Institute of Actuaries of India
9th Seminar on Current Issues in Life Assurance

With-profits business session 1:
A UK perspective

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29 November 2013

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Agenda

1. Market and regulatory background
2. Role of the with-profits committee
3. With-profits committees in practice

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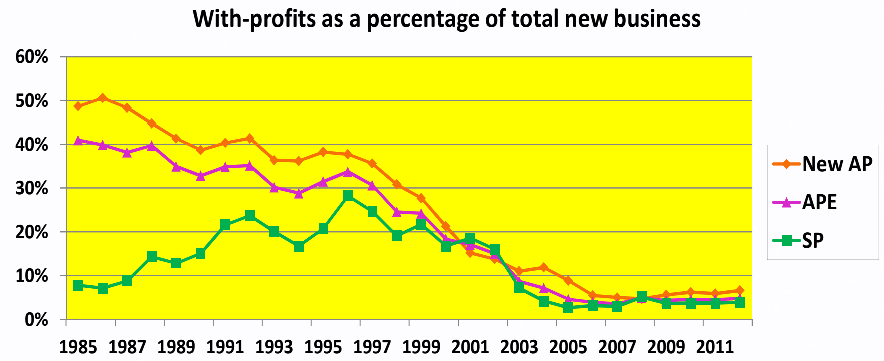
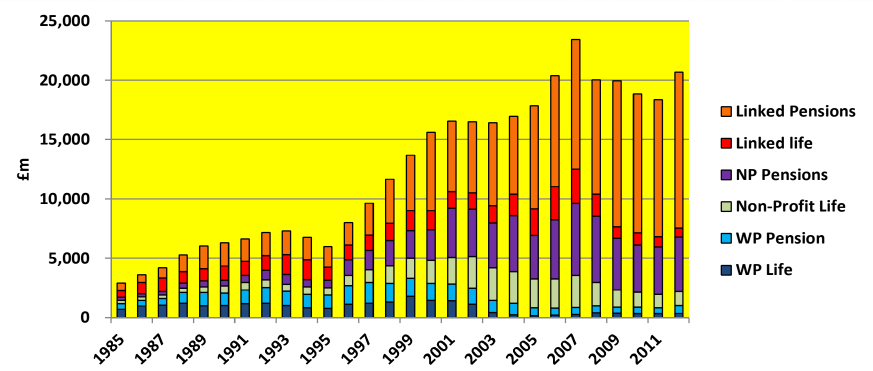
The UK with-profits market: background

- At the end of 2012 there were 19 million with-profits policies held with UK insurers representing £260bn of Pillar 1 reserves
- With-profits policies as a proportion of total new business written have fallen to around 6.2% in 2012 from 42.6% in 1985
- New business APE has fallen from £1,196m in 1985 to £995m in 2012
- Over the same period:
  - New linked business APE rose from £1,172m to £13,882m
  - New non-profit business APE increased from £518m to £5,777m





Source: FSA Returns

Press comment has invariably been negative

- Endowment policies, popular in the 1980s, have produced steadily declining maturity values, forcing policyholders to use other resources to pay off mortgages

Endowment Crash: Payouts on a 25 year £50 a month policy

Year	AXA Equity &	General Accident/CGNU	Friends Provident	Norwich Union	Standard life
1992	104,403	110,093	106,948	100,723	110,399
1993	101,296	110,452	103,733	97,645	105,897
1994	104,436	110,639	103,980	98,423	106,632
1995	102,476	108,081	100,271	92,457	103,704
1996	104,944	111,900	103,658	92,535	104,671
1997	100,679	114,578	103,719	93,179	102,674
1998	97,497	120,809	106,188	100,247	107,379
1999	100,412	116,672	106,434	98,037	109,618
2000	98,495	118,567	102,341	89,518	100,373
2001	94,889	106,090	93,145	86,028	110,136
2002	78,666	89,795	82,100	73,640	99,747
2003	60,373	69,976	70,222	59,567	75,984
2004	50,697	62,832	54,984	53,770	62,603
2005	45,998	57,223	45,295	48,451	51,219
2006	40,676	51,815	38,843	46,653	41,806
2007	41,305	45,911	37,654	47,677	38,338
2008	39,653	46,820	36,425	40,545	38,970
2009	39,746	43,158	29,184	34,496	32,508
2010	33,899	36,797	29,966	28,325	28,139
2011	34,930	33,937	31,374	25,253	28,900
2012	34,695	31,110	30,264	25,871	27,791

Source: Money Management, Money Mail

Scottish Amicable, bought by Prudential in 1987, has 37,090 policies maturing this year, of which only 16,290 look likely to meet their targets

"With-profits investors left behind In the rally" - The Sunday Times 9th Aug 2009

93% of Aviva's with-profits endowment holders received red letters warning them that their policies were unlikely to generate returns originally projected

"Should you sell your with-profits policy?" - The Observer 20th Feb 2011

Standard Life warns that 97% of its mortgage endowment policies will not cover customers' home loans

"Standard Life cuts endowment payouts" - The Guardian 26th Jan 2010

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What went wrong?

