Introduction to GN6: Management of Participating Business

A presentation at 8th CILA Seminar

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Disclaimer

The views and opinions expressed in this presentation are those of the author and not of the employer he represents.

Background

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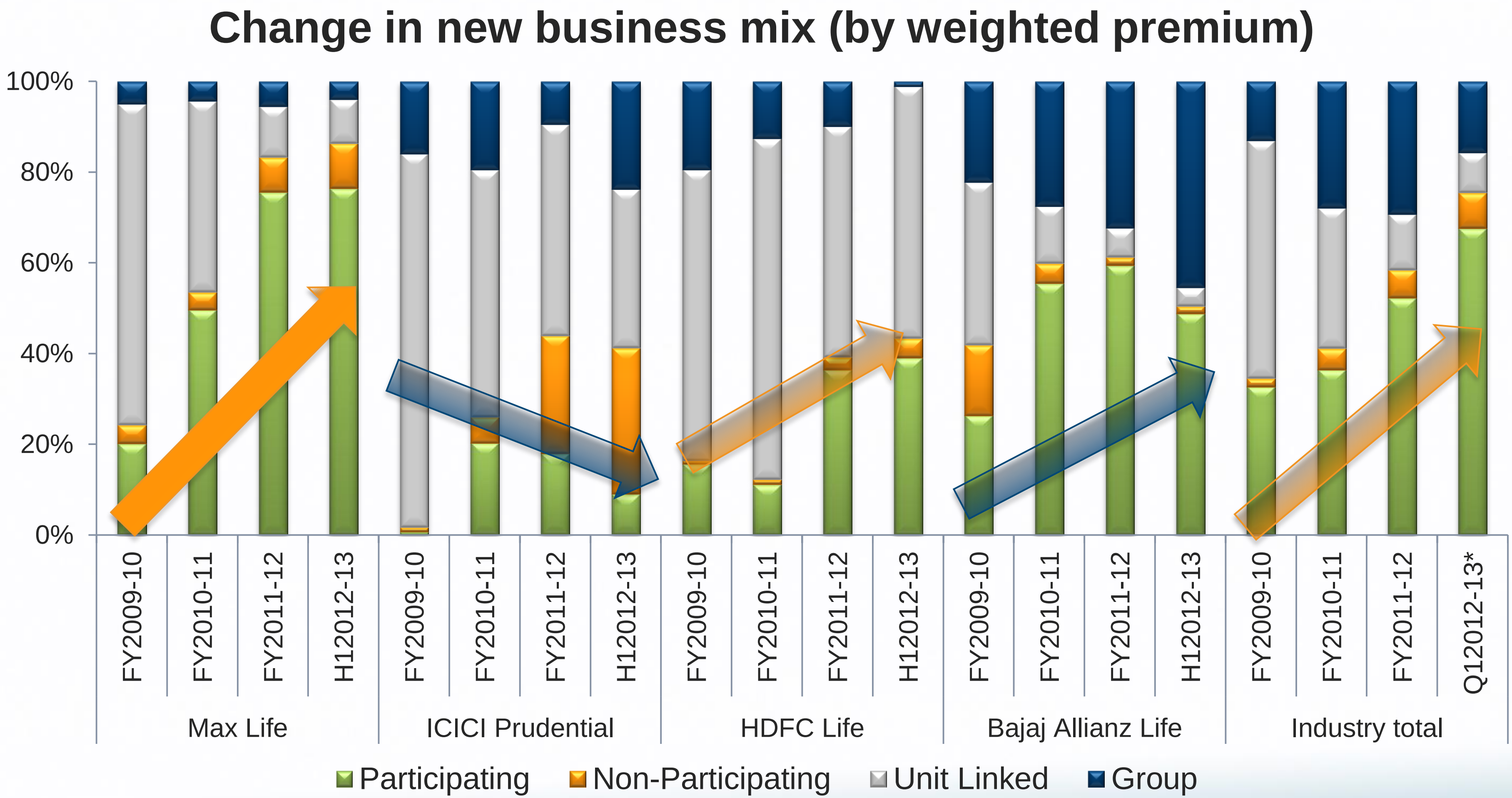
Increasing par business



Source: Company quarterly disclosures

**Industry total: Q1 FY2012-13 figures presented as H1 FY2012-13 figures were unavailable at the time of producing this presentation*

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Existing rules on par business

