In the last few years, however, with-profits has increasingly become the subject of criticism from the press and consumer organisations. Some of the principle complaints include:

- lack of transparency;
- lack of consumer understanding of the risks involved in with-profits investments;
- concern over the extent of discretion companies have over the management of funds;
- the perception that companies are deliberately underpaying policyholders in order to build up their estates;
- the fear that with-profits policyholders are footing the bill for management mistakes including pension mis-selling, endowment shortfalls and the costs of guaranteed annuity options;
- poor surrender values; and
- hidden charges.

### 6.1 Transparent With-Profits

The Faculty and Institute’s Transparency of With-Profits working party was formed in late 1999 to respond to the critical perception of with-profits and to support the inclusion of with-profits as an option under Stakeholder pensions.

The working party’s report *Transparent With-Profits – Freedom with Publicity* was published in early 2001. The report identified the need to improve the transparency of operation of with-profits business whilst retaining sufficient discretion to allow effective management for example over smoothing and bonus policy.

The authors observed that many of the criticisms of with-profits stemmed from a lack of understanding by consumers resulting from poor communication. To tackle this the working party recommended extending Raising Standards requirements for with-profits. As well as improved disclosure at the point of sale Raising Standards proposed yearly statements to policyholders including the current value of policies and projected maturity proceeds. The additional working party proposals include the disclosure of the investment return on the assets backing the with-profits fund, the asset mix of the fund and the effect of miscellaneous profits on policyholder returns.

The report also proposes a reporting model for with-profits. This includes the identification of separate asset share, smoothing and guarantee accounts for each class of with-profits business.
6.2 Financial Services Authority With-Profits Review

The events surrounding the closure of Equitable Life to new business pushed the future regulation of with-profits high up the FSA’s agenda. Early in 2001 the FSA announced a review of with-profits. Acknowledging the benefits with-profits had provided in the past, the FSA identified what it described as serious disadvantages of with-profits. The review is looking at the prospects for change in:

- the extent of discretion available to management over the operation of with-profits funds and how that discretion is exercised;
- improvements in the transparency of information sent to policyholders and regulatory returns;
- better information for policyholders about the progress of their investments; and
- the clarification of the interests of consumers and the fair treatment of consumers in the context of with-profits.

To date four issue papers have been produced:

- Process for dealing with attribution of inherited estates – October 2001
- Regulatory reporting – November 2001
- Disclosure to Consumers – February 2002
- Discretion and fairness in with-profit policies – February 2002

A fifth issue paper covering Governance of with-profits is expected in the near future.

The second issue paper considers a reporting model based on asset shares for with-profits business with summary information disclosed for each with-profits fund. The actuarial profession’s response points out that some companies are likely to experience extreme practical difficulties in calculating asset shares for all policies and that existing calculations would be unlikely to be of audit standard.

The fourth paper looks at the extent of discretion available to management of with profit funds and how discretion can be exercised without treating policyholder unfairly. One indication that policyholders have been treated unfairly is when they feel “unpleasantly surprised” by an event or decision. The paper identifies the exercise of unqualified discretion as potentially delivering unpleasant surprises. Such unqualified discretion may also fall foul of the Unfair Terms in Consumer Contracts Regulations 1999 on the grounds of causing a significant imbalance in the rights of parties to the contract.
The paper proposes publication of ‘principles’ and ‘practices’ qualifying the use of discretion stressing that it is not intended that greater transparency should constrain the operation of with-profits to the detriment of consumers. Principles are intended to be high level and not subject to change for example ‘investment strategy will look to provide the highest returns commensurate with an appropriate level of risk’. Practices reflect the insurer’s current approach given current circumstances and could be expected to change for example ‘the target proportion of the fund held in equities is x-y%.

It is clear that there are going to be significant changes in the regulation of with-profits including very much greater disclosure. The final report is due in spring 2002.

