

# ON POLICYHOLDER'S REASONABLE EXPECTATIONS

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## ABSTRACT

In this paper we discuss the interpretation of policyholder's reasonable expectations ("PRE") by the actuarial profession, the regulators and the Courts. We also cover three Court rulings and their impact on the interpretation of PRE. We set out some developments in India in relation to PRE. A sample checklist of issues to be considered in relation to PRE has also been included.

## KEYWORDS

Policyholders' reasonable expectations; Equity; Asset shares; Estate; Discretion; Equitable Life

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*"Blessed is he who expects nothing, for he shall never be disappointed" – Alexander Pope*  
*"Reason has always existed, but not always in a reasonable form" – Karl Marx*

## 1 Introduction

- 1.1 The phrase policyholders' reasonable expectations has been used by actuaries and the regulators to describe a concept without ever defining it. As a result the definition became a legal matter with its interpretation in specific circumstances being left to the Courts. For several years in the UK the concept was largely untested till the recent Court rulings that have led to discussion over the interpretation of PRE.
- 1.2 Participating business constitutes a large amount of the in-force business in India. More recently, unit-linked business with variable charges is gaining popularity. It is therefore an appropriate time to debate on the interpretation of PRE in an Indian context.

**1.3** In Section 2 we set out some interpretations of PRE. In Section 3 we cover PRE issues raised in professional guidance by the actuarial profession in the UK, Canada and India. Section 4 contains case studies on the legal tests of PRE related issues and its impact. We provide some comments on the developments in India in Section 5. A sample checklist of issues to be considered in relation to PRE is included in Appendix A.

**1.4** The views expressed in this paper are personal views of the authors and not necessarily those of Watson Wyatt.

## **2 Interpretation of PRE**

**2.1** PRE has been interpreted differently by the actuarial profession, the regulators and the Courts. In this section we set out:

- circumstances giving rise to PRE
- stakeholders in PRE
- sources of PRE
- measuring and monitoring PRE
- views of the UK regulators and the Actuarial Profession before the Equitable Life Judgement

### *Circumstances giving rise to PRE*

**2.2** The origin of PRE lies in the discretion available to an insurer regarding the benefits payable to its policyholders. This discretion allows the policyholders to benefit from investment in a variety of assets without having to bear the full volatility inherent in them. With-profits policies allow this benefit by smoothing the returns earned on the underlying assets. For unit-linked business companies may have the ability to vary charges again leading to PRE regarding the actions of the company.

**2.3** Various examples of the discretion available to life insurers include:

- bonuses declared on with-profits policies
- non-guaranteed surrender values
- market value adjustments on unitised with-profits policies
- variable charges on unit-linked policies
- unit pricing basis for unit-linked policies
- variable rates on yearly renewable term policies

**2.4** This discretion naturally leads to an expectation by the policyholders that the company's affairs will be conducted in a fair, transparent and responsible manner. Policyholders' may also expect a reasonable degree of continuity in the exercise of discretion by the company.

**2.5** There may be circumstances in which a company may have to depart radically from its past actions, for example, if the company's financial position rapidly deteriorates. In such situations the company needs to carefully manage its actions including consulting policyholders about the various courses that may be available to the company. The actions

taken by the company should be consistent with the communication made to policyholders at point of sale and subsequently.

#### *Stakeholders in PRE*

**2.6** An interpretation of PRE necessitates defining whose expectations are being addressed. Besides current and prospective policyholders the following stakeholders may also influence the expectations of policyholders :

- Courts
- financial advisers , agents and other intermediaries
- press and other professional advisers

**2.7** From the company's perspective, PRE is not the sole preserve of the actuary (or indeed the Appointed Actuary) but is the responsibility of all Directors of the company. Several markets including the UK, Australia and Singapore have shifted the onus of responsibility on PRE from the Appointed Actuary to all Directors of the company.

#### *Sources of PRE*

**2.8** There are several sources through which PRE is formed. These include:

- Policy literature
- Sales illustrations
- Statement of bonus philosophy
- Communication with policyholders, including what might be implied
- History and past practice of the company
- Advertisements and press releases
- Practices adopted by the life insurance industry

**2.9** As discussed in the Equitable Life judgment, the Courts ruled that disclosure and communication with the policyholders may well be given equal weight to policy conditions.