Product / fund management / governance

- Minimum guaranteed surrender value (GSV)
- Separate ring-fenced fund
- 90 / 10 profit sharing
- Riders attached to par products classified in the par fund
- Investment restrictions (‘controlled fund’)
- Bonus declaration only after elimination of deficit in par fund. Transfers info par fund limited only up to 12 years from commencement

Reserves and solvency

- Gross Premium Valuation (GPV) with margins for adverse deviations (MADs) in reserving bases
- Elimination of negative reserves
- Reserves subject to the GSV floor
- GPV to allow for future discretionary policyholder bonuses, subjected to policyholder reasonable expectations (PRE)
- Future bonus assumption to be consistent with valuation bases
- Allowance for shareholder transfers and tax
- Formula based (% of reserves +% of sum at risk) solvency capital
- Currently no restrictions on using par fund surplus to meet solvency requirements of other funds

Sales illustrations / disclosures

- No requirement for a formal point of sale illustration
- No requirement for regular communication / disclosures

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Current practices in the industry

Documented framework for management of par business

- Differing levels of internal documentation
- Varying between a formal Board-approved framework, to little or no documentation at all

Expense allocations to different funds

- Typically carried out by Finance Department
- Level of actuarial oversight varies

Bonus declaration

- Appointed Actuary recommends to the Board
- Either reflects the documented policy or ad-hoc calculations carried out by the Appointed Actuary
- May or may not be linked to “asset shares”

Reserving

- May or may not be compared against “asset shares”

How is PRE defined and reflected in the valuation?

- Again, varying practice on level of internal documentation and external disclosures

PRE: Public disclosure (1)

Future bonuses have been allowed for within mathematical reserves. This has been done by projecting the bonuses likely to be paid in accordance with the company's bonus philosophy and the projected levels of experience forming the valuation basis.

Although the Company's participation system is nominally based on cash 'dividends', the preferred dividend option is for dividends to be taken as reversionary additions to sums insured. An election to use cash dividends in this way is incorporated into the application process and the company's experience is that more than 85% of policyholders exercise this option. An indicator as to the dividend option is contained within individual policy valuation records so that the option is allowed for precisely in the valuation.

Benefit illustrations have been part of the Company's sales process since it was founded. These illustrations have always been well qualified including statements along the lines 'This is only an illustrative document does not convey any rights or obligations. Bonuses are not guaranteed and bonus rates will be based on the actual Company experience from time to time.'

Prior to implementation of 'dual rate' illustrations conforming with the Circular issued by the life Insurance Council in 2004, **single rate illustrations** were used with the level of bonuses illustrated conforming broadly with the prevailing projected portfolio rates. Close examination of the various bonus scales showed that as portfolio rates changed and new illustrative bonus scales developed, not only did the overall level of bonuses change but the duration based 'shape' also changed.

Having considered the issues carefully and discussed with senior members of the Company's management familiar with the historic sales processes, the Appointed Actuary concluded that a reasonable expectation would be for the **shapes** attributable to the various illustrative bonus rate eras to be maintained even though the overall **level of bonus rates** might change as a result of interest rate changes.

PRE: Public disclosure (2)

Thus within the various participating products, the allowance for future bonuses depends upon the illustration 'era' to which the individual policy concerned. Thus the allowance is effectively the outworking of the single rate illustration used at point of sale and the difference between the current projected portfolio rate and the portfolio rate used to determine the original illustrative bonus scale.

In addition, the Company had established a practice whereby bonuses were paid even though there was no distributable surplus in the conventional sense. Shareholders had felt that the early generations of policyholders should receive a bonus and that in determining the amount of bonus, a notional expense level should be assumed that excluded the costs of establishing the company and its sales infrastructure. The Appointed Actuary at that time considered this a reasonable approach but it could create an expectation and thus future bonuses allowed for in the valuation took into account a **'structural' level of expense** reasonably attributable to policyholders on an ongoing basis and therefore a higher level of bonuses than would otherwise be the case. This is no longer the case and the expenses used in the valuation and set out in (3) are based on current level of expenses.

The reserves have been set at least equal to the guaranteed surrender value or the currently illustrated surrender value whichever is higher. In allowing for future lapses and surrenders, the illustrated surrender scales have been assumed to continue.

PRE: Public disclosure

Due consideration is given to the reasonable expectations of policyholders when making a distribution of surplus. “Reasonable” is not explicitly defined in the regulations and is left to the interpretation of the Appointed Actuary. Our interpretation of “Reasonable” refers to a **well-informed, financially literate policyholder**.

