19th India Fellowship Seminar

Institute of Actuaries of India

Case Study L6 — Distribution of profits

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Contents

1. The Case Study
2. Issues
3. UK Regulatory Requirement
   - With-Profit Governance
   - Principles and Practices of Financial Management (PPFM)
   - Treating Customer Fairly (TCF)
4. Impact on bonuses
5. Issues to be considered
6. Indian Context
7. Final Remarks

The Case Study

Case Study L6 — Projected policy values

You are the With Profits Actuary of a proprietary composite office directly reporting to the Finance Director. You have been asked to attend the annual board meeting to discuss setting of the bonus rates for with profit policies.

The Company’s constitution is such that “any profits arising from participating life business are allocated 90% to policyholders and 10% to shareholders and further any profits arising from non-participating business shall be allocated to policyholders at the discretion of the Company”.

An increasing proportion of unit-linked business is now being written. All the life business is written in a single fund with one group of assets, but separate revenue accounts are kept so that premiums, claims, expenses etc. (but not investment income) can be analyzed separately for without profits and with profits business.

The Case Study (Cont..)

It has been the company's practice for many years to allow all the profits from the fund, those arising both from participating and non-participating business, to be included in the 90:10 calculation. However, the Board wishes to exercise its right to restrict the 90:10 calculation to the participating business only.

Issues

The 100% of profit arising from non-participating business in the participating fund will go to the shareholders.

- Regulatory requirement

- Impact on bonuses
  - Collective Investments
  - Allocation of expenses
  - Bonus Rates

- Meeting policyholders reasonable expectations

UK Regulatory Requirement

UK Regulatory Requirement (1)

COBS 20.5 - With Profit Governance

- The governing body has overall responsibility of managing the with profits business, including setting Bonus rates.
- A firm must appoint with profits advisory committee mostly consisting of members who are independent of the firm.
- The role of with profits advisory committee includes
  - reviewing bonus recommendations
  - reviewing ongoing compliance with the Principles and Practices of Financial Management (PPFM)
  - considering issues that may have an impact on treating customers fairly (TCF)
  - the impact of any management actions planned or implemented
  - with-profits customer communications such as annual policyholder statements and product literature
  - any significant changes to the risk or investment profile of the with-profits fund

UK Regulatory Requirement (2)

- With effect from 31 December 2004, the statutory requirement for a life insurance company transacting long-term business to have an Appointed Actuary was replaced by
  - the statutory need to have an Actuarial Function Holder, and
  - for a company transacting with profits business to also have a With-Profits Actuary

- With-Profits Actuary needs to be a Fellow of the Faculty of Actuaries or the Institute of Actuaries, and must hold a practicing certificate.

- Role of With-Profit Actuary
  - Draw the attention of the management of the Firm, to any circumstances in which he/she believes that a communication should be issued by the Firm to the Firm's With-Profits Policyholders, or a particular class of such policyholders.
  - The With-Profits Actuary must give advice to a Firm on the future exercise of discretion affecting its With-Profits Business
  - Where, in the With-Profits Actuary's opinion, there is uncertainty regarding the extent to which the Governing Body can exercise discretion when allocating surplus, he/she must state in his/her report or advice.

UK Regulatory Requirement (3)

COBS 20.3 - Principles and Practices of Financial Management (PPFM)

The Financial Services Authority requires firms to establish and maintain the Principles and Practices of Financial Management (PPFM), according to which the business of each of its with-profits funds is conducted.

Principles are statements that reflect the general approach adopted in managing the with-profits business and are expected to be enduring.

Practices are statements of specific practice employed in managing the with profits business. They reflect current approaches given the current regulatory framework and the particular circumstances and economic conditions affecting the with-profits business.

UK Regulatory Requirement (4)

The PPFM must set out how with-profits business is conducted in each of the following areas:

- Determining payouts to policyholders
- Investment strategy
- Business risk
- Charges and expenses
- Management of the inherited estate
- Volumes and type of new business
- Closure to new business
- Achieving equity between policyholders and shareholders

UK Regulatory Requirement (5)

COBS 20.2 - Treating Customer Fairly (TCF)

With Profit Business, by virtue of its nature and the extent of discretion applied by firms in its operation, involves numerous potential conflicts of interest that might give rise to unfair treatment of policyholders.