#### *Measuring and monitoring PRE*

**2.10** In order to satisfy PRE a company would need to consider:

- fair treatment of policyholders vis a vis shareholders
- fair treatment of different groups and generations of policyholders

**2.11** Thus the concept of PRE is closely related to the use of discretion to achieve equity. Asset shares are considered as the most common method of measuring equity. Asset shares are defined as the accumulated value of premiums less expenses incurred and benefits paid, allowing for the investment return earned for a group of similar policies. The calculation for asset shares would include a charge for any options or guarantees, the treatment of any miscellaneous surplus and cost of capital.

- 2.12** Assets shares are a useful benchmarking tool but may not necessarily constrain the discretion available to companies to manage PRE. Indeed, as the Equitable Life judgement highlighted, asset shares may be overridden by other factors such as the company's communication to policyholders.

*Views of the UK regulators before the Equitable Life judgment*

- 2.13** In February 1995, Mr Evans, Corporate Affairs Minister of the Board of Trade in the UK stated, in response to a Parliamentary Question on orphan assets that:

*“The Department 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 a vis shareholders;*
- *any statements by the company as to its bonus philosophy and the entitlement of policyholders to a share in profit, for example, in its articles of association or in company literature;*
- *the history and past practice of the company;*
- *general practice within the life insurance industry.”*

*Views of the Actuarial Profession before the Equitable Life judgment*

- 2.14** The Actuarial Profession set up a working party which produced three reports during 1990 to 1993 to consider the ways in which PRE had been used in practice and to recommend how it should be regarded in the UK actuarial profession. The first report of the working party stated, in relation to policies having a discretionary element:

*“The holders of such contracts may reasonably expect that life offices will behave fairly and responsibly in exercising the discretion which is available to them. They may also expect a reasonable degree of continuity in an office's approach to determining variable charges or benefits.”*

- 2.15** The working party also stated:

*“in the normal day-to-day actuarial management of a life office PRE is virtually synonymous with equity and the almost universal method for measuring it is asset-share calculations ....”*

### **3 PRE in the Guidance Notes**

*UK Guidance Notes*

- 3.1** Appointed Actuaries to life insurance companies in the UK have to comply with the practice standard guidance notes GN1 and GN8 of the Faculty and Institute of Actuaries. GN1 deals with broad matters relating to the prudential supervision of long-term insurance business. There are specific references to PRE in GN1.
- 3.2** Section 3.6 of GN1 requires the Appointed Actuary to consider any liability arising from the requirement to treat customers fairly including having regard to PRE while placing a value on the policyholders' liability. It also requires the Appointed Actuary to inform the insurers' management on his/hers interpretation of PRE. This requires the Appointed Actuary to have regard to the insurer's:

- practices and business plans
  - approach to the treatment of policyholders, individually and as a group, vis a vis shareholders
  - controls to ensure that policyholders are not misled as to their expectations
- 3.3** The Appointed Actuary must consider PRE in determining terms which are at the company's discretion. These include variables expenses, charges, market value adjustments, the basis of unit-pricing and the price at which units are bought/ sold.
- 3.4** These requirements cover the various examples of discretion available to the company as set out in Section 2.3.

*Canadian Standard of Practice*

- 3.5** Valuation Technique Paper No 10 of the Canadian Institute of Actuaries discusses the valuation of with-profits policy liabilities. Section 2 of this paper requires actuaries to value with-profits policy liabilities consistent with the reasonable expectations of policyholders. The paper recognizes that this provision is a complex matter.
- 3.6** The paper states that policyholders' reasonable expectations usually relate to the application of an experience-related formula or policy. However, in cases where policyholder communication has been loosely controlled and the insurer has declared the same nominal bonus amount for several years, the policyholder may reasonably expect to receive such bonuses in the future. In such circumstances the actuary needs to value liabilities as though the policies were written on fixed bonus terms.

*ASI Guidance Notes*

- 3.7** GN1 of the ASI requires an Appointed Actuary to have regard to PRE when ensuring that the life insurance business of the company is conducted on sound financial lines. This requires:
- equitable treatment of groups of with-profit policyholders and unit-linked policyholders
  - having regard to PRE when exercising discretion in unit pricing and fund charges
  - confirmation to the Board of Directors that PRE is being met while allocating surplus

**4 Case studies**

*Equitable Life Assurance Society ("Equitable Life")*

- 4.1** The first significant test of PRE in the Courts came in 1999 with the dispute between the Equitable Life and a number of with-profits policyholders who had policies containing guaranteed annuity rates ("GARs"). The policyholders disputed the manner in which the directors of Equitable Life exercised their discretion as to the allocation of terminal bonus (called "final bonus" in Equitable Life's terminology). In order to obtain a declaration, Equitable Life set up a representative action against Mr Hyman, a policyholder.
- 4.2** Equitable Life determined the guaranteed minimum annuity amount at retirement by applying the GAR contained in the policy to the guaranteed fund. The guaranteed fund at

retirement is the sum of basic original policy benefits and declared reversionary bonuses. The company allocated final bonus such that the actuarial value of the annuity was not greater than the policyholder's asset share.

