularly hard to bear, as, over recent years, rates of reversionary bonus have been cut by a third or more.

Last year *Money Management* did a survey on the financial strength of life offices, and it summarised the assumptions used in the three valuations from 1992 to 1994. Some offices had changed their interest rate assumptions in a way likely to increase the declared surplus, and some had changed it in a way likely to reduce the declared surplus. For many companies the assumptions used for life and pensions business had moved in different directions.

However, there were five offices which reduced the assumed rates of interest for both conventional life business and pension business, in such a way as to hold back the declaration of surplus. Although this is a very rough and ready tool, that list seemed to produce a disquieting correlation with a list of those companies in discussion with the DTI on the issue now being discussed.

One accepts that there may be a number of reasons for changing the valuation basis. However, I find it a little surprising that companies which feel that they have an excessive IE find it necessary to further strengthen their valuation basis. On the face of it, such action is likely to reduce the amount of disclosed surplus and make the situation worse.

As regards the expectations of current policyholders, I would think that their expectations must be affected by past pay-outs. If I had an endowment policy maturing next year, I would expect the returns I receive to be consistent with policies of the same term maturing this year and with the returns on policies taken out at the same time with a shorter term.

As regards new policyholders, I would expect that, in many cases, their choice of insurer is based on the returns achieved on policies currently maturing. It would seem that insurers are of the same opinion, in view of the prominence given to past performance in marketing literature.

I do not think that any statements by insurers in with-profits guides or in circulars sent to policyholders explaining bonus philosophy can change that. In particular, I do not think that any health warnings required by the Financial Services Act can be relied upon, because insurers have to say that anyway.

My answers to both questions is a resounding 'yes'.

Mr J. H. Webb, F.I.A. (closing the discussion and replying): I start with a quotation. "Nobody I should imagine would effect an insurance in the belief that the laws and regulations of the office which he selects are immutable. What an insured relies upon is the character and reputation of the company, and the certainty that no office which hopes to keep its business would think of altering its distribution of its profits to the prejudice of its policyholders. Such a step would ruin the most flourishing company. It would simply be suicide."

That quotation comes from Lord MacNaughton's judgment in the House of Lords in 1906, when he was overruling the Court of Appeal and allowing the British Equitable to amend its Articles of Association against the wishes of a group of policyholders. Regrettably, Lord MacNaughton's view

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that commercial imperatives would be sufficient to constrain companies from acting against the interests of the policyholders did not stand the test of time, even though the period from 1870 to 1970 was a remarkably long one free of major failures or scandals.

The provisions of the 1982 Insurance Companies Act on PRE were introduced in the early 1970s. They are not defined and have never been tested in the courts. In my view this is a desirable situation. The previous reliance on commercial reputation has clearly been strengthened in favour of policyholders; but the boundary between the acceptable and the unacceptable is imprecise. Regulation probably works best when there is flexibility and the opportunity to argue a case with the regulators, with both sides being reluctant to seek the involvement of the courts.

PRE was enshrined in legislation long before the use of asset share techniques became usual, let alone universal, in determining bonuses and payouts. The rational policyholder looks for an office with a record of stability and strength, but not unnecessary strength built up by failure to distribute sufficiently to policyholders. I consider that the assessment of this balance is an essential part of PRE.

There were a large number of contributions on the issue of whether asset shares should or should not be regarded as more than the accumulation of the policyholders' own contributions. Mr Brimblecombe was strong on this; and Mr Daykin used the words, 'fair play', which, I think, sums up my view.

Regarding public interest, the profession is putting increasing weight on its role as a public interest body — something I regard as essential if we are to be seen by government and the public as a fully self-regulatory profession, and not as primarily representing our members' interests. In the context of this discussion, this means that our focus has had to be on the interests of policyholders and generally giving support to the DTI, whose position paper, set out in Appendix 1, has been generally favourably received.

The discussions between the DTI and the profession led to the conclusion that the high profile public interest aspects made it desirable that an independent actuary should be appointed in these cases. Normally the Appointed Actuary will remain in post, and, indeed, play a major part in formulating any scheme and explain the actuarial aspects to the board of the company. A division of duties, with consulting actuaries advising the company and the independent actuary acting on behalf of policyholders, avoids difficulties over conflicts of interest. The problems which normally concern the Professional Affairs Board are those where one actuary is responsible for reconciling two or more interests, hence our concern for maintaining the delicate balance for Appointed Actuaries of life offices and pensions actuaries advising both employers and trustees.