- With-profits policies were fashionable in the early 1980s: a perfect time to invest
  - Interest rates were high which led to healthy returns and optimistic projections of sums at maturity
  - Investors initially got tax relief on their premiums
- As a result, estate agents and mortgage advisors sold endowments with the expectation that they would provide a substantial sum in excess of the value of the required mortgage
- Insurers retained a high degree of discretion over the management of with-profits business, but competitive forces kept maturity payouts high
- But:
  - Interest rates started falling, taking the strong returns with them and payouts and projections subsequently fell
  - Tax relief on premiums was abolished for new policies in 1984
- Furthermore, high guarantees required investment in secure assets, but these were low yielding

Consequences of Equitable Life's "failure"

2000 – The closure of Equitable Life

This sparked a chain of significant consequences for with profits regulation, bringing the issue of treating customers fairly into the frame with an emphasis on with-profits business

2003 – CP207: "Treating with-profits policyholders fairly"

This paper was intended to be the last of a series of consultations stemming from the With Profits Review to codify the principles leading to good practice in the with-profits sector

2005 onwards – The Conduct of Business Sourcebook

Following a major review of the sector, new rules and guidance were introduced concerning the treatment of with profits policyholders

2002 – The Sandler Review

This report undertaken by Ron Sandler concerning issues of equity from the policyholder perspective highlighted various problems and outlined proposals

2004 – The Penrose Report

Lord Penrose publishes a report on the events at Equitable Life and is critical of the Board, the management, actuaries and regulators (but not the legal profession)

2011 – CP11/5: "Protecting with-profits policyholders"

A consultation paper proposing changes to the rules governing the management of WP funds. A policy statement followed in 2012

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The Sandler Review 2002

- Sandler's report found deficiencies in several areas related to competition and efficiency
- These concerns were addressed by a proposal to re-design with-profits policies

Key Observations

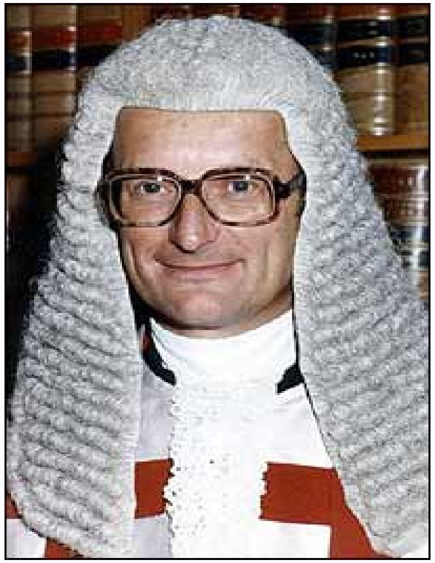
- Support for with-profits as a concept for pooling investment risks between generations and allowing lower income groups access to professional asset allocation
- Opacity of current with-profits focuses competition on maturity payouts and insurer's financial strength, which are not good measures of value for money
- Interests of shareholders have priority over those of policyholders with "unambiguous duty" of directors set against "vague contractual rights" of policyholders
- Charging expenses entirely to with-profits fund and distribution of fund profits on "90/10" basis is considered weak for cost efficiency
- Use of the "inherited estate" in with-profits business also raised concerns

Proposals

- Shareholders should not received a share of the returns of the fund, i.e. replace "90/10" with "100/0"
- A separate management company should run the fund for which explicit charges are made
- A separate smoothing account should be set up with supporting capital aiming to be neutral in the long-term
- Policyholders should be provided with annual statements detailing key information
- Market Value Adjusters should only be used in specific pre-defined circumstances
- With-profits funds should not be used to finance other business
- Policyholder funds can be charged for capital support provided

The Penrose Report

- Completed in 2004, the report concludes Equitable Life's problems were primarily a result of senior management failings
- The main issues concerned:
  - The treatment of terminal bonus
  - Liability valuation and financial adjustments
  - Policyholders' reasonable expectations
  - Clarity of the regulatory objective



Lord Penrose concluded that:

- A consistent smoothing policy would reduce the possibility of allocating returns on policies at an unsustainable level that gradually eroded reserves
- Equitable Life had not provided for accrued terminal bonus and had used a weak, or "dubious" basis for valuing liabilities
- Guaranteed annuity rates were not thought to represent an additional cost to Equitable Life and these were not reserved for, though the regulator belatedly required them to do so
- Regulatory solvency tests made no allowance for non-contractual financial benefits, e.g. terminal bonuses, and so had limited regard to policyholder reasonable expectations

Treating with-profits policyholders fairly

Between 2004 and 2012 new rules were introduced covering *inter alia*:

- A requirement to prepare Principles and Practices of Financial Management (PPFM), and a customer-friendly version
- The role of the with profits actuary, and the with profits committee or alternative governance arrangement
- Determination of amounts payable under policies, including the introduction of target ranges for payouts
- A requirement to balance the interests of departing and remaining policyholders in setting surrender values
- Charges to with-profits funds
- The terms on which new business may be written
- The basis on which strategic investments may be held in with profits funds
- Additional information requirements for with-profits policyholders on closure to new business

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What kinds of conflict could arise?