**4.3** Equitable Life treated its policyholders as participating in a 'managed fund'. The premiums they paid after meeting expenses and cost of benefits and options, were invested in the fund. In Equitable Life's approach, the benefits that a policyholder ultimately received would reflect the value of the assets in the fund attributable to his policy (the policyholder's asset share). In particular, Equitable Life did not believe in the concept of an 'estate'. They believed that the business belonged to the current generation of with-profits policyholders and when they left, they should take the 'full value' from the fund.

**4.4** However, Mr Hyman argued that the guaranteed minimum annuity amount at retirement should be calculated by applying the GAR to the sum of guaranteed fund and any final bonus amount otherwise available. The company should not reduce the final bonus amount if the policyholder took the benefits in guaranteed annuity form.

**4.5** In order to illustrate we present a worked example below:

Current annuity rate:	Rs75 pa per Rs1,000 of fund
Guaranteed annuity rate:	Rs90 pa per Rs1,000 of fund
Guaranteed fund:	Rs150,000
Non-guaranteed final bonus:	Rs50,000
Total fund:	Rs200,000

**Equitable Life's approach**

Current annuity =  $200,000 \times (75/1,000)$   
 = Rs15,000 pa

Guaranteed minimum annuity =  $Rs150,000 \times (90/1,000)$   
 = Rs13,500 pa

So, actual annuity paid = Rs15,000

In order to achieve an annuity of Rs15,000 pa, Equitable Life reduced final bonus from Rs50,000 to Rs16,667 [as  $(Rs150,000 + Rs16,667) \times (90/1,000) = Rs15,000$ ].

**Mr Hyman's approach**

Annuity should be =  $Rs200,000 \times (90/1,000)$   
 = Rs18,000 pa

**4.6** The House of Lords ruled in favour of Mr Hyman stating the following:

*"...final bonuses are not bounty. They are significant part of consideration for the premiums paid.....In this context the self-evident commercial object of the inclusion of guaranteed rates in the policy was to protect the policyholder against a fall in market annuity rates by ensuring that if the fall occurs he will be better off than he would have been with market rates. The choice is given to the GAR policyholder and not to Equitable Life. It could not be seriously doubted that the provision for guaranteed annuity rates was a good selling point in the marketing by Equitable Life of the GAR policies. It was also obvious that*

*it would have been a significant attraction for purchasers of GAR policies. Equitable Life had pointed out that no special charge was made for the inclusion of GAR provisions but this factor did not alter the reasonable expectations of the parties.”*

- 4.7** Equitable Life had thought that, if the case went against it, it could have declared a differential bonus depending upon whether the policy did, or did not, include GARs. However, the House of Lords determined that this suggested route was not open to Equitable Life, because the object would still be to eliminate, as far as possible, any benefit attributable to the inclusion of a GAR in the policy.

#### *AXA*

- 4.8** This case refers to the transfer of long-term business of AXA Equity & Law Life Assurance Society (“AXA Equity & Law”) to AXA Sun Life that was approved by the High Court in December 2000. This judgment makes several references to PRE, particularly in relation to PRE in respect of the inherited estate. It states that it is accepted that the starting point for assessing the PRE of a long-term policyholder is his ‘asset share’. It also states that:

*“It is accepted that PRE results from a number of different sources and that it will vary in extent from company to company. It is the collective reasonable expectations of the policyholders of a company as a class. Those sources include the company’s promotional material, the provision of its Articles, the past practice of the company, in particular its bonus policy, and the current practice of the insurance industry generally.”*

- 4.9** The judgment states the following in relation to the inherited estate:

*“It is not an issue that an AXA policyholder would have PRE in the inherited estate to the extent it has been available to back its policy and for the uses which I have described above (supporting investment policy, smoothing etc). Such a policyholder would also have a reasonable expectation that any distribution from the long term fund would be on the basis of 90 / 10 in favour of policyholders. In my judgment, however, an AXA Equity & Law policyholder would not have, prior to the promulgation of the Scheme by AXA, a reasonable expectation that the whole or any part of the inherited estate would be distributed to him as a bonus or otherwise during the currency of his policy.”*

- 4.10** Hence this judgment went in favour of AXA and the policyholders did not receive the share of inherited estate.