PRE can be formed with respect to many areas including the following.

- Nature of Bonus
- Reversionary (added each year) vs. Terminal (added only on claim)
- Type of Reversionary bonus
- Simple vs. compound vs. super compound
- Level of bonus
- Level of guarantees implicit in the declaration

The main drivers of **PRE** are currently our **point of sale material, the bonus rates declared last year and past communication** with policyholders. We interpret our point of sale material as having created the expectation that bonuses would be compound reversionary for all products except for the products “Wholelife” and “Future Secure” for which it would be simple reversionary.

PRE ultimately needs to be set to the principle that each customer should receive a **fair return** on the premiums he has paid, allowing for the insurance protection and guarantees provided over the duration of his policy. The basic reference point for this, and therefore PRE, will be the **asset share** under the policy.

Policyholders enjoy the benefits and protection of both guarantees and smoothing for which they may be charged appropriately. However, the Company will **not seek to make any systematic profit** through these charges over generations of policies.

PRE will be shaped and actively managed through **appropriate communication** to the policyholder. The tools that will be used for this purpose are Sales Brochures, Policy Illustrations and annual communications of bonus rates.

Early duration **surrender benefits** will be established at a level that enables the Company to recover the **cost of acquisition and capital support provided** subject to the minimum surrender values written into the contracts.

Draft Guidance Note (GN) 6

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GN 6 (1)

Status

- Currently a ‘draft’, under due process
- Recommended Practice

Various sections

- Purpose
- Grouping
- Method and Assumptions
- Fund Management
- Reinsurance and Investment
- Segregation and Merging
- Documentation

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GN 6 (2): Purpose, Grouping

Purpose

- Guidance to AA advising on declaration of bonus rates

Grouping

- AA to consider whether appropriate to group policies
- Should not materially disadvantage one group of policyholders at the expense of the other
- Grouping will be influenced by the risk sharing rules
- AA to balance the need for equitable treatment between classes of policyholders and practical constraints

GN 6 (3): Method & Assumptions

Definition of asset shares (AS)

- No specific definition provided
- ST2 study material: *"The asset share is the retrospective accumulation of past premiums, less expenses and the cost of cover, at the actual rate of return on the assets. The accumulation could be carried out for a single contract or a group of contracts. In the case of with-profits contracts, allowance may be made for miscellaneous profits from without profits contracts and from surrenders and lapses, and also for the cost of guarantees and any capital support provided."*

Uses of asset shares (AS)

- AS should be determined for each group separately
- AS can be used to set bonus scale such that:
  - the ratio of AS to surrender value/maturity value lies within a specified range
  - the ratio of AS to GPV lies within a specified range

