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# Lessons from the U.K.

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On December 21, 2000, the Faculty and Institute of Actuaries in the United Kingdom established a committee to investigate the events surrounding the closure to new business on December 8, 2000 of the UK's Equitable Life Assurance Society. The objective of the report was to determine whether there were any implications for the profession in the United Kingdom, particularly whether the standards of practice (i.e., the guidance notes that the Faculty and Institute provide to the profession) needed any amending, strengthening, extending or rewriting. A report has now been published and is discussed below, so that we can consider the implications for the profession in North America.

## Background

To place events in context, the committee considered it necessary to reach some understanding of events at the Equitable since 1956. The earliest form of Guaranteed Annuity Rates (GAR) offered by the Equitable to its policyholders was a premium-based guarantee. This promised to a policyholder an annuity of X per annum from age 70, where X depended on the amount of premium paid and the age at which benefits began. But the form of GAR that eventually created problems for the Equitable was a different kind; it was based on a declared cash value of the policy (i.e. the benefit was illustrated as a cash amount, and the guarantee related to the terms on which this cash could be turned into an annuity). The transition from the premium-based guarantee to a guarantee related to an annuity option on an accumulated fund was a response to a succession of acts of parliament. These first allowed a part of the proceeds of a policy to be taken as a tax-free lump sum. Later they permitted the accumulated fund to be used to purchase a pension annuity from any provider, referred to as the 'open market option' or OMO. Until 1988, the Equitable continued to offer policyholders the option of making further investments in any year up to their retirement on terms that included these GARs.

The committee identified several critical events: the granting of premium-based guarantees and open-ended options from 1956; the introduction in 1971 of a tax-free lump sum as an alternative for part of the benefit; the high inflation rates and interest rates of the 1970s, leading to the increase in the guaranteed annuity rate; the introduction of terminal dividends in 1975; the introduction of OMOs in 1978, with the consequence that the Equitable then related the guarantee to the terms on which the cash value of the policy benefit could be turned into an annuity; further legislation in 1988 changing the format of pension policies, leading to the Equitable's no longer granting GARs on new policies and modifying the terminal dividend structure; interest rates first falling below the rate reflected in the GAR in 1993; and market annuity rates falling from 1998 onwards to a level significantly below the GAR.

The Equitable was unusual, if not unique, among U.K. mutual life insurance companies, in that it did not maintain an unassigned surplus. The philosophy on policy dividends that led to this position was that each generation of policyholders should get its own 'asset share', and neither inherit from the past nor give to the future. This philosophy had both supporters and detractors. In its evidence to the investigating treasury committee, the Equitable explained that each policyholder had a declared stake in the overall surplus and that the eventual benefits received in the form of annuity or cash value did, so far as possible, reflect the policyholder's notional share of surplus.

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This philosophy created participation that was seen to be higher than that declared by other life insurance companies. The larger dividends materially contributed to the effectiveness of the sales force in acquiring new business and, through the consequent high volumes, to the low costs of administration. This generated a momentum that boosted overall efficiency.

The absence of unassigned surplus meant that the company lacked a potentially valuable instrument to cope with unforeseen financial problems as compared with other mutual life insurance companies that had built up funds for such events.

A high proportion of Equitable's business was individual and group personal pension plans. These plans carried the GARs, and some contained the open-ended option to invest future sums in the plan on the same terms as applied to the original investment.

In 1991, the Equitable combined roles of chief executive and appointed actuary. The roles remained combined until 1997 when there was a change of chief executive.

The Equitable adopted practices in a number of areas different from the practices generally adopted by other insurance companies at the time:

1. Using terminal dividend adjustments as the means for meeting the cost of guarantees.

2. Applying various technical assumptions that restrained increases in the value of the liabilities that would have reduced the distrib--utable surplus.

3. Reporting to policyowners on a different basis than other insurers.

Of these factors, there is not a single item, considered in isolation, that the appointed actuary or any other actuary need necessarily have changed. However, the unusual combination of the open-ended nature of the guarantees, the size of the GAR business in relation to the whole and the absence of unassigned surplus inherited from the past could well have been, and perhaps was, of concern to actuaries and to the Equitable board.