#### *Needler v Taber*

- 4.11** This concerned the use of demutualisation windfall benefits in the calculation of compensation payments for mis-selling. This judgment makes specific reference to PRE in relation to inherited estate distributed at the time of demutualization. It states:

*“the policyholder was contractually entitled to share in the profits of the Society by way of bonus. Such bonus was likely to provide him a reasonable return on his asset share in accordance with the PRE. But in the absence of the transfer of the long term business under the Insurance Companies’ Act 1982 or the winding up or closure of the Society to new business it was most unlikely that he would ever share in a distribution of the inherited estate..”*

#### *Impact of court rulings*

- 4.12** The Equitable Life ruling made it clear that the Courts would interpret PRE in a less intricate way compared to the views of the actuarial profession. The judgments have made it clear that adherence to asset shares cannot override PRE arising out of disclosure and communication to policyholders. However the AXA judgment reinforces the profession's view that asset shares are indeed a useful benchmark tool for determining PRE.
- 4.13** In the UK both the actuarial profession and the regulator have withdrawn their views replacing them by a requirement for life companies to seek legal opinion.
- 4.14** In February 2001 the FSA set up a review of with-profits business which has resulted in:
- new reporting regime for with-profits business
  - creation of a "With-Profits Actuary"
  - greater transparency and constraints in communication with policyholders

## **5 Developments in India**

- 5.1** Historically, the Indian market has been very savings-oriented with endowment and anticipated endowment products being very popular. These two products combined with single premium bond still account for over 80%, by premiums, of the total sales of LIC. For private players, endowment and anticipated endowment products contributed nearly 50% of new premium income in the FY2002/03. More recently most insurers have introduced unit-linked products which are gaining popularity in the Indian market.
- 5.2** In a developing economy like India, most insurers face the risk of volatile investment conditions. In this environment insurers need to carefully manage the expectations of policyholders regarding:
- bonuses – cash, reversionary and terminal bonuses
  - non-guaranteed surrender values
  - practices of its sales force including sales illustrations
  - advertisements including electronic and print media
  - variable charges on unit-linked policies
  - market value adjustments on unitised with-profits policies
- 5.3** The IRDA (Protection of policyholders' interests) Regulations, 2002 prescribes a standard sales illustration format clearly identifying guaranteed and non-guaranteed benefits. Under this regulation, the Life Insurance Council is responsible for prescribing the maximum projected investment return under two bases. This development is likely to assist in forming reasonable expectation of policyholders in respect of guaranteed and non-guaranteed benefits.
- 5.4** Bank Negara Malaysia has recently introduced "Surat Pekeliling JPI: 29 / 2004" which stipulates that asset shares should form the basis for bonus management and a guide to determining non-guaranteed surrender values of with-profits policies. Subsequently the Actuarial Society of Malaysia has circulated a draft Practice Note on "Asset Share Study".



The Actuarial Society of India may consider issuing guidance on calculation of asset shares having specific regard to the start-up nature of all private players in India.

**5.5** Point-of-sale disclosure in Hong Kong and Singapore include:

- cost of financial advice provided
- profit test on prescribed bases so that premiums meet benefits
- risk warnings
- projection period set
- consistency between illustrated bonuses and underlying assumptions including total distribution and maintenance costs for participating policies

**5.6** The industry/regulator in India may consider increasing transparency of policyholder communication at point-of-sale by making it mandatory for life insurers to disclose their commission payable to intermediaries and expenses. This will address some issues of mis-selling by encouraging need-based selling. Full disclosure to customers may however run the risk of encouraging rebating.

**5.7** It may also consider introducing a with-profits guide, available to policyholders on request, setting out the company's principles and practices of management of with-profits fund. This should cover among other things the company's bonus philosophy.

**5.8** Insurers have discretion over variable charges in unit-linked products. Increased competition, changes in investment conditions and emerging company experience may lead companies to exercise this discretion. The actuary should consider what representations and communications have been made to policyholders with respect to adjustments in variable charges.

**5.9** In Appendix A we set out a sample checklist that may be considered to address various issues relating to PRE. In Appendix B we set out references to PRE in the IRDA regulations.