With-profits policyholders vs …

Shareholders

- What is a reasonable profit margin for administration or investment management services provided by shareholder-owned entities to a WP fund?
- If a shareholder-owned service company makes a mistake which results in overpayments to some WP policyholders, where should the cost be borne?
- De-risking a WP fund will typically reduce the expected cost of shareholder support for minimum benefit guarantees on WP policies ("burn-through cost")

Non-profit policyholders in the same fund

- Capital requirements for non-profit policies may affect the surplus available for distribution to with-profits policyholders – this may be of particular concern in a closed fund

Other with-profits policyholders

- Policyholders within a fund may have certain interests which take priority over those of other members of the fund, such as those with guarantees and those without

Management

- Management may have a preference for courses of action which preserve jobs, or may be reluctant to accept that strategies that they have previously advocated are not working
- Bonuses and other incentive schemes may be linked primarily to shareholder profits

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Some potential areas of conflict

- Charges from shareholder-owned entities to a WP fund
- Build-up of guarantees under WP policies
- Guarantee charges
- Asset mix and hedging
- Volume and terms of new business
- Treatment of compensation costs
- Treatment of exceptional costs (timing)
- Distribution of the estate
- Smoothing and payout subsidies
- Market value reductions and surrender values
- Service standards
- Management actions

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With-Profits Committees – the rules

Set out in the Conduct of Business Sourcebook, COBS 20.5

A firm must, in relation to each with-profits fund it operates:

1. appoint:

a) a with-profits committee; or

b) a with-profits advisory arrangement, but only if appropriate, in the opinion of the firm's governing body, having regard to the size, nature and complexity of the fund in question;

2. ensure that the with-profits committee or advisory arrangement operates in accordance with its terms of reference; and

3. make available a copy of any terms of reference on the firm's website.

Role of the with-profits committee

Ultimate responsibility for managing a with-profits fund rests with the firm through its governing body. The role of the with-profits committee is to:

1. act in an advisory capacity to inform the decision-making of a firm's governing body
2. act as a means by which the interests of with-profits policyholders are appropriately considered within a firm's governance structures
3. address issues affecting policyholders as a whole or as separately identifiable groups of policyholders generally, rather than dealing with individual policyholder complaints or taking management decisions with respect to a with-profits fund

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Matters to be covered by terms of reference

- Excess surplus
- Setting bonus rates/MVRs
- Relative treatment of policies with and without valuable guarantees
- Customer communications
- Changes to the risk profile of the with profits fund
- Strategic investments
- New business strategy

- Impact of management actions
- Complaints data and other management information
- Compliance with court schemes and run-off plans
- Expenses and expense allocation
- PPFM compliance

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Obligations of the firm

A firm must:

- ensure that its governing body
  - (a) obtains relevant input from the with-profits committee (WPC)
  - (b) allows the WPC enough time to provide fully considered input
  - (c) considers fully and gives due regard to the input of the WPC
  - (d) provides a full explanation if it decides to depart from the advice or recommendations of the WPC; and
  - (e) considers any further representations from the WPC
- provide a with-profits committee or advisory arrangement with sufficient resources to perform its role effectively
- notify the FCA of the decision of the governing body to depart from the advice or recommendation of the WPC