7 Regulation and Reporting

7.1 The Financial Services Authority

The Financial Services and Markets Act 2000 finally came into full force at midnight on 30 November 2001. With this the Financial Services Authority assumed its full powers and responsibilities as the single regulator responsible both for conduct of business and prudential regulation of the financial services industry.

The FSA has four statutory objectives under the Act:

- maintaining confidence in the UK financial system;
- promoting public understanding of the financial system;
- securing appropriate protection of consumers; and
- reducing financial crime.

The rules and guidance for all regulated firms are contained together in one place in the FSA Handbook. The handbook contains over 4,500 pages.

There are likely to be significant changes in the approach to regulation under the new regime. The FSA will be taking a risk based approach with attention focussed on companies where the risk is judged to be greatest based on an impact and probability assessment.

The FSA have indicated that they will be more assertive and challenging than in the past, be more focussed on industry wide issues and engage in themed visits to companies.

One change is that greater emphasis will now placed on the responsibilities of key individuals in the management of organisations. There are now several controlled functions that can only be carried out by approved persons. Approved persons are responsible for ensuring that there are appropriate and adequate risk management systems and controls in their area of responsibility. These individuals can be fined for failing to carry out their obligations.
Far more radical changes are likely to occur over the next few years. In December 2001 the FSA announced a far-reaching overhaul of insurance regulation led by John Tiner, FSA managing director of consumer, investment and insurance matters. A report on the progress of the Tiner Project will be issued in September 2002.

7.2 Regulatory Returns

Most of the previous regulations and guidance have been carried into the FSA Handbook in the Interim Prudential Sourcebook for Insurers. This brings together the previous rules under the Insurance Companies Act 1982, the Insurance Companies Regulations 1994, the Insurance Companies (Accounts and Statements) Regulations 1996, the Insurance Company Prudential Guidance Notes and Dear Appointed Actuary letters.

In many respects the rules have been carried forward unaltered from the previous regime. There have, however, been a few changes to the valuation regulations discussed below. Additionally:

- Annual returns will need to be submitted earlier. The 6 month deadline has been reduced to 4 months for reporting years ending on or after 31/12/2001 reducing further to 3 months for years ending 31/12/2002. Tighter deadlines apply if the returns are not submitted electronically.
- The European Union Groups Directive has been implemented. One requirement is that the solvency position of groups is to be calculated at the level of the holding company above the insurer. This prevents double counting of capital.

7.2.1 Modifications to the Valuation Regulations

The Interim Prudential Sourcebook also contains some amendments to the valuation regulations.

The regulatory returns now require greater disclosure on with-profits business. Information is required for each fund in which policyholders are entitled to participate in profits including:

- how the with-profits fund is defined, which assets, liabilities, income and expense are allocated to it.
- whether any non profits insurance business, or profit from such business, is allocated to the fund;
- details of how the assets are invested;
- the level of surplus or free reserves to be maintained in the with-profits fund;
- the relationship between the performance of the with-profits fund and discretionary benefits allocated to policyholders; and
- the principles followed by the insurer in setting actual proportions of profits distributed to policyholders and shareholders.

There have also been changes to the rules on the valuation yield assumed on equities. Previously, under Regulation 69 of the Insurance Companies Regulations 1994, the dividend yield was required. In response to the view that companies are now distributing their earnings in other ways, share buy backs for example, the rules have been changed to take some credit for earnings not distributed as dividends. The new rules allow the dividend yield plus half the excess, if any, of the earnings yield over the dividend yield. This amount is subject to a maximum of twice the dividend yield.

7.3 Integrated Prudential Sourcebook
Far greater changes to the prudential regulation of insurers are only a few years away. The Integrated Prudential Sourcebook is intended to form a uniform, risk based approach to regulation that is not sector specific. The aim is, as far as it is possible, to bring the regulation of banks, life insurers, friendly societies, general insurers, investment firms etc. under one consistent set of rules. Current plans are for the Integrated Prudential Sourcebook to take effect from the beginning of 2004.

The FSA issued a consultation paper, CP97, on the Integrated Prudential Sourcebook in June 2001 setting out draft rules and guidance.

