INHERITED ESTATE – WHAT'S LEFT?
THE CURRENT POSITION AND FUTURE DEVELOPMENTS

By Pollyanna Deane

Introduction

Given the current market conditions and some more pressing concerns that insurers may have who have inherited estates, they will be forgiven if they have put this issue on the back burner. Nevertheless it remains a potential area of interest for a company's policyholders, its shareholders and the regulator. This much is clear from the FSA's With Profits Review, its public statements and accompanying consultation and discussion process.

What are Inherited Estates?

Inherited estates (or commonly "orphan assets") are held in the long term funds of life assurance companies. Neither term has a statutory definition. Inherited estates arise from a build-up of non-distributed surplus and amounts derived from shareholder contributions. The estate usually refers to the amount of the assets maintained in a life assurer's long term fund over and above the amount required to meet liabilities including expected terminal bonus. It is not usually possible to give it an exact value, since much depends on stock market conditions.

Companies will use the estate to support their business in a number of ways, for example:

- to allow greater investment flexibility by enabling a higher proportion of investment in more rewarding but higher risk assets (such as equities);
- to facilitate the smoothing policy of the fund, particularly when there are sudden changes in the investment markets;
- to provide a "cushion" against unexpected adverse events: the estate is therefore very valuable to the insurer and its policyholders at a time of volatile market conditions (such as are being experienced at present);
- to develop the company's business, by investing to improve efficiency or the provision of additional services to customers;
- to support the sale of new business into the fund.

At present, many companies are probably using their estates to support their long term fund's operation. If an insurer considers, on actuarial advice that any of the

inherited estate is no longer necessary for these purposes then potentially some of it may be distributable to policyholders and shareholders.

Past Attributions and Re-attributions – a History of the Inherited Estate

There have in the past been a number of negotiated settlements with the regulator (whether the DTI or its successors) which has established the division between policy holder and shareholder interest in the inherited estate. These include the negotiations involving London & Manchester Assurance (since acquired by Friends Provident) and United Friendly Group (following its acquisition by Refuge Assurance).

Following the United Friendly deal, a Ministerial Statement was issued in 1995. The statement made it clear that where a company had a distribution policy for surplus which was on the basis of 90:10 between policyholders and shareholders, then there could normally be no other basis on which any distributions could be made.

AXA Equity & Law (which had articles of association which included a 90:10 provision) had been discussing matters with the FSA for a number of years before drawing up the scheme which it eventually put to the court. In view of the 90:10 provision in its articles of association and the Ministerial Statement, AXA Equity & Law was keen to find some way to ensure that it could make attribution of the inherited estate on a different basis.

To do this, it developed, taking into account feedback from the FSA, a scheme including a unique reorganisation of AXA Equity & Law's inherited estate. This balanced the interests of shareholders and policyholders by effectively offering those policyholders who elected, a fair price to buy them out of a somewhat uncertain interest, namely a hope that at some future stage AXA Equity & Law would distribute its inherited estate, and they would then participate in the distribution. Policyholders' interests in the security of the fund, its capacity for smoothing and so on would not be affected.

AXA (again taking into account FSA feedback) took particular account of policyholders' reasonable expectations in developing the scheme which was eventually put to the court in order to ensure that they were not prejudiced.

Policyholders' Reasonable Expectations

The Ministerial Statement had previously considered the interpretation of the term "policyholders' reasonable expectations" or "PRE" and the DTI's view of this. PRE was of particular importance for the exercise of the regulator's powers. Section 45 of

the Insurance Companies Act 1982 ("ICA") gave the regulator power to take such action as appeared to it to be appropriate for the purpose of protecting policyholders (or potential policyholders) against the risk that a company may be unable to fulfil policyholders' reasonable expectations ("PRE"). It was not, however, defined in the legislation and was rarely considered by the courts. Nor was it a right or rights that policyholders could enforce themselves.

The Financial Services and Markets Act 2000 ("FSMA") which replaced the ICA, has removed the concept of policyholders' reasonable expectations, replacing it with a more flexible description of paying due regard to the interests of customers and of "treating policyholders fairly". Further, Consultation Paper 167 refers to the obligation of treating customers fairly with regard to with profits business as including the principle known as "policyholders' reasonable expectations". The FSA plans to consult on this and it suggests that the concept remains with us.