## The Committee's Conclusions

The committee opines that the main reason for the readiness of the Equitable to be able to accept the risks was that its management had determined, after it had introduced the terminal dividend, that such a dividend provided the substantial flexibility required. In its view, this flexibility could permit adjustments to the company's liability day by day and policy by policy, even reflecting the decision each policyholder made about which annuity to purchase when the time came to convert the policy into an annuity. Unless circumstances arose which resulted in no terminal dividend payment, the Equitable believed it could rely on adjusting the level of terminal dividend so as to provide for the full cost of meeting the GARs.

The committee considered whether the course of events would have been changed if the work of the appointed actuary had been subject to independent peer review. An independent actuary, with appropriate knowledge of practice elsewhere, performing an external peer review might well have found grounds for challenging the Equitable's philosophy and practice. However, it is also possible that the response would have been considered satisfactory, but the exposure of the points of concern (if any) in peer review and their defense might have introduced additional caution into the process.

The committee concluded that an external peer review could possibly have made a difference in the course of events at the Equitable up to 1999, but not necessarily. In particular, it might have drawn attention to areas of significant differences with practice elsewhere. It stated its belief that an external peer review would have value and strengthen the effectiveness of the appointed actuary system. The appointed actuary might well benefit from talking to an actuary with relevant experience gained outside the organization. The committee recommended that the Faculty and Institute, in their current investigation into ways of monitoring compliance with professional standards, make an external peer review of the work of the appointed actuary a requirement.

It also suggested that presenting a financial condition report to the board might have opened up the subject of risk, and such a report would also be invaluable in an external peer review. It also recommended that the provision of an annual financial condition report be made mandatory.

It noted that present-day actuaries should recognize that guarantees and flexibility can both be expensive, and should examine carefully the scenarios that could cause them to be used by some policyholders in a way that has the effect of reducing the returns available to the main body of policyholders. Where an actuary is giving an opinion on new contract terms, he or she should have full regard to the potential liability arising from whatever guarantees and flexibility are built into the terms of the policy. It recommended that valuation standards refer specifically to open-ended guarantees and their potential impact on the financial condition of a life insurance company.

In the committee's view, a present-day appointed actuary should carry out a risk appraisal for each new contract and periodically for the overall portfolio. That is not to say that a new contract has to be riskless, or even profitable, provided that the aggregate of the risks is manageable within the total size of the funds and that any built-in loss can be covered easily. The appointed actuary has a duty to investigate whether the premium rates for new contracts, on reasonable actuarial assumptions and allowing for the overall financial resources of the company, enable the company to meet its commitments.

The committee reviewed an illustration issued to a prospective policyholder in 1985. The Equitable illustration shows the policyholder what the capital value of the contract might be under certain assumptions about the dividends at the point of entering into pension status and purchasing an annuity. It also shows how much annuity could be purchased for that capital sum, first using the GAR, and then again using the then-current annuity rate. There is no suggestion that the size of that capital sum will differ according to whether the policyholder opts for the GAR or the current market annuity rate. The committee stated it is a management responsibility to ensure that information given to policyholders does not mislead them, and the appointed actuary shares in this responsibility. It recommended that the guidance notes make plain that the appointed actuary should require that there is a process for reviewing communications to policyholders and potential policyholders. The process should embrace: (1) stated principles that the illustrations and other literature must reflect, and (2) a consideration of how the policyholder who is not familiar with the constraints on a life insurance company might read them.

## Denouement

When certain policyholders began to question the differential dividend issue through the U.K. pensions ombudsman, the Equitable acknowledged that its position was wholly dependent on its ability to determine, policy by policy, the amount of terminal dividend to be awarded at the point of entering into pension status and purchase of an annuity. The committee believed that since Equitable had the apparent acquiescence of the regulators, and legal advice, it must have considered its position as lawful and expected to have that view confirmed in the courts.

A unique judgement in the House of Lords, the U.K.'s Supreme Court, did not support the Equitable's interpretation of the powers of discretion available to directors. The Equitable therefore had to set aside sufficient provision to cover the possibility that a high proportion of policyholders would take advantage of the GARs and that many of those with contracts providing for the open-ended option to invest future sums qualifying for GARs might exercise that option to increase their investment. The Equitable then undertook to try to find a purchaser, and when that failed, stopped writing new business.