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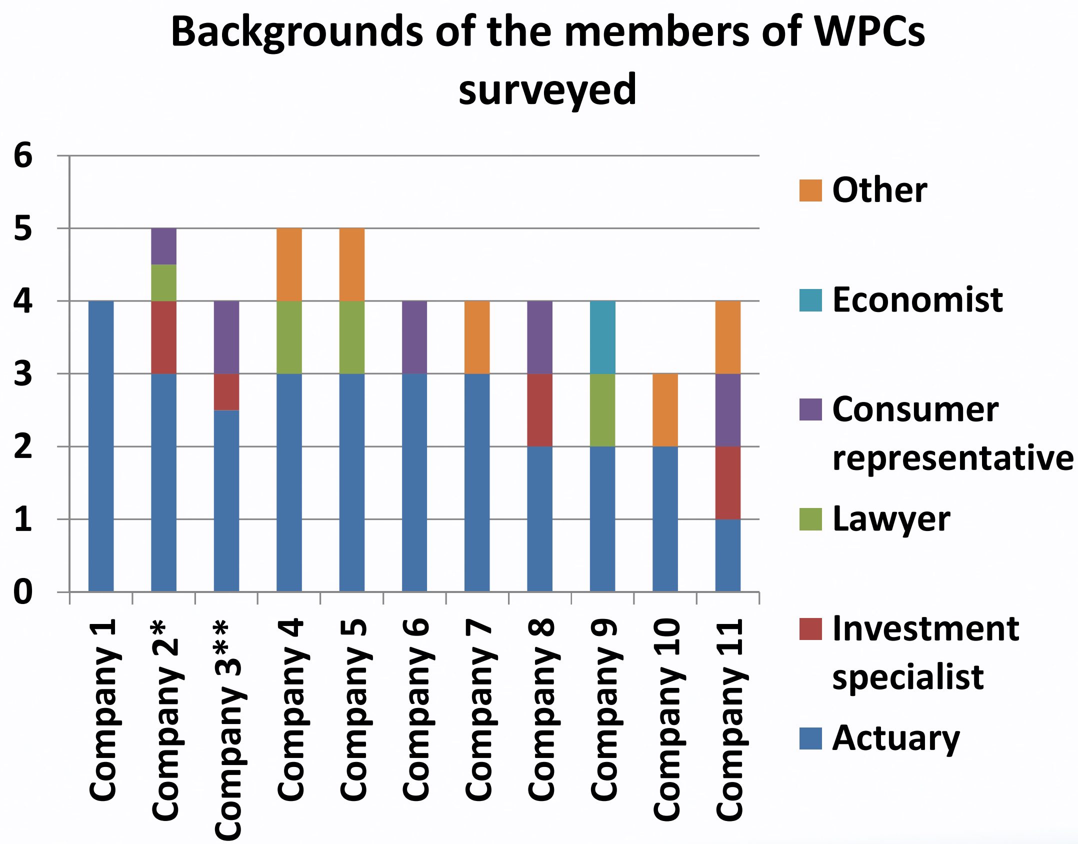
Survey of with profits committee chairs

A questionnaire was sent to members of the With-profits Committee (WPC) Chairs Group. Completed questionnaires were received from the WPC Chairs of the following companies:

- Aviva
- RL(CIS)
- Countrywide Assured
- Friends Life
- Guardian
- LV=

- Phoenix
- Prudential
- Royal London
- Scottish Widows & Clerical Medical
- Standard Life

