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Life funds: orphan estates

By Timothy Edmonds

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Summary

At about the turn of the last century there were several reports of some types of insurance companies releasing assets from their invested life funds. The assets in question are of uncertain ownership, but are sometimes referred to as 'orphan assets' or the 'orphan estate'. Members have received letters from constituents arguing that if any assets are to be released from the life funds, the policyholders rather than the shareholders should be the beneficiaries. Many of these letters relate specifically to one company, the Prudential. This note provides a simplified guide to the policy and practice in this area, and then deals specifically with the Prudential case.

1. Introduction

At about the turn of the last century there were several reports of some types of insurance companies releasing assets from their invested life funds. The assets in question are of uncertain ownership, but are sometimes referred to as 'orphan assets' or the 'orphan estate'. Members have received letters from constituents arguing that if any assets are to be released from the life funds, the policyholders rather than the shareholders should be the beneficiaries. Many of these letters relate specifically to one company, the Prudential. This note provides a simplified guide to the policy and practice in this area, and then deals specifically with the Prudential case.

2. Background

Life insurance companies fall into two broad classifications: the mutual insurers who are owned by their policyholders, and the proprietary insurance companies which are owned by shareholders. The question of unattributed or orphan assets only relates to proprietary insurance companies, where the business and investment profits are applied both to generating funds for the policyholders (paid at the maturity of their long term life insurance policies) and to generating funds for the shareholders (in the form of dividend payments and the capital growth of their investment in the company). In a mutual insurer, the policyholders are also the owners, so there can be no equivalent dispute over the assets.

The assets of life insurance funds are set aside in the insurance company's long term life fund. At issue is who the assets of an insurance company's long-term fund belong to. The difficulty is that two groups have claims to the assets: the policyholders who have 'invested' in the company's long-term insurance business, and the shareholders who have provided the capital for the company's activities.

The problem relates to old business rather than current business. In any normal year, when a life insurance company comes to assess its profits, it first allocates to its technical reserves those funds which it thinks will be required to meet its liabilities on the policies it has written. This technical reserve provides for the sums which the company will have to pay out to policyholders in the future, although the precise amount required is an actuarial calculation since there are many uncertainties inherent in future obligations.

Once the technical reserve has been set aside, the residue is profit, loosely speaking, or more correctly surplus. Some of this surplus is kept for general contingencies, but the remainder is divided between the policyholders (in the form of terminal and reversionary bonuses) and the shareholders (in the form of dividends). The division of the surplus between policyholders and shareholders is normally in the ratio of 90:10. So the policyholders in a with profits policy benefit from the profitability of the company (including its investment profits) to the extent that roughly nine tenths of the surplus is allocated to them, whilst the shareholders receive ten per cent. Surplus which has been allocated to policyholders is then counted as part of the technical reserves in future years.

Whilst that simplified account holds good for the profits of recent years, the past is more uncertain. Some insurance companies have been

trading for many years now, and over that period they have accrued sometimes very substantial sums in their life funds. These have been built up partly because investment returns have been good, and partly because companies have been prudent over the years in deciding how much of their funds they need to retain in order to maintain solvency. Insurers have become much more aware of the value of these surplus assets in recent years, but because the assets of the life fund have come from various different sources it is not always easy to apportion their ownership.

Before an insurance company can use the orphan assets in its funds, it needs the approval of the Government's Insurance Directorate (formerly located in the DTI, then in the Treasury and now at the Financial Services Authority). The policy of the Directorate in adjudicating applications to apportion the orphan assets was set out in a written answer of 24 February 1995 by Jonathan Evans, then Under Secretary of State for Corporate and Consumer Affairs:

> The Department is in principle in favour of greater clarity in the attribution of the long-term funds of proprietary insurance companies. In any such attribution, it has a responsibility to ensure that the reasonable expectations of policyholders are fulfilled.
>
> 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.[1]

From press references, which are not always precise, approval seems to have been given in recent years for restructuring schemes proposed by among others United Friendly, Legal & General and Pearl Assurance, Refuge Assurance, and Britannic Assurance.[2] As the extract quoted above indicates, it is by no means certain that approval will be given in any one case, and the proportion of assets which are allocated to shareholders will vary from company to company.[3]

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1 HC Deb 24 February 1995 c 360-1W

2 HC Deb 15 July 1996 c 368W; Britannic: according to the *Daily Mail* on 18 September 1997, in future 7.5 per cent of orphan funds will be available for shareholders.