## Conclusion

The committee did not find evidence to suggest that any appointed actuary of the Equitable failed to take account of the guidance that was current at the time the various decisions were made. It concluded that an accumulation and combination of decisions, actions and communications over a long period, and involving not only the appointed actuary but also the management and the board, made the Equitable vulnerable to the impact of adverse events. It also concluded that there are two clear lessons for those concerned with life insurance companies and other risk-bearing enterprises. The first is that it is not only individual risks that have to be taken into account but the chance of many risks arising simultaneously and compounding the liability. The second is that it is the cumulative and compounding effect of these risks that must be assessed in the context of the available unallocated capital.

In view of the Corley Committee's report recommendations, I sent a copy of the report to Don Cody, FSA 1939, a colleague in the structuring of the 1980 and 1990 standard valuation law amendments, and a prolific commentator on

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valuation issues over several decades. Don thoughtfully provided some pertinent comments as follows:

Thanks for the opportunity for an 88-year-old actuary to comment on the Corley Report. I believe that this report is significant not only for British actuaries, but also for North American actuaries. It ought to be studied by all actuaries engaged in developing the valuation actuary matter.

It involves recommendations much like the guidance that we tried to install in the early days of the U.S. valuation actuary effort. Those early efforts, prior to 1980, proved to be politically incorrect.

The first thing that impressed me was this: the Corley Committee exhibited a gut feeling that there was actuarial responsibility for interdicting a debacle such as Equitable's. I am unaware of any SOA expression of institutional responsibility for any American or Canadian insolvencies.

I was struck by the importance of the C-4 risk, which I introduced years ago during a discussion at an SOA meeting, defining it rashly as risk of management stupidity. The definition was cleansed to something like "risks common to all businesses other than C-1, C-2 or C-3 risks." C-4 risk would commonly involve bad judgement by top management in exposing the company to insolvency from options whose costs were not foreseen. I suggest that the valuation actuary must have the responsibility for advising management of such potential costs.

Another salient point of the Corley Report was that an annual financial condition report of the actuary should be made mandatory in the guidance. I understand that such reports are mandatory in Canada. We have made great progress in defining the scope and mechanics of financial condition reports such as set forth in our dynamic rinancial condition analysis handbook and at our annual valuation actuary seminars. But we have not undertaken an ASOP for such reports nor have we attempted to make them mandatory in our guidance.

NAIC regulations have emerged for allocation of risk based capital, and for opinions as to adequacy of assets supporting reserves. While worthwhile, these are no substitute for a mandatory annual financial condition report to management and/or board. I suspect that these regulations would not prevent many insolvencies because they would not have caught major C-4 risks. They also encourage appointed actuaries to become mere journeymen whose objective is to meet regulatory tests, rather than to judge the solidity of the company as true professionals.

Twenty years ago, our initial belief was that the valuation actuary should do most of the things now recommended by the Corley Committee. This hope was not realized for such reasons as these:

- Management conviction that the actuary should not have such authority.
- Potential abuse of such reports by insurance departments and public.
- Unwillingness to base regulation on actuarial guidance.
- Unwillingness of company actuaries to aspire to such status.
- Need for appropriate education of actuaries and for research.

It is appropriate to review the validity of these objectives. Finally, I pondered deeply the Corley Committee recommendation to "make an external review of the work of the appointed actuary a requirement." It eventually became clear to me that this was a reasonable idea quite consistent with the thrust of their overall plan. It might even be regarded as a keystone in any adaptation of their approach by the SOA-AAA-NAIC. It would assure appropriate attention to the C-4 risk and to other important risks about which an inside actuary might be, or appear to be, prejudiced. Also, the inside actuary would be under scrutiny like other members of management and such independent audit could alleviate some of the objections listed in the above paragraph. It is notable that outside actuarial opinion is sought in mergers and demutualizations; the financial condition report seems no less important.

Apparently in Canada our initial convictions have been realized. In the U.S., the most evident response has been more and more regulation. However, we have made great strides in knowledge and education. Perhaps we now can say that we are ready to ask for trust in our ability to assume all the responsibilities of the Corley Report! I hope that you find my reactions constructive. ❖

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