In most cases actuaries dominate the WPC membership

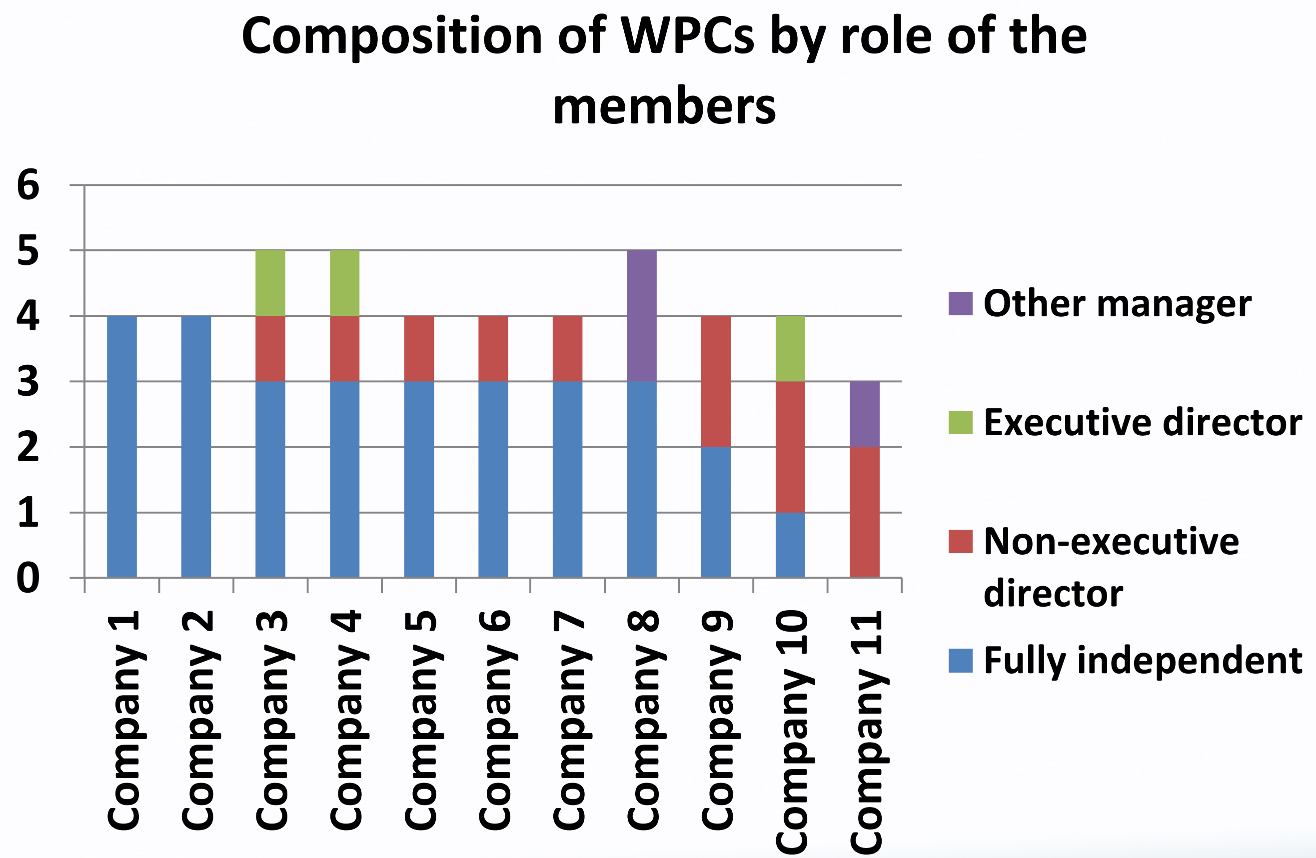


* Consumer rep role filled by a lawyer

** Chair of investment committee is an actuary

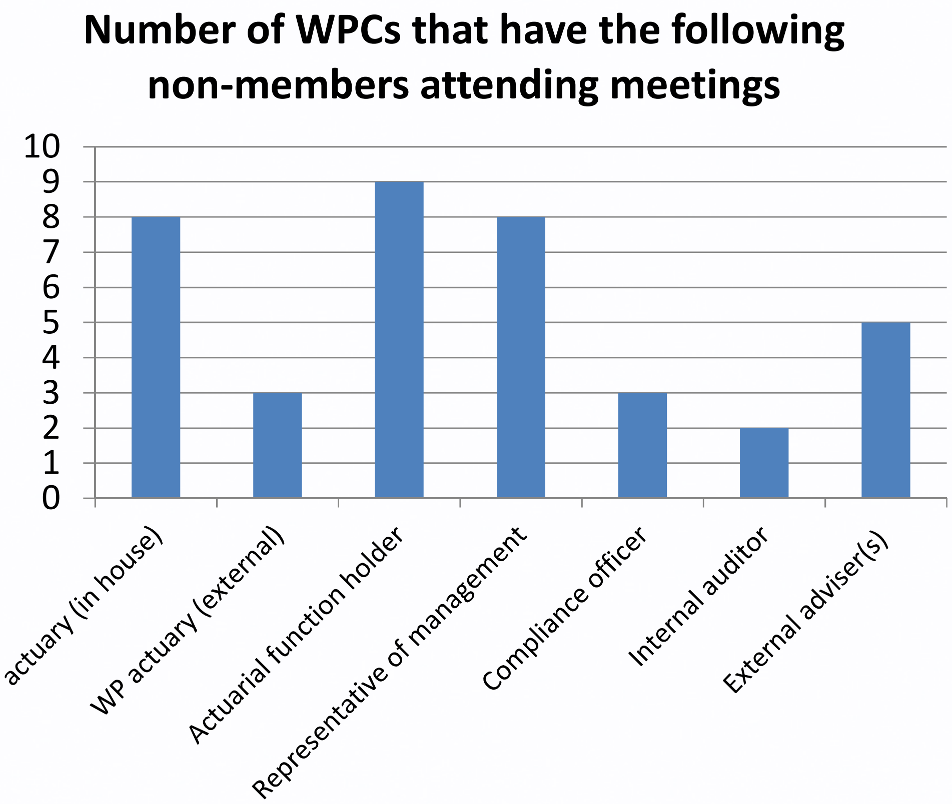
Note: The 'Other' category includes: accountant, former civil servant, former insurance company director, and 'undisclosed'.