3 'Orphans everyone wants', *Sunday Telegraph*, 8 February 1998

3. Prudential Assurance

3.1 Long term funds

The Prudential is one of the UK's largest life insurance companies, and was the largest provider of personal pension policies. It is currently engaged in discussions with the Treasury about utilising its orphan assets, which it prefers to call unattributed capital in the long-term life fund. Those discussions were first announced in 1996.

The Prudential gave evidence before the Treasury Select Committee's enquiry on the mis-selling of personal pensions on 2 July 1998. As part of that evidence it submitted a memorandum which has the following to say about its plans for the long-term life fund:

> CAPITAL IN THE LONG-TERM FUND
>
> The capital of the Life Fund has grown to its present size since the formation of the Company in 1848. The sources of the original capital have included injections of capital by shareholders at various times, retained earnings from the business which have also arisen over many years and, most significantly, the impact of compounded investment returns on these monies over what is now 150 years.
>
> Our ongoing discussions with the Treasury are intended to clarify the ownership of the estate as between shareholders and policyholders. These discussions have been in train for some time. We are presently clarifying the origins of the estate prior to recommencing discussions with the Treasury. As noted above, the capital in the fund is necessary to support the business.[4]

In evidence, Jonathan Bloomer, the Finance Director of the Prudential argued that the capital in question had not been accumulated as a result of underpaying policyholders:

> Our capital is made up from a number of sources over 150 years. Some of it comes from capital which was injected by policy holders a long time ago and some of it relates to the profits of business, written non-profit on different non-90/10 bases prior to about 1950. A large part of it relates to the years that shareholders did not take that[5] and the largest piece of it relates to rolled-up investment income on those amounts over again 150 years. It is not as a result of under-payments to our policy holders over that time.[6]

Mr Bloomer also set out the Prudential's interpretation of ownership, and the proportion which it thought the policyholders should be entitled to:

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4 HC 712-II 1997-98, p.84 [Memorandum from the Prudential Corporation plc]

5 Note by Witness: i.e. their full ten per cent out of the fund

6 HC 712-II 1997-98 Q390

> We have not had any guidance from the DTI as to what the definition of policy holders' reasonable expectations is. As you might be aware, there is a debate within the industry as to exactly how one might define policy holders' reasonable expectations. We define it based on a concept of asset shares. We actually look at the amount of premiums that our policy holders invest with us. We track those premiums, we track the investment income that is earned on those assets, minus the costs and charges, and that rolls up to be their asset shares. Our view of their reasonable expectations is that they would expect to get the premiums back with the return that was made on the assets that they were invested in and smoothed to allow for fluctuations in the equity market.[7]

It remains to be seen whether the Prudential will be able to persuade the Treasury to accept this interpretation, whether the Treasury will agree to the apportionment of the assets in question, and then how the assets (once apportioned) will be applied by the Prudential.

There are perhaps several points which should be made. The first is that although the long-term life fund can be used for purposes other than paying policyholders, the guiding principle in the allocation of surplus assets is that the reasonable expectations of the policyholders should be protected. Second, the negotiations on the allocation of surplus or orphan assets have been protracted, and a decision is probably unlikely for some time yet. Third, it would be a departure from recent practice if the Government were to permit all the surplus, or even the major part of the surplus to be paid to shareholders, as some correspondents suggest, unless there is evidence of their entitlement.

3.2 Pension mis-selling

The Prudential has also stated that it is to use the capital in its life fund to pay for its liabilities in respect of pensions mis-selling. It is easy to confuse the question of apportioning ownership of the unattributed, or orphan assets in the life fund, with applying the life fund's capital to a specified cost which has arisen in the business. The liabilities were estimated to amount to £2 billion in 2000. There has been considerable discussion of whether by allocating the cost to the life fund, the Prudential and other companies are penalising policyholders in order to benefit shareholders. Again in evidence to the Treasury Committee, the Prudential has set out the reasons for its policy:

> The provision of £450 million in respect of Phase 1 cases and associated costs has been charged to the estate of the Life Fund. The estate is, in practice, the "capital" of the Life Fund. In essence, it is the difference between the present value of the amounts due to policyholders, including future bonuses, and the assets in the fund at market value.