### 7.4 Role of the Appointed Actuary

In December 2001 the Faculty and Institute set up an inquiry into the events surrounding the closure of Equitable Life to new business and its implications for the profession. The Corley inquiry reported back in September 2001. A principle recommendation of the Corley Report was that the work of Appointed Actuaries should be subject to external peer review. The Baird review into the role of the FSA in the supervision of Equitable Life also recommended independent external review of Appointed Actuaries equivalent to an external audit.

In response to the Corley Report the Faculty and Institute’s Life Board issued a set of seven principles in relation to compliance review. These include a duty on the reviewer to report to the directors and “whistle-blow” where necessary. The compliance review proposed is to cover the FSA rules and mandatory guidance. The Life Board intends to issue more detailed proposals for compliance review and the implications for professional guidance.

The Actuarial Governance Working Party of the Life Board has recently (February 2002) issued a discussion paper on Actuarial Governance. The paper covers the work of actuaries in the life office, the regulatory framework, and compliance review. Four models for the future shape of actuarial governance are considered. These give particular consideration to managing the potential conflict of interest that may arise when the Appointed Actuary is a senior manager or director of a life office.

The role of the Appointed Actuary will also be considered as part of the FSA’s Tiner Project and falls within the scope of the With-Profits Review where it will be considered under the Governance Issues paper.
Section 3 – Pensions

1 Reform of the MFR

1.1 Security for Occupational Pensions

In September 2000 the Government issued *Security for Occupational Pensions: A consultation document*. This paper sought views on various options including compulsory insurance, prudential supervision, a central discontinuance fund, and a common funding standard such as an amended MFR or on-going funding statement. This was included in last year’s Current Topics paper.

The consultation period ended on 31 January 2001 and subsequently the Government issued *Security for Occupational Pensions – The Government’s proposals* on 7 March 2001. It stated the responses indicated little support for the MFR. There was also little support for a central discontinuance fund, compulsory insurance or prudential supervision by a regulator.

There was, however, some support for a common funding standard that would apply to all pension schemes irrespective of size. Those who supported this approach felt it should be designed with the aim of ensuring an adequate level of long term funding without distorting investment management plans. However there was no general agreement on the exact basis of this standard, and the Government decided to reject the proposal as it felt it was little different to the current MFR environment.

The other option, which received substantial support during the consultation process, was for a long-term, scheme specific funding standard with a regime of transparency and disclosure. The Government has therefore decided to replace the MFR with this option. It builds on the framework recommended by the Myners Report, and also includes the following extra measures:

- A statutory duty of care towards scheme members on the scheme actuary
- Stricter conditions about voluntary wind-up
- An extension of the fraud compensation scheme

1.2 Key Elements of the Proposals

1) Funding Statement

Each scheme will have to have a funding statement setting out:

- The funding objectives of the scheme
- The scheme’s investment policy and projected returns on its assets
- Assumptions for projecting its liabilities
- A contribution schedule agreed by the trustees and the employer

The statement will be scheme specific, and on a long-term basis assuming the employer will continue in business. It will also take account of the employer’s financial strength. As the employer pays contributions into the scheme, and has to ultimately meet the balance of any costs, it is important the employer is fully involved in discussions about funding and in agreeing the contribution rate. The statement will be distributed to members and made publicly available.
2) Recovery Plan

Each scheme will have to compare itself regularly against the Funding Statement. If the scheme is not adequately funded it will have to produce a recovery plan for returning the fund to adequate funding within a relatively short period of time. This is suggested to be three years. The scheme will have to file this recovery plan with OPRA (as well as making it available to members) and to report annually to OPRA on progress against it. The trustees, actuaries, and auditors will have whistleblowing duties to report to OPRA if contributions are not paid in accordance with the recovery plan. OPRA will have some discretion to allow extensions to the deadline for making good funding shortfalls, and will keep its existing powers to dismiss and replace trustees.

The three year timescale is relatively short, especially considering the five year period to achieve 100% MFR funding, and there may be pressure from the pensions industry to lengthen this timescale.