Influences on PRE

The Institute of Actuaries and the Faculty of Actuaries, in its report on the ownership of the inherited estate delivered in June 1995 stated the generally accepted view of the actuarial profession, that PRE is formed and influenced by:

- references to participating rights in a company's articles of association;
- promotional and publicity material and public statements by the company;
- the with-profits guide;
- history and past practice of a company; and
- general industry practice.

Similar factors were also cited by the Ministerial Statement as forming and influencing PRE.

The Court in AXA considered PRE, particularly in the light of the Equitable case, (*Equitable Life Assurance Society v Hyman* [1999] O.B.L.R. 213). In the AXA case, Evans Lombe J took as a starting point for PRE, a policyholder's "asset share". He noted that the inherited estate had developed from surplus and was the excess of the sum of the asset shares of current policyholders. The judge also reiterated the accepted view that sources of PRE included the company's articles of association, its past practice including its bonus policy, the current practice of the insurance industry generally and its marketing and other literature. In addition, he accepted that a policyholder would have PRE in the inherited estate being available to back

his or her policy for the purposes of smoothing and eventually as part of its role as "working capital".

Payments such as those made to policyholders who elected to join the 'New With Profits Fund' should, as Evans-Lombe J identified, be described as "windfalls". They form no part of PRE either at the time that policyholders take out their policies or at any time before the promulgation of the scheme. Nor did policyholders have, prior to the scheme being made public, a reasonable expectation that the whole or any part of the inherited estate would be distributed by way of bonus or otherwise during their policy's lifetime.

The FSA and the independent actuary concluded that the offer made to policyholders under the AXA scheme was within a reasonable range and that PRE was not prejudiced.

Current Position Regarding PRE and Inherited Estates

As already noted, the term PRE is no longer with us except in certain parts of the IPRU (INS) and the professional guidance of actuaries, thanks to the relodging of much of the previous legislation in the FSA rules. However, it remains a concept with which the industry is familiar and satisfaction of it would appear, in the FSA's view, potentially to be part and parcel of the principle of treating policyholders fairly.

As a result of the AXA scheme, policyholders' reasonable expectations in other life companies would now appear to have been enlarged. It may be reasonable for them to anticipate that their company's board should consider whether or not to distribute or reallocate all or any part of any inherited estate that may exist. If so, the board will need to consider whether this should involve an incentive payment or not.

The FSA itself recognises that the inherited estate is now "in issue". In its With Profits Review, it referred to a number of mechanisms for its distribution, attribution and re-attribution setting out a number of ways to do this including:

- scheme of arrangement for compromise with "creditors or members" under Section 425 of the Companies Act 1985;
- varying the contractual terms and rights of policyholders by obtaining their explicit consent;
- obtaining prior FSA consent not to object to the process used.

These are anticipated to be examined in more detail in consultation later this year and the FSA makes the comment that choice of the mechanism adopted depends on the circumstances of a particular case. The AXA case was very much predicated on AXA's own position.

Further, given the intervention by the Consumers Association and their appearance at the AXA hearing, it is likely that they will seek to be involved in the negotiations leading up to any scheme that may be put to policyholders in the future should any other insurance company seek to follow in AXA's lead and put a proposal to its policyholders. Companies such as the Prudential and CGNU have announced that they are looking at better use of some or all of their inherited estate.

Future Attributions of Inherited Estates

Although the FSA considers that the current AXA process has not led to consumers being disadvantaged, it has given considerable thought to attributions of inherited estates. An attribution is made to define the interest that policyholders and shareholders would have in any future distribution of that estate. An attribution does not imply a distribution. A distribution will only occur if some part of the estate is identified as no longer required in the business and hence available for release. Any such distribution will only be made if the insurer is satisfied, after carrying out vigorous analysis of the financial condition of the company, that it can be justified on prudent assumptions.

The With Profits Review looked carefully at the processes involved, identifying that there have to date been two ways of attributing the estate:

- *Clarification:* this is where a company seeks to clarify the attribution of the inherited estate between policyholders and shareholders. Most early cases took this form. They involved "industrial assurance business", where there was a lack of clarity over the proportions in which surpluses should be allocated between policyholders and shareholders in the company's accounts. In this process, shareholders' and policyholders' interests are unchanged. Assets are not taken from the long term fund, but the accounting records recognise the respective interest of policyholders and shareholders in any surplus in that fund;
- *A re-attribution:* this is where shareholders seek to buy out policyholders' rights to any future distribution of the inherited estate; attribution of the inherited estate is already clear but the company offers to buy out all or part of the with-profits policyholders' interests in possible future distributions from the inherited estate. This was the approach taken in the AXA case.