In most cases there is a majority of fully independent members



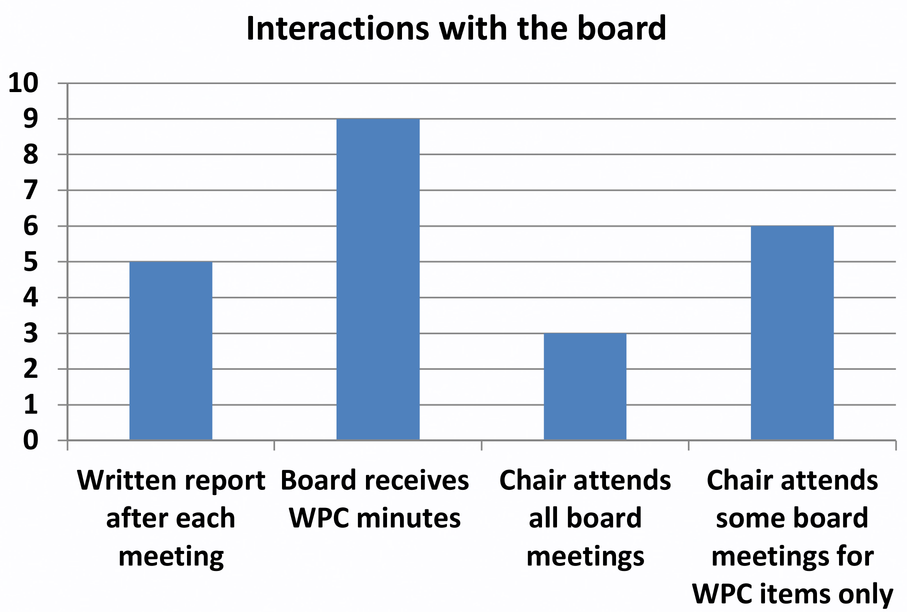
Note: the company order is not consistent with the previous slide.

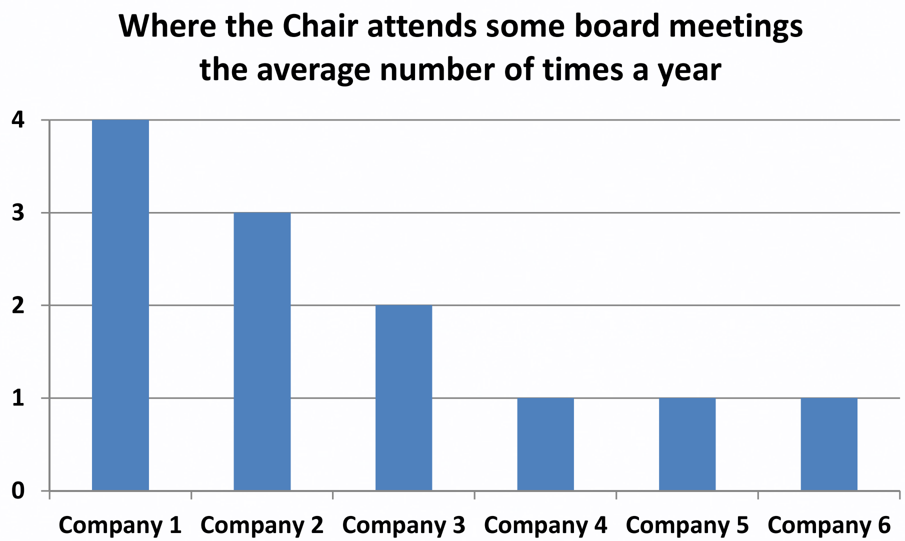
Non members most likely to attend the WPC are the WP Actuary and the Actuarial Function



Note: A number of other attendees were listed: Group board members; CEO; CIO; company secretary; communications; subject-matter expert; legal.

Beyond communicating the WPC minutes, interaction with the board varies





Note: Other interactions given by respondents include: Feedback to group board; WPC chair sits on group board; WPC chair attends group risk committee; reports to NEDs.