3) Statutory duty of care on the actuary

This proposal will mean a duty of care on the scheme actuary directly to the scheme members and will be set out in legislation. It will include an explicit duty to consider the implications of funding plans for the scheme members and beneficiaries.

The actuary will have a duty to report to OPRA if:

- Contributions are not being paid according to the funding statement
- There are any delays in drawing up a recovery plan in an underfunded scheme
- Contributions in an underfunded scheme are not being paid in line with the recovery plan
- Either the funding statement, or the recovery plan in an underfunded scheme, are not being adhered to.

An important change is the scheme actuary will now be expected to take into account the employer’s financial strength when making recommendations about the funding plan. This could be a difficult area for actuaries to become involved with, and may require access to the type of information produced by credit rating organisations.

4) Voluntary wind-up

The Government will legislate to make it clear companies will not be able to walk away from a scheme leaving it insufficiently funded to meet liabilities. The company will have the choice of meeting these liabilities immediately, or putting in place an arrangement to meet them as they fall due.

5) Pensions Compensation scheme

The level of compensation will be increased to cover not simply 90% of the MFR liabilities as at present, but the cost of securing member’s accrued benefits (or the amount of the loss, whichever is the lesser).

6) Wind-up on the insolvency of an employer

The Government will consider whether any increase to the priority of the debt relating to the pension scheme can be made.
7) Priorities on wind-up

As the MFR is to be replaced the priorities on wind-up will also need to be examined.

8) Cash-equivalent transfer values

Similarly, cash equivalent transfer values will need to be further considered as the MFR currently provides a legislative minimum.

9) Interim changes suggested by the Faculty and Institute of Actuaries

As the Government has decided to replace the MFR it did not feel it sensible to introduce some proposed changes recommended by the profession. These involved changes to mortality and pension increase assumptions, and altering the equity MVA reference yield from 3.25% to 3%.

1.3 Minimum Funding Requirement: The Next Stage of Reform

Following the publishing of the Government’s proposals on 7 March 2001 it received various comments from interested parties about what should happen in the meantime. In light of this the Government issued The Minimum Funding Requirement: The Next Stage of Reform on 18 September 2001 which proposed some short term interim changes and draft regulations which it hopes to bring in before 5 April 2002. It also announced the setting up of a Consultative Panel with representatives from pension industry bodies, consumer organisations, employers, trade unions etc. to take forward the MFR reform. The Faculty and Institute of Actuaries are also included.

The interim changes proposed were:

1) Extension of the period for making up MFR deficits

The current MFR requires an MFR deficit to be corrected within five years or by 5 April 2007 if later. If a scheme is less than 90% MFR funded then it must achieve the 90% level within one year or by 5 April 2003 if later.

The Government proposes the five year period be extended to ten years, and the one year extended to three years. These extensions will only apply for MFR valuations signed after the new regulations are in place.

This has been generally welcomed by the industry as it means any short-term volatility in investment returns will not drive a scheme’s funding and investment policy. It also means the proposed three year correction period with the new funding standard looks increasingly short thus adding pressure for it to be lengthened.

2) Removal of the current requirement for automatic annual recertification

The current requirement is for a schedule of contributions to be recertified on each anniversary of its start date. It is proposed to remove this requirement for schemes which at the last MFR valuation showed the scheme fully funded on the MFR basis. The Government is also considering combining this with bringing into force Regulation 11 of the current MFR regulations. This would be the requirement for an MFR valuation to be carried out if the
Trustees suspect an event (or series of events) has meant there is a serious risk the MFR will not be met throughout the remaining period of the schedule of contributions.

The Government is working with the actuarial profession on the detailed wording of Regulation 11. The profession, however, is concerned about potential increases on the duties for scheme actuaries and further regulatory burden arising from this Regulation.