Re-attributions are typically very lengthy, and deal with complex technical issues. They can also involve large sums of money, and are likely to be commercially and market sensitive. There are, therefore, limitations as to how much of the detailed negotiations can be carried out publicly. Two points emerged from FSA consultation and work on the With Profits Review:

- a re-attribution essentially represents a commercial negotiation between those with interests in the inherited estate (for example, shareholders and current policyholders). There is, however, no explicit and distinct "negotiator" on behalf of policyholders with the specific responsibility to secure the "best possible" deal in their interests. Until now, the FSA have acted as "de facto" negotiator for policyholders as well as being responsible for the regulatory scrutiny of the proposals under the current legislation. In addition, because AXA's proposals involved a "Part VII Transfer" (as it is now under the FSMA) the independent actuary (or expert) considered the policyholders' position in reporting on the Scheme to be put to the Court;
- re-attribution exercises are - to some extent unavoidably - complex and opaque to policyholders. There are two aspects to the issue of transparency:
  - transparency of the details of the negotiations; and
  - transparency of the process of the negotiations and scrutiny of the proposals.

Concerns have been expressed by respondents to the With Profits Review that if discussions are undertaken "behind closed doors", with proposals being presented to policyholders on a "take it or leave it basis", this lacks transparency.

The With Profits Review suggested several options for improving the process for attribution and re-attribution. Following consultation, respondents have preferred the involvement of a proxy negotiator. A separate person or entity would be appointed to act as a policyholder negotiator by proxy. The proxy – in contrast to the independent actuary or independent expert (under a Part VII transfer) and the FSA who would retain responsibility for regulatory scrutiny – would hold only the role of policyholder negotiator to secure for the policyholder the best possible deal.

Issues paper 1 also proposed a framework of publicity requirements with the aim of introducing an element of early warning of negotiations and more transparency in relation to the process of scrutiny with the aim of increasing confidence that policyholder interests have been fully addressed. These included formal signals to policyholders, shareholders and other stakeholders of the start of the negotiations,

the issue of regular progress reports, and communication of the final agreed position or formal offer.

Future Development: FSA Conclusion

Respondents to the With Profits Review had their views analysed and the FSA published them together with its own response in a Feedback Statement in May 2002, concentrating for the purposes of the inherited estate on the two key issues of the policyholder advocate and the wider question of transparency.

A New Role – the Policyholder Advocate

The FSA accepted that lack of an explicit "negotiator" acting on behalf of the policyholders could be seen as a weakness of the current process for dealing with the re-attribution of inherited estates, this is particularly so where an offer is being considered to buy out policyholders' interests in possible distributions from the inherited estate. The "policyholder advocate" is therefore expected to be adopted as a new role in the process.

Further consultation by the FSA will look at the detailed responsibilities of the advocate and how, in practice, the role could be best introduced into the current process. The initial view from respondents to the With Profits Review was that the advocate's objective ought to be to secure the best deal that he or she can for policyholders. It would be for policyholders to decide whether they were satisfied with proposals put to them. The FSA would also need to be satisfied that the proposal was fair to policyholders, and in doing so:

- that any proposal was consistent with the principles set out in the Ministerial Statement of February 1995, and in particular the so-called 90:10 principle;
- that policyholders' security and their fair treatment were properly protected;
- that policyholders have been given the opportunity to retain the status quo, that is to retain their interest in the inherited estate without suffering detriment; and
- that the terms of the offer to policyholders are such that, set against the likely value to policyholders and to the company itself, the offer falls within a 'reasonable range' to put to policyholders.

The FSA envisages that a policyholder advocate would be involved early on in the negotiation process and, in practical terms, would probably need to be an individual, rather than a panel. The advocate would need to have access as necessary to specialist advice for areas outside his/her own expertise. The FSA proposes further

consultation to consider how the advocate should best be appointed, recognising that this might involve the non-executive directors of the company and/or a court process. The FSA acknowledges the use of the court process because of the need to ensure that the holder of the position of advocate has some form of protection from possible civil suit by policyholders, or groups of policyholders, who may be discontented with the outcome of any deal. It also should be noted that few, if any, individuals would be willing to act as policyholder advocate without an indemnity.