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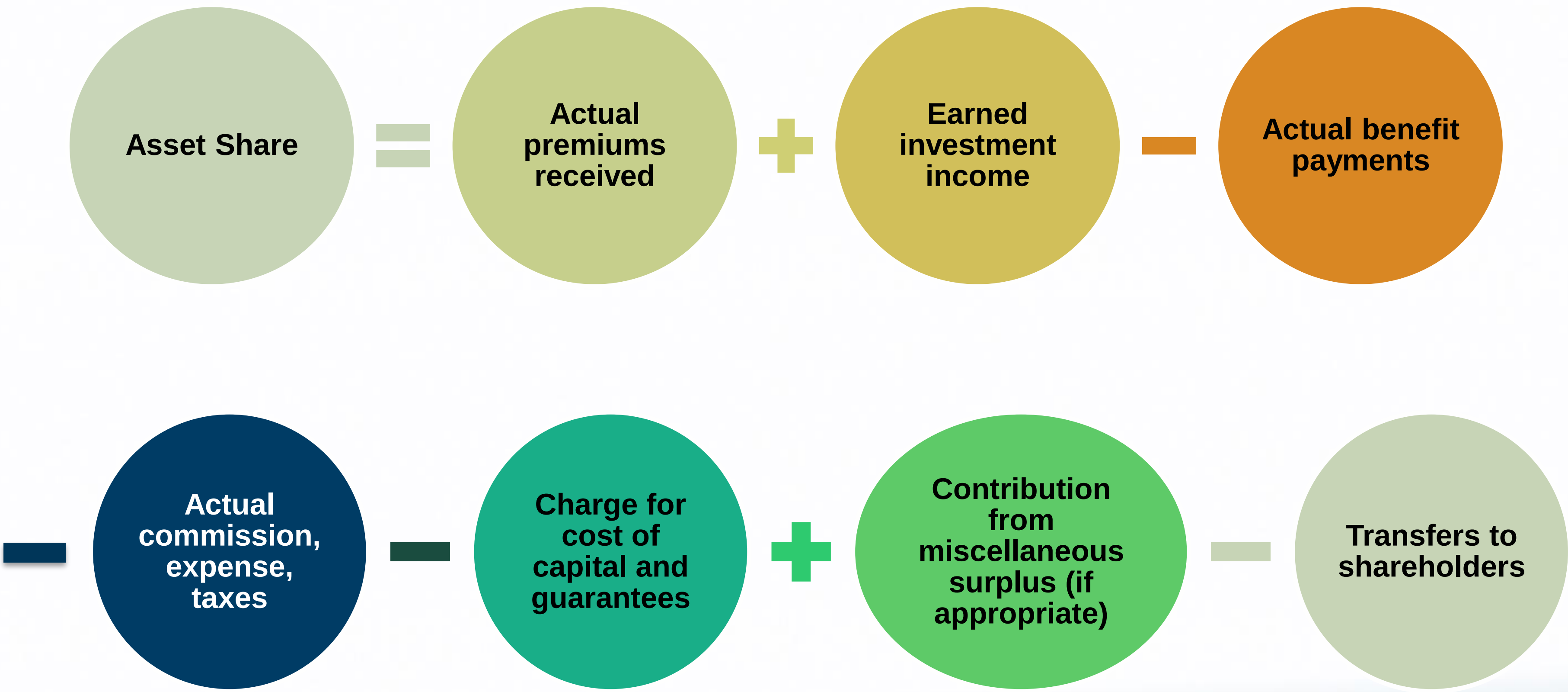
GN 6 (4): Method & Assumptions

Calculation of asset shares



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GN 6 (5): Method & Assumptions

Key items to consider in the calculation of asset shares

- Approach should be fair and consistent from year to year
- Various sources of surplus – should be part of asset shares or estate?
- Explicitly identify the items of surplus that do not belong to participating policyholders and should not be re-distributed to current / future generations of policyholders
- Allow for all decrements in determining the asset share
- Miscellaneous surplus - part of the asset shares or estate?
- If surrender profits are to be included, consider whether to allow for this explicitly or implicitly (e.g. by adjusting investment returns)?
- Cost of guarantees – explicit charge or allow implicitly by having a target payout less than the asset shares
- Consider the interaction between RB, TB and the level of prudence in the valuation bases in GPV, while determining bonus rates by comparing asset shares with GPV
- Consistency between the asset shares used to determine bonuses and the liability on the balance sheet

GN 6 (6): Method & Assumptions

Setting assumptions

- Use actual historical data
- May use proxies only when actual historical data is not available
- Investment returns on a marked to market basis, consider need for smoothing
- Consider the extent of smoothing of investment returns
- Expenses allocated to asset shares - consistent with PRE?

Shareholders' transfer computation and tax

- Asset shares would not typically reflect any transfers into the par fund to support new business strain etc.
- Derivation of asset shares is consistent with prevailing tax rules considering the following:
  - Deductions for taxation of cost of bonus
  - Treatment of tax on participating fund in isolation, and how it differs from the tax applicable on the company as a whole
  - Treatment of any deferred tax asset

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GN 6 (7): Fund Management

Smoothing

- While smoothing total benefits over time, the following should be considered:
  - whether the smoothing genuinely reduces the volatility of payouts
  - whether there is a significant increase in the risk of insolvency (statutory or realistic)
  - whether policyholders are treated fairly

Treatment of over or under distribution (relative to reserves)

- The bonus distribution should reflect the performance of the par fund and ensure fair payouts
- The company’s approach to setting RB and TB should be documented, including:
  - Extent to which RB may be changed from one year to the next
  - The proportion of asset share targeted for maturity claim pay-outs
  - The projected financial strength of the participating fund and the bonus strategy assumed in that projection
  - Consistency of the assumed strategy with current rates of bonus
  - Any differences in the intended treatment of different categories of policyholder
- Treatment of surplus or deficit arising from smoothing of maturity values – reflected in asset shares or estate? Should be in accordance with PRE.