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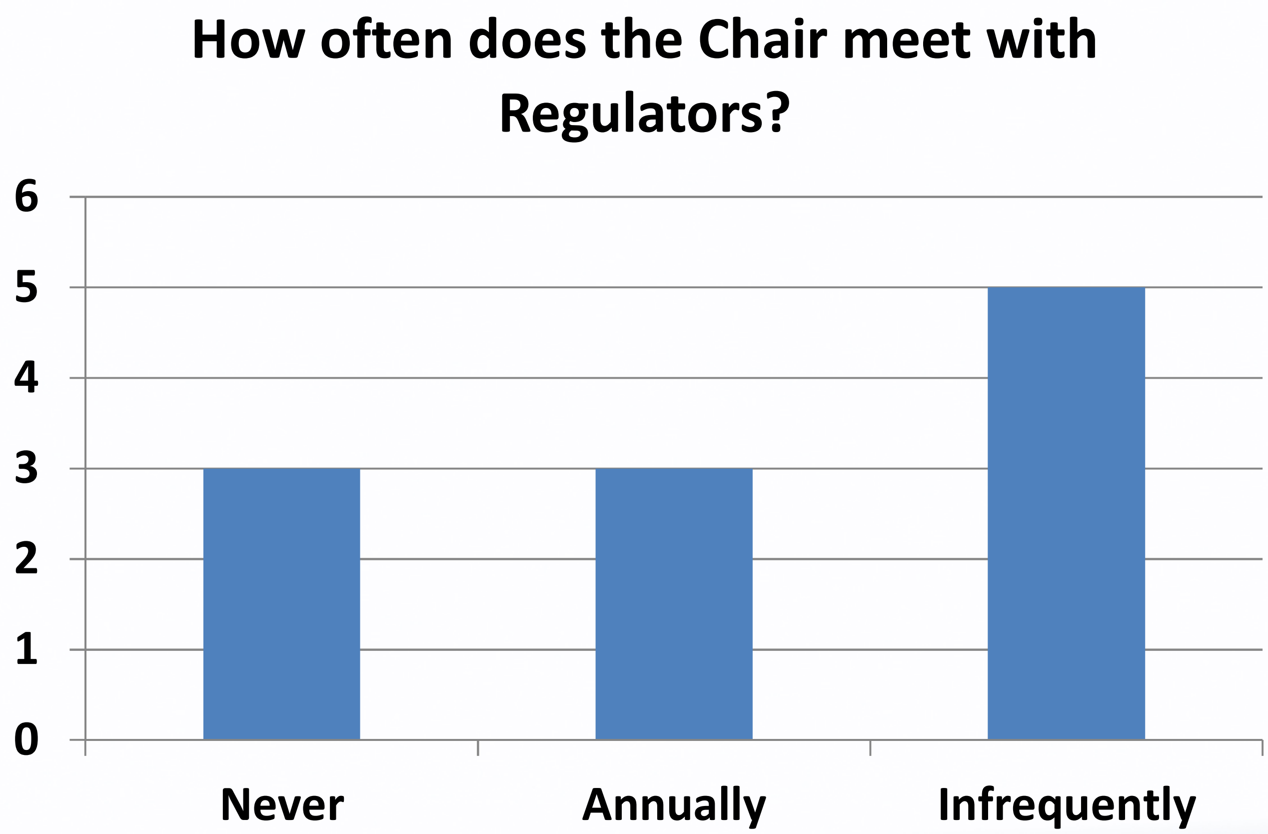
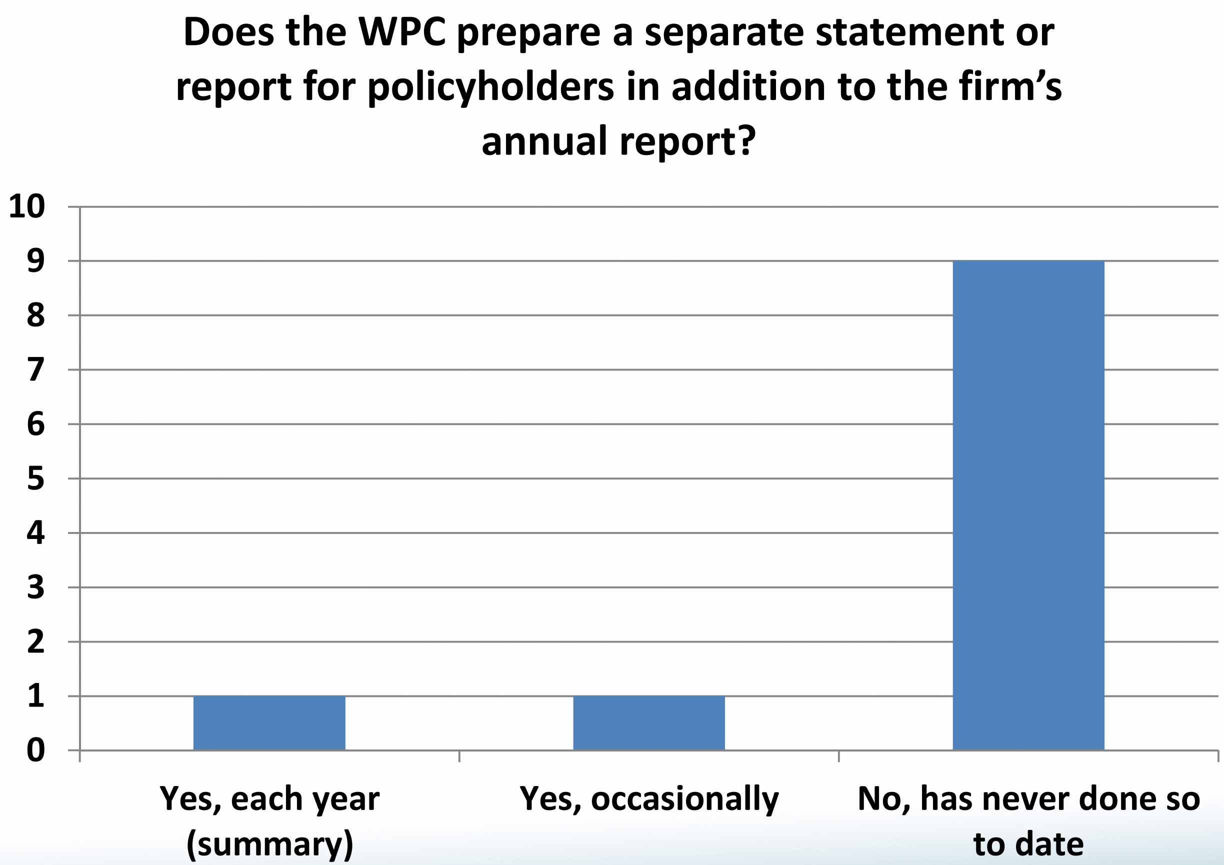
There is generally a low level of interaction between WPCs and the regulators



Note: Only one respondent answered yes to “do regulators ever attend WPC meetings?”