The subject under discussion is one where the history and the constitution of the company concerned may be very different from those of other companies. This really is an instance where each case must be considered on its merits. However, there were some fundamental differences in approach set out in Section 5, and these have been reflected in this discussion.

I remain firmly on the side of those who considered that it was not sufficient to demonstrate that policyholders had only a tenuous claim to an asset in order to support a shareholder claim. We need, in Frank Redington's terms, to look at the flock as a whole and not just individual sheep. Even though the generations of policyholders and the nature of their contracts change, there is still continuity within the fund, in contrast to the ownership of shares, which can change completely overnight.

Particularly difficult issues arise concerning funds where the shareholders are entitled to a percentage of profits and have not taken their full entitlement in the past. Mr Nowell argued that this is equivalent to an explicit transfer of shareholders' funds to the life fund. Several people criticised this, and I would ask why the full entitlement was not taken at the time, as, presumably, the directors were aware that, in the absence of a change to the articles, they could revert to the full percentage in future years, but not catch up on the past. In the absence of evidence, my presumption would be that the surplus was retained to enable the fund to expand by admitting more new policyholders with enhanced bonus prospects. Assuming that no accounting entries showed an attribution to shareholders, I would regard the increased strength of the fund as a factor contributing to the reasonable expectations of the policyholders.

The future distribution policy was referred to only by Mr Allen. I strongly support what he had to

https://doi.org/10.1017/S1357321700004906 Published online by Cambridge University Press

say about the need for clarity, so that these identification and attribution exercises settle matters permanently.

The President (Mr D. G. R. Ferguson, F.I.A.): There has been much discussion on the subject of PRE: Mr Hairs was concerned that the obligations of PRE, referred to in the paper, were a dangerous concept; Mr Daykin talked about concepts of equity and fair play; and Mr Urmston referred to the fact that the more one tried to define PRE, the harder it gets.

I was surprised that nobody mentioned the fact that, ultimately, PRE may well be something that has to be determined by the courts. Like the closer, I do not advocate rushing off to the courts to get resolution of issues, but we should not forget that PRE is a term that appears in legislation, and does not depend solely upon our determination of it.

I understand why the DTI, Mr Allen and the closer called for clarity. I should like that request tempered a little. I am not in favour of total clarity. I do not suggest that we should go back to the great mystique which was once reputed to surround all actuarial work, and which left those actuaries on the inside total freedom to do what they wanted, but I do think that we should preserve a certain amount of mystique and avoid absolute clarity in the interests of doing what policyholders really want and need: giving value for money; smoothing returns; and having something there for the proverbial rainy day.

I was pleased that several speakers, including Mr O'Shea, referred to actuaries as the profession and the people who are there to guide the DTI and others to a determination of what is fair and reasonable to all parties in the particular circumstances of a case, but especially having regard to the interests of policyholders. This is the reputation that we aspire to live up to.

I thank the working party for all the work that they put into producing this paper, and I ask you to join me in thanking them.

WRITTEN CONTRIBUTIONS

Mr M. Arnold, F.I.A. and Mr J. L. McKenzie, F.F.A.: Having been involved in several projects recently which have required identification and attribution of the IE, we welcome the opportunity which the paper presents to discuss some issues which we have encountered.

First, with regard to the definition of IE in ¶3.1, we believe that the general statement requires clarification of what is meant by 'obligations to the shareholders'. Since the purpose of any investigation to identify IE is likely to be to confirm the entitlement of shareholders, a circular definition may exist. We believe that a definition which refers to shareholder entitlement arising from meeting policyholder obligations (including PRE) is preferable.

The qualification of the IE is a complex issue requiring judgement on past practices and statements made by the individual offices. It unfortunately also depends, to an extent, on actuarial lore — the actuaries of the day had a general idea of the aims of bonus distribution which was to be achieved, but the detail was not recorded, and thereby the general concepts were passed on by word of mouth.

One of the principal problems which exists is that we believe that few companies had well-defined statements of bonus philosophy either current in the actuarial management or approved by a board of directors. Attempts to do so have been required by the with-profits guides, which offices must now publish. A study of the evolution of the statements made therein demonstrates that offices did not start with clear definitions, and even now these often do not express bonus philosophy with a clarity which would be useful for the average policyholder. Therefore, it is not clear how the current statements reflect the philosophy which may have applied when the current business in force was effected, and what PRE was created by the philosophy in force a generation before that.