3) Stricter conditions on voluntary wind-up

There was a fear the interpretation of the Government’s original proposal meant the debt on the employer would be based on the full amount needed to buy-out members’ benefits. The Government has now decided this would be too high a cost for schemes to bear. It suggested young members may be better off in a money purchase type arrangement instead of a guaranteed deferred annuity, and also the size of the insurance company buy-out market would be insufficient to cope with the potential huge increase in volumes.

The proposal is the current method of calculating the debt on the employer should be strengthened in the long term to include:

- the actual costs of winding-up the scheme;
- the actual costs of annuities for pensioner members; and
- cash-equivalent transfer values for non-pensioner members calculated on the new long-term funding basis.

As the new long-term funding basis has yet to be formalised the interim proposal is for cash-equivalents on the MFR basis to continue for non-pensioner members.

This move away from the possibility of full buy-out costs will limit the number of employers choosing to wind up schemes quickly under the current rules in order to minimise any debt. A problem with the new proposal, however, is it still requires a buy-out cost for pensioners which can only really be obtained from the annuity market. It is unclear how the limited bulk annuity market would cope with this.

1.4 The Future

The Government is hoping to implement the proposed interim changes by 5 April 2002. The longer term changes will be developed in conjunction with the new Consultative Panel, however, it seems certain the MFR environment will remain with us for another two to three years. It will be interesting to see the development of the new long-term funding standard, and any changes required on scheme actuaries to cover their revised statutory duty of care.

2. Myners Review

Paul Myners was asked to carry out a review of institutional investment by the Chancellor in the 2000 budget. The review was to consider if there were any factors that encouraged institutional investors to follow industry standard investment patterns which focus overwhelmingly on quoted equities & gilts, and avoid investing in other smaller companies.

The review makes recommendation in a number of areas:
In this paper we have chosen to concentrate on the code of investment principles that was published as part of the report.

2.1 Investment Code

Paul Myners published his review of institutional investment on 6 March 2001. The review contained a number of proposals and principles which the Government consulted on between 15 March and 15 May 2001. Over 115 responses were received from institutions, pension funds, fund managers and other interested parties. The Government subsequently issued its response to the review on 2 October 2001. Some of the principles were amended to reflect concerns raised during the consultation process.

The Government expects pension schemes to voluntarily adopt the principles and set out annually what they are doing to comply with each of the principles. If trustees choose not to meet a particular principle they should explain their decision publicly and to their members.

There were a number of criticisms that the principles were difficult to implement for small schemes. The Government does not accept this and the code also applies to small schemes. Again, if the trustees choose not to comply with a principle they should explain why. The principles do not apply to insured schemes.

The Government will review progress in March 2003 to see if the voluntary code has been effective in changing behaviour. If further action is needed the government is willing to legislate to ensure compliance.

2.2 Defined Benefit Schemes

The proposed investment principles for defined benefit schemes are:

1) Effective decision-making

Decisions should only be taken by people with sufficient knowledge and skills, and trustees taking investment advice should have the expertise to evaluate it.

Trustees should be paid for their duties and have sufficient in-house staff to support them in their investment responsibilities.

2) Clear Objectives

Trustees should set out an overall investment objective for the fund, including taking account of the fund’s liabilities and their attitude to risk.

3) Focus on asset allocation

Strategic asset allocation should be fully considered and looked across all asset classes, including private equity. The assets should reflect the fund’s own characteristics and not those of other funds.

4) Expert advice
Contracts for actuarial and investment services should be opened to separate competition.

5) Explicit mandates

The mandate between the Trustees and investment managers should cover the investment objective and benchmarks to be measured against. It will also include details of the manager’s approach in achieving the objective, and clear timescales for measurement and evaluation.

6) Activism

There should be an increase in Fund managers’ shareholder activism.

7) Appropriate benchmarks

Trustees have to consider in consultation with their investment managers the ongoing suitability of any benchmarks, and for each asset class whether active or passive management would be more appropriate.
8) Performance measurement

Trustees should arrange for measurement of the performance of the fund, and assess their own and their
advisers’ procedures and decision making.

9) Transparency

A strengthened Statement of Investment Principles is required.