The vast majority of WPCs do not communicate directly with policyholders



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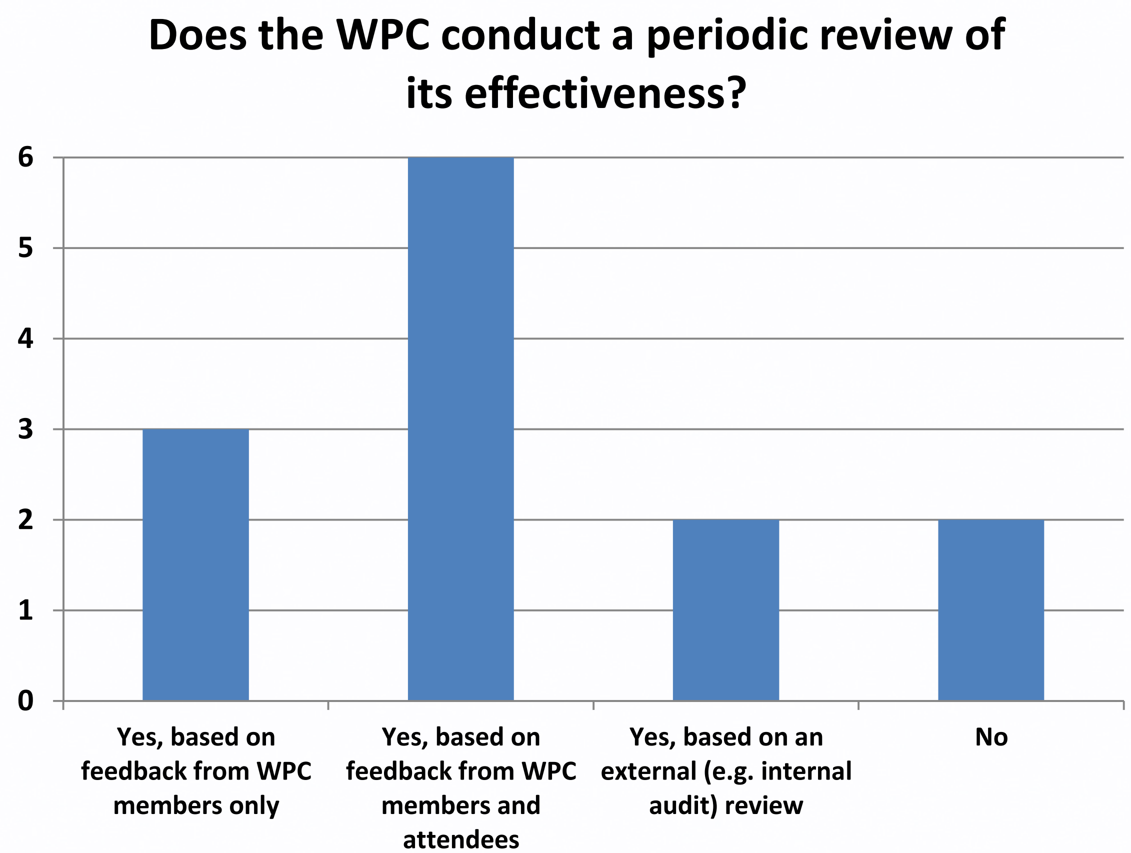
The majority of WPCs conduct effectiveness reviews



Notes: Where they happen, reviews are usually annual, except for one where it is every three years. No respondents conduct performance reviews on individual WPC members.

Common WPC agenda items beyond COBS 20.5

- Investment matters, including
  - Asset allocation
  - Review of investment performance
  - Appointment of investment managers
- Hedging strategy
- Projection rates
- Changes to PPFM and customer-friendly PPFM
- Compensation for errors in managing the business
- Expense allocation
- Appropriateness of retaining non-profit business in a WP fund
- Future of with-profits

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Topics that cause the most concern to WPC

- Investment strategy and performance (5)
- Transactions involving WP fund and shareholders (3)
- Annuities in WP fund (3)
- Potential for, and timing of, surplus distributions (2)
- Restructuring, re-risking/de-risking (2)
- Asset allocation (1)
- Level of guarantee charges (1)
- Conservation in run-off (1)
- Estate distribution, capital requirements and risk mitigation (1)
- Future of mutuals as with-profit business declines(1)
- New business volumes (1)
- Overseas branch business (1)
- Property in run-off (1)
- Regular and final bonus rates in funds with substantial estates (1)
- Service standards for policyholders (1)

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