[7] HC 712-II 1997-98 Q395

> The amount of this capital is not disclosed. However, taking account of all bonuses, it will be significantly less than the £12 billion which will be indicated in form 9 of Prudential's Treasury returns for 1997. The capital is used in the fund to ensure solvency for existing business, to provide the capital to write new business and to support the equity orientated investment policy which the Company pursues.
>
> The decision to charge the provision for Phase 1 cases against the Life Fund capital was taken after consideration of the size of the capital in relation to the policyholder liabilities i.e., "the strength of the fund", and confirmation by the appointed actuary that such a charge would have no impact on policyholders' reasonable expectations. This was in accordance with guidance from DTI and is consistent with the position adopted by the Economic Secretary when she appeared before the Treasury Select Committee on 6 May 1998 and with the statement to the House made by the Trade and Industry Minister, Nigel Griffiths MP on 16 June 1997. Any decision as to the appropriate place to charge the provision for Phase 2 will be taken after similar consideration of the financial position of the fund and of policyholders' reasonable expectations.[8]

When the Committee published its report on 17 November 1998, one of its recommendations was relevant to the question of long term funds:

> Insurance companies hold large amounts of other people's money. We were concerned to learn that the regulation of this aspect of their business is ill-designed, little known and rarely exercised. We believe that there is scope for improvement in the protection given to policyholders. We recommend that the Treasury examine whether legislation or further rules are necessary to define what is meant by policyholders' "reasonable expectations", the extent to which surplus "orphan" assets should be distributed, and to whom, and whether the role of the appointed actuary of an insurance company (see paragraph 29) in safeguarding policyholders should be strengthened. We also believe that the Treasury should examine whether legislation is necessary to tighten rules about fraudulent selling and about competition (paragraph 49).[9]

The Government responded by restating its position. For the record, the full response is reproduced below:

> 5. Assets in with-profit funds of shareholder-owned life offices should be attributed between policyholders and shareholders in exactly the same proportion as any annual distribution of surplus (normally 90 per cent or more to policyholders and up to 10 per cent to shareholders) unless there is clear evidence that a different attribution is appropriate in the particular circumstances of that

8 HC 712-II 1997-98 pp 83-4
9 HC 712-I, para 50(p)

fund. The Treasury would expect such special circumstances to be the exception rather than the rule.

6. The Government's policy is set out in the statement of the then Minister of Corporate Affairs on 24 February 1995, which was reaffirmed by the then Economic Secretary to the Treasury, in a reply to Mr Derek Twigg on 24 July 1998, Official Report, cols *750-2*.

7. The main factors which the Treasury considers relevant to policyholders' reasonable expectations in respect of attribution of surplus are:

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

8. The concept of policyholders' reasonable expectations is not restricted to attribution of surplus, but also applies more generally to policyholders' interests in the life fund. The Treasury has powers of intervention under the Insurance Companies Act 1982 (section 45) to protect policyholders' reasonable expectations, and stands ready to use these if the merits of a particular case warrant it. But the Treasury believes it better to work through prudential regulation. In particular, all UK insurance companies writing long term business must appoint an Appointed Actuary, to carry out a range of statutory and professional duties, including advising the directors of the company on protecting the interests, and reasonable expectations, of policyholders. The Appointed Actuary must have sufficient independence and freedom within the company to discharge his professional responsibilities. The actuarial profession also provides guidance to actuaries on the interpretation of policyholders' reasonable expectations.

9. Current legislation contains no definition of policyholders' reasonable expectations. The disadvantage of lack of clarity and certainty which this involves has to be set against the very real advantage of flexibility and adaptability, through the requirement to give the term a purposive interpretation in the light of the particular circumstances of each case.

10. The Treasury believes that the prudential regulation of life insurance companies, including the role of the appointed actuary, has served policyholders well. This is evidenced by the fact that, with one small exception, there have been no life insurance company insolvencies for over a decade. It is not surprising that this specialist area of legislation is little known outside the life insurance industry. The relatively rare exercise of the formal powers is a tribute to their deterrent effect, and the preventative way in which insurance supervision is conducted.[10]

[10] *The Mis-selling of Personal Pensions: Responses by the Government and the Financial Services Authority to the Committee's Ninth Report of Session 1997-98*, Treasury Select Committee, 18 January 1999, HC 140 1998-99 paras 5-10

No further decisions have been made by the regulators about orphan assets:

> **Mr. Cohen**: To ask the Chancellor of the Exchequer what decisions he has made since 1998 in respect of requests from financial services companies for the disposal of orphan asset surplus funds; and if he will make a statement.
>
> **Miss Melanie Johnson**: None.[11]

[11] HC Deb 17 January 2000 c 353W

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