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GN 6 (8): Fund Management

Surrender values

- AA should consider the impact of his/her recommended bonus rates on surrender and other factors of discretion that might determine the payout to customers.
- The AA should also consider the following while setting surrender values:
  - Progression of surrender values over the life of the policy (e.g. surrender v/s maturity values)
  - PRE
  - Consistency of expected surrender surpluses with PRE
  - Use of surrender surplus to support payouts for policyholders who hold their policies for longer – method of distribution matches the source of surplus?

Treatment of riders or non-par business written in the par fund

- Where riders and non-par business are written in the par fund, the following should be considered
  - Fair pricing following actuarial principles
  - Consistent treatment of surplus and deficit and in line with PRE
  - Pricing of these products should not put undue strain on the fund

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GN 6 (9): Fund Management

PRE

- Assumed to be influenced by, inter alia,
  - sales material,
  - benefit illustrations and other documents shared with the policyholder,
  - company's past practice
- Impact of writing new business on existing policyholders? They should not be expected to be disadvantaged

Expense allocations

- Expenses charged to the par fund compared to other funds – approach reasonable? Consistent from year to year?
- Expenses charged to the AS – consistency against benefit illustrations?
  - Treatment of renewal expenses – PRE encompass expense risk?
  - Treatment of acquisition expenses – less scope to deviate
- If the expenses allocated to the fund exceed those allocated to the asset shares, AA should be satisfied that:
  - the approach adopted is sustainable;
  - is not expected to affect PRE adversely and materially; and
  - is appropriately reflected in the expenses in valuation of liabilities.

GN 6 (10): Reinsurance & Investment

Reinsurance

- The reinsurance programme should be robust, consistent with the risk appetite of the participating fund and protect the balance sheet vis-à-vis insurer's risk appetite and capital strength

Investment

- The AA should evaluate the appropriateness of the investment policy with regard to the nature and term of liabilities, the investment environment and take into consideration the interests of policyholders.

Investment management of participating funds and treatment of costs of guarantees

- AA to ensure that PRE is appropriately set through sales literature by considering the likely investment management approach for the par funds
- If guaranteed benefits exceed the asset shares, consider if this is borne by the estate or some / all participating policyholders
- Investment return credited to asset shares – on amortised cost or market value or smoothed market value? Rationale for differential crediting rate to different groups and how assets are hypothecated for this purpose?

GN 6 (11): Segregation and Merging

Segregation and Merging

- Prior to segregation or merger of par funds, the AA should consider :
  - Clear allocation of expenses and investment income to each fund
  - Bonus outlook for all affected policyholders
  - Pre- and post- financial condition of the par funds
  - Pre- and post- diversification benefits on a risk capital basis
  - Any material impact on the affected policyholders' interests?
  - Appropriate disclosure to existing and prospective policyholders
- Document the structure and rationale of the sub-funds, risks shared for experience pooling. Rules should be consistent from year to year.
- If significant weakening of these factors, or if any deviation from pre-merger investment strategy, AA should inform the Board and document the reasons to proceed with the merger.

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GN 6 (12): Documentation

Documentation

- AA should prepare appropriate documentation covering various aspects
- Be prepared to share the documentation with the Board or the Regulator

Example: Sample PPFM from UK

Item	Details
Aviva Life & Pension UK Limited	
Maturity benefit	Target 80% - 140% of asset share, Year on year change in maturity benefit on comparable conventional WP policies is limited to a maximum of 15%
Bonus rates	Different bonus rates for different types of policies, floored at 0%
Surrender benefit	Average pay-out of 100% of asset share, less any deductions required to protect the interests of the remaining policyholders
Investment strategy	Set with respect to various benchmark assets, equity backing ratios and strategic investments as approved by the Board
Governance	Changes to principles and practices to be decided by the Board, reviewed by the With-Profits Committee, after considering advice from the With Profits Actuary
Prudential Assurance Company Limited UK	
Maturity benefit	Target 80% - 120% of asset share, at least 90% of policies should fall within this range
Bonus rates	Gradual changes expected, not expected to exceed 1% p.a.
Surrender benefit	Target 80% - 120% of asset share, at least 90% of policies should fall within this range
Investment strategy	Overall responsibility lies with the Board, practices set out in a number of Investment Management Agreements and Investment Policy Documents, which list out: approved investment types, benchmark assets, permitted variations in asset mix and limitation on credit risk and counterparty exposures.
Governance	The Board is responsible for management of with-profits business, advised by Actuarial Function Holder, With Profits Actuary and With-Profits Committee

Thank you!