## **6 Summary**

**6.1** In this paper we have discussed the interpretation of PRE by the actuarial profession, the regulators and the Courts. The Equitable Life judgement was the first extensive legal test of PRE and has had significant impact on the life insurance industry. This has led to changes in the UK including a new reporting regime for with-profits business, creation of a "With-Profits Actuary" and greater transparency and constraints in communication with policyholders. Developments in other markets signify the importance of all Directors to be responsible for PRE.

**6.2** It is an opportune time for the actuarial profession and the insurance industry in India to address various facets of measuring, managing and monitoring PRE.

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## **Appendix A – Checklist of issues to consider in relation to PRE**

- A.1 Have you reviewed the contents of policy documents, sales literature, and advertisements?
- A.2 Are illustrated maturity values comparable with
- those illustrated by competitors?
  - those illustrated in the past taking account of changed circumstances?
- A.3 Are illustrated non-guaranteed surrender values comparable with
- those illustrated by competitors?
  - those illustrated in the past taking account of changed circumstances?
  - calculated asset shares, if appropriate?
- A.4 Are any changes to variable charges reasonable compared with
- past communications with policyholders?
  - company practice?
  - market practice?
- A.5 Have you considered the consistency of the company's proposed course of action with
- market practice and performance?
  - company practice and performance?
  - fair to different classes of policyholder? If yes, how is this fairness defined?
  - If not, can policyholders reasonably expect such a course of action?
- A.6 Have you complied with aspects of GN1 of the ASI that relate to PRE?
- A.7 Are illustrated cash, reversionary and terminal bonus rates consistent with
- those declared in the past taking account of changed circumstances?
  - those illustrated in the past taking account of changed circumstances?
  - those illustrated by competitors?
- A.8 Have you considered that in the absence of other information policyholders may reasonably expect that bonus rates will remain unchanged, or that they will move broadly in line with gilt yields? Have you considered appropriate communication to policyholders if the proposed course of action does not fulfill PRE?
- A.9 Have you considered consistency between illustrated bonuses and underlying assumptions?
- A.10 Have you included appropriate risk warnings, for example investment returns can fall, in communications to policyholders?

## **Appendix B – References to PRE in IRDA Regulations**

### ***Insurance Regulatory and Development Authority (Appointed Actuary) Regulations, 2000***

- B.1 Section 7 (3)-(b)-(iii) of the regulation states that:  
*“The appointed actuary shall be entitled to speak and discuss on any matter, at such meeting, that may affect the ability of the insurer to meet the reasonable expectations of policyholders.”*
- B.2 Section 8 (g)-(viii) of the regulations states that:  
*“In particular and without prejudice to the generality of the foregoing matters, and in the interests of the insurance industry and the policyholders, the duties and obligations of an appointed actuary of an insurer shall include in the case of the insurer carrying on life insurance business to ensure that the policyholders’ reasonable expectations have been considered in the matter of valuation of liabilities and distribution of surplus to the participating policyholders who are entitled for a share of surplus.”*

### ***Insurance Regulatory and Development Authority (Actuarial Report and Abstract) Regulations, 2000***

- B.3 Section 4(b)-(v) of the regulation states that:  
*“There shall be appended to every Abstract and Statement a certificate signed by the appointed actuary with his remarks, if any, to the effect that in his opinion, the mathematical reserves are adequate to meet the insurer’s future commitments under the contracts, and the policyholders’ reasonable expectations.”*

### ***Insurance Regulatory and Development Authority (Assets, Liabilities, and Solvency Margin of Insurers) Regulations, 2000***

- B.4 Section 2 (2) of Schedule II-A Valuation of Liabilities – Life Insurance pertaining to the method of determination of mathematical reserves states that:  
*“The valuation method shall take into account all prospective contingencies under which any premiums (by the policyholder) or benefits (to the policyholder/beneficiary) may be payable under the policy as determined by the policy conditions. The level of benefits shall take into account the reasonable expectations of policyholders (with regard to bonuses, including terminal bonuses, if any) and any established practices of an insurer for payment of benefits.”*

### ***Insurance Regulatory and Development Authority (Insurance Advertisements and Disclosure) Regulations, 2000 (Monitored by Compliance Officer and IRDA)***

- B.5 Section d (ii) of the regulation states that  
*“...‘unfair or misleading advertisement’ will mean and include any advertisement that makes claims beyond the ability of the policy to deliver or beyond the reasonable the reasonable expectation of performance.”*