Moreover, care has to be taken in applying the asset share technique. It must be recognised that most offices have been using such a technique for only a decade or so, and would admit to little refinement in the early numbers. With the availability of increasingly sophisticated office modelling packages and relatively cheap computing power, the early methods have become redundant, and calculations are now made in much greater detail. This means that the aggregate asset shares of

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business in force can be calculated with high reliability, but, if PRE are to be allowed for, some retrospective comparison must be made between claim payments and asset shares.

Such a comparison may reveal a pattern of asset shares looking procedurally smaller than payments, but how do we ascribe this to bonus philosophy and PRE? Indeed, if payments were typically less than asset shares in the past, would that set PRE for the future — we think not! The simple message is that great care must be taken in using current statements and techniques and using these to backsolve history.

In endeavouring to attribute the IE, it may be necessary to identify the sources of surplus and how these have been applied. Whilst this is probably more a demand for the computational accuracy of asset shares and setting practice for the future, it does help to identify the significant sources of surplus which have not been distributed, and does aid in the attribution to shareholders.

The paper implies that the identification of the IE is a one-off process, but we believe that this is only the case once procedures have been put in place which are adequate for the identification and quantification of emerging surplus. The independent review process must include this specifically, but it should be noted that the process has to be sufficiently flexible to deal with future (unknown) changes in circumstances.

We believe that it is worth reiterating that the IE may not be distributable in its entirety, since it remains as the working capital on which the business will grow and develop. This is particularly the case if the IE contains assets which may be required beyond the asset shares to allow appropriate investment freedom.

The paper is written very much from the perspective of a mature proprietary office. We have encountered similar considerations in the issues confronting a mutual insurer undergoing reconstruction. We believe that the principles discussed in the paper have applicability in these circumstances also.

Mr P. J. Packham, F.I.A.: My view of this matter is that the IE is due to the combined contributions and sacrifices of shareholders and with-profits policyholders. If there is surplus now which can be distributed, let it be distributed like other surplus, e.g. investment gain surplus. Seek to pass it smoothly to policyholders, with shareholders' funds being attributed with the normal percentage of the surplus being assigned to policyholders, e.g. 10%, but, perhaps, more or less depending on the Articles of Association and practise of the particular office.

Because some or most of the IE derives from policies no longer on the books, I do not see the logic of passing a different fraction to normal of that surplus to shareholders. As with policyholders, some or most of the original shareholders who made sacrifices which helped build up the estate may no longer have an interest in the company.

Mr G. W. Strang, F.F.A.: Being one of the very few actuaries who can claim to represent customers, I now comment on the paper.

Firstly, the term 'inherited estate' is much preferable to 'orphan estate'. The latter phrase already answers the question that you are asking by implying that this part of the estate does not belong to the policyholders, and must, therefore, belong to shareholders. The phrase 'orphan estate' is, therefore, not helpful in furthering this debate.

The main points for discussion are contained in ¶5.1, which lists the sources of the IE. Three of the sources, (b), (c) and (e), relate to under-distribution of profits to policyholders in the past. Whilst one might argue that current policyholders do not have a strong claim on the assets arising from these sources, the shareholders have no claim whatsoever on these assets. This point is made in ¶5.7, which I fully support. Indeed, I worry that there could be some actuaries who do not fully support this paragraph.

A number of miscellaneous sources are mentioned in (d). Of these, profits from surrenders of with-profits policies and from taxation and miscellaneous gains arising from with-profits policies are quite clearly not the property of the shareholders. Profits from non-profit policies and other miscellaneous profits probably belong to the shareholders. This will depend on the Articles of Association, custom and practice, etc.

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Similarly, assets arising from the injection of shareholder capital in the past probably belong to the current shareholders. This view will depend on the Articles of Association and any promises which may have been made in marketing literature and elsewhere.

I am concerned that there may be actuaries being driven to increase shareholder value by their employers. As a result, they may be losing their professional objectivity in favour of a view that disadvantages policyholders. It is possible to argue that the IE belongs to nobody, and therefore, by default, to the shareholders, but such arguments are mere sophistry, which should be avoided by the profession.

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