10) Regular reporting

The Statement of Investment Principles and the results of any monitoring of advisers or investment
managers should be annually sent to members.

Myners also made other recommendations including:

- the replacement of the MFR;
- the Law Commission to look at clarification of the legal ownership of pension surpluses;
- reduction of the rate of tax on withdrawal of any surplus;
- a legal change which would raise the duty of care for trustees, requiring them to be familiar with
  investment matters where they take investment decisions.

In reply:

- the Government’s response on the MFR has been discussed in the previous section;
- the Government is discussing with the Law Commission whether more clarity could be obtained
  over the ownership of surplus;
- in the 2001 Budget the Government reduced the taxation rate on repayments of pension surpluses
  from 40% to 35%;
- the raising of care for Trustees is to ensure they take decisions with the skill and care of someone
  familiar with the issues concerned. The Government is aiming to issue a consultation document on
  the possible legislation required.

2.3 Defined contributions

Much of the reviews analysis focused on occupational defined benefits pension schemes. However, the
review also recognised that defined contribution schemes will become increasingly important in new
pension provision.
Many of the issues raised for defined benefit schemes apply equally to defined contribution schemes. The review recommended that investment decisions taken on behalf of defined contribution members should also follow the principles of the investment code. In particular:

- where a fund is offering a default option trustees should ensure that an objective is set for the option including expected risks & returns

- when selecting investment options trustees should
  - take into account members preferences
  - ensure that they offer a sufficient range of funds to satisfy the risk and return combinations reasonable for most members

- defined contribution schemes should, as a matter of best practice, consider a full range of investment opportunities, including less liquid and more volatile assets. In particular, investment trusts should be considered as a means of investing in private equity

- the Government should keep under close review the levels of employer and employee contributions to defined contribution pensions and the implications for retirement incomes

- the NAPF investigate ways of collecting more comprehensive data on the investment decisions of defined contribution scheme.

3. Stakeholder Pensions

Previous current topics papers have discussed the reasons why the government introduced stakeholder pensions (2000) and the key features of stakeholder pensions (2001). This year’s paper will look at the impact stakeholder pensions have had on the pensions market.

Stakeholder pensions are low cost, value for money, flexible pensions that were launched on 6th April 2001. They are a key part of the Government’s attempt to help those on moderate earnings (between £9,600 and £20,000 pa) to save for retirement.

3.1 Employer Designations

Employers were given until 8th October to designate a stakeholder scheme for their employees. The Department of Work and Pensions estimate that between 300,000 and 350,000 employers fall into this category.

The employer does not have to contribute to the stakeholder scheme but must they must provide access for relevant employees to join the scheme. Employers that failed to meet the October deadline may be liable to a fine of up to £50,000.
## 3.2 Sales of Stakeholder

<table>
<thead>
<tr>
<th></th>
<th>Number of Policies (at end of month)</th>
<th>Number of Employer Designations (at end of month)</th>
</tr>
</thead>
<tbody>
<tr>
<td>June</td>
<td>224,598</td>
<td>88,073</td>
</tr>
<tr>
<td>July</td>
<td>293,685</td>
<td>123,158</td>
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<tr>
<td>August</td>
<td>356,899</td>
<td>146,950</td>
</tr>
<tr>
<td>September</td>
<td>415,805</td>
<td>212,242</td>
</tr>
<tr>
<td>October</td>
<td>491,694</td>
<td>284,821</td>
</tr>
<tr>
<td>November</td>
<td>567,728</td>
<td>304,750</td>
</tr>
<tr>
<td>December</td>
<td>637,966</td>
<td>312,096</td>
</tr>
</tbody>
</table>

The sales of stakeholder pensions have increased steadily from April to December. As the end of the tax year approaches we can expect to see an increase in the number of people buying stakeholders.

The pace of employer designation rose sharply in September as the 8th October deadline approached. The latest figures for November and December 2001 show that the number of companies designating schemes has started to slow as expected now that the deadline has passed. A large percentage of the relevant employers have now designated schemes.