Given the diversity of policyholder interests, and the reasonableness of giving individuals a freedom of choice, the FSA believe (as reflected in paragraph 5.108 of the Feedback Statement) that it is appropriate for policyholders to be given the opportunity to choose to retain their interest in the inherited estate without detriment, effectively retaining the "status quo". Although the FSA accepts that if this can be shown to be uneconomic, it may be that the majority view should prevail.

Transparency

The aim of transparency colours the With Profits Review as a whole. In the light of the inherited estate, the FSA consider that transparency for a re-attribution exercise can be achieved through enhanced publicity requirements.

However, companies need to provide information in sufficient detail that is useful but also need to maintain commercial confidentiality, including safeguarding against the effects of releasing market sensitive information. The FSA have proposed that the following framework is implemented:

- *Announcement of the start of negotiations:* to be made on the appointment of the policyholder advocate, to be accompanied by a statement of the outline details of the initial proposals, the key principles to be applied in the negotiations and a target timeline.
- *Regular progress reports:* to be made to policyholders regularly, e.g. every six months, commenting on the progress of negotiations. As with all communications to policyholders, any report would need to be clear, fair and not misleading and focussed on the outcomes of agreements reached and their impact, rather than anything overly technical.
- *Communication of final agreed position or formal offer:* full disclosure of the final terms of the proposed deal before it is put to policyholders.

Clearly, additional costs will accrue with the involvement of a policy-holder advocate and enhanced publicity. It will be part of the FSA's and advocate's role to

discuss with the company who should bear them, e.g. the shareholders of the company or the inherited estate. The FSA has already started some preliminary work on the re-attribution of inherited estates to look at how the arrangements for a policyholder advocate might work, stating that it intends to consult on processes for re-attribution in Summer 2003.

What is Left of the Inherited Estate – Other Than Attribution or Re-attribution?

Recent stock market falls have increased the importance of the inherited estate in its role as working capital. It can provide a capital buffer:

- to absorb unexpected losses (and so reduce the risk of insolvency);
- to shift costs of failure from policyholders to owners (and so enhance incentives on firms and shareholders to operate effective oversight over management); and
- to enhance market and public confidence in the firm (and so its market position).

Increasing capital support is not without cost, and firms are interested in extracting better value from their inherited estates for this purpose. As the industry is aware, the demands for enhanced capital support will also soon increase thanks to new regulation, e.g. individual capital requirements for firms (which requirements may, depending on the risk profile of the firm, exceed the enhanced regulatory requirements which will apply to all firms from 2004). The FSA has also been consulting on increasing regulatory solvency requirements to implement the Solvency I Directives. Finally, the FSA is looking to require firms to increase their capital to cover the terminal bonuses which the firm expects to pay as its policies mature or on surrender. In addition, the use of financial engineering is under scrutiny both by the FSA and more widely.

These proposals will have a very substantial impact on many insurance firms, who will need to consider the FSA's proposals on re-attribution of inherited estate in the light of other proposals on capital.

In addition to the With Profits Review, the Sandler Review, ("Medium and Long Term Retail Savings in the UK – A Review", July 2002), considered and made recommendations on the nature of with profits policies. The Review's proposals raise some important issues in relation to inherited estates suggesting that:

- future new with-profits business should not participate in any distribution from an existing inherited estate, and

- the capital used to support future new business should normally be provided by shareholders, either from their own funds or from their share of any distributable assets from an existing inherited estate.

Thus, an existing inherited estate would provide support only for the existing with-profits business. If the existing business runs off in a closed fund as envisaged by the Review, the inherited estate could be expected to be distributed in accordance with existing participation rights (commonly 90:10).

This interpretation of the Review's proposals would have two major effects. First, the existing inherited estate (or, at least 90% of it) would no longer be a source of capital to support future new with-profits business. Secondly, the prospects of the existing policyholders receiving the benefit of a distribution from the inherited estate would be greatly enhanced. In the current climate, these proposals may not accord with the needs perceived by the industry.

Conclusion

In the light of current economic conditions, flexible use of the inherited estate, such as a source of working capital, offer advantages which make attributions or re-attributions (involving different accounting treatment) attractive. However, if companies are currently experiencing difficulty because they have no spare capital or indeed as is probable, the value of their estate has decreased, it is hard to see any attributions or re-attributions being made in the near future.

However, the AXA case did bring the inherited estate into issue, arguably changing "PRE". Interest in the area remains, particularly because of the nature of the inherited estate and its role as an asset to be exploited by different groups with different interests. In time we are likely to see more re-attributions and further developments in this area – just perhaps not yet.

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