The FSA expects senior management to incorporate its approach to treating customers fairly into the firm's corporate strategy, and to support delivery of the strategy with an appropriate framework of controls.

Some of the areas where TCF applies:

- Distribution of surplus
- The contents of sales literature, advertisements, promotional material and policy documents
- Terms on which new business is written

Impact on bonuses

Impact on bonuses (1)

A company's approach to asset shares in terms of its philosophy and its calculation are documented, having been approved by the directors and communicated to the policyholders in the Principles and Practices of Financial Management (PPFM).

- Surplus for distribution to with-profits policyholders will arise from various sources
  - investment surplus
  - release of any bonus loadings in the premiums
  - expense surplus
  - mortality surplus
  - Withdrawal surplus
  - **miscellaneous surplus**
- Annual Bonuses – The surplus should emerge in a rising pattern
- Terminal bonus - The best way of distributing profit from volatile source of surplus

Impact on bonuses (2)

- Business written in single fund
  - Collective investment of assets
  - Allocation of expenses
- The bonus rates are required to be re-estimated
  - Future additions to surplus arising from profits on non-participating portfolio not available
  - Investment strategy might alter
  - Fund size might reduce

Impact on bonuses (3)

- Scenarios testing of the bonus rates with respect to:
  - Investment returns
  - The investment mix
  - Surrenders
  - Expenses
  - The amount of new business written

Issues to be considered

Issues to be considered (1)

- **Treating Customers Fairly (COBS 20.4)**

  – A company’s actual past practice will be expected to continue into the future

  – A company’s marketing and other literature will set out how it intends to distribute surplus:
    - Split between the annual and terminal bonuses
    - Any target payouts

  – A company is expected to conform to what other companies are doing for similar fund set-up

Issues to be considered (2)

- **Principles and Practices of Financial Management (COBS 20.3)**

  – The practice needs to be modified to take into account the change with regard to exclusion of the surplus from non-participating business.

  – The change will be particularly with regard to the calculation of the asset share.

  – Any proposed changes to the PPFM principles, three months notice in advance of the effective date has to be given to the affected policyholders.

  – Changes to the practices can be notified retrospectively within twelve months to the affected policyholders.

Issues to be considered (3)

- **Other Considerations**
  - External Consultation
  - The impact of the possible fall in the maturity values can lead to bad publicity
  - The new business communication should take into account any changes made to specifically to the projected benefit after the change
  - Advisable to write non-participating business in a separate fund to avoid any confusion about the future stake of shareholder in the retained surplus of the single fund

Indian Context

Indian Context (1)

IRDA (Non-Linked Insurance Products) Regulations, 2013

- Role of With-Profit Actuary replaced by Appointed Actuary
- The appointed actuary should demonstrate in Actuarial Report and Abstract (ARA):
  - Appropriate allocation of expenses to the with profit fund
  - Overall sound financial management and governance of the with profit fund
- With profits committee
  - Constitutes of one independent director of the board, CEO, the Appointed Actuary and an independent actuary.
  - The report of the with profit committee required to be appended to the ARA
- Asset Share
  - Determination of asset share in accordance to the guidance note issued by IAI
  - The methodology for determining asset share to be approved by with profits committee

Indian Context (2)

Professional Guidance (GN6): Management of participating life insurance business

- Guidance on management of participating life insurance business with reference to distribution of surplus
  - Recommend use of asset shares for determination of the bonus rates
  - Recommends approach to calculate the asset shares
- Appropriate allocation of expenses to the with-profit fund
- Treatment of non-participating business written in the participating fund
- Recommends documentation of the company’s approach to setting bonuses

Final Remarks

- Both the annual and the terminal bonus may be revised taking into account change in the surplus distribution methodology.
- Need to take into considerations the TCF, PPFM and communications to the policyholders.
- The final changes post consultation with external party have to be approved by the governing body of the with profit funds.
- The actions of the governing body are subject to review of the With Profit Committee.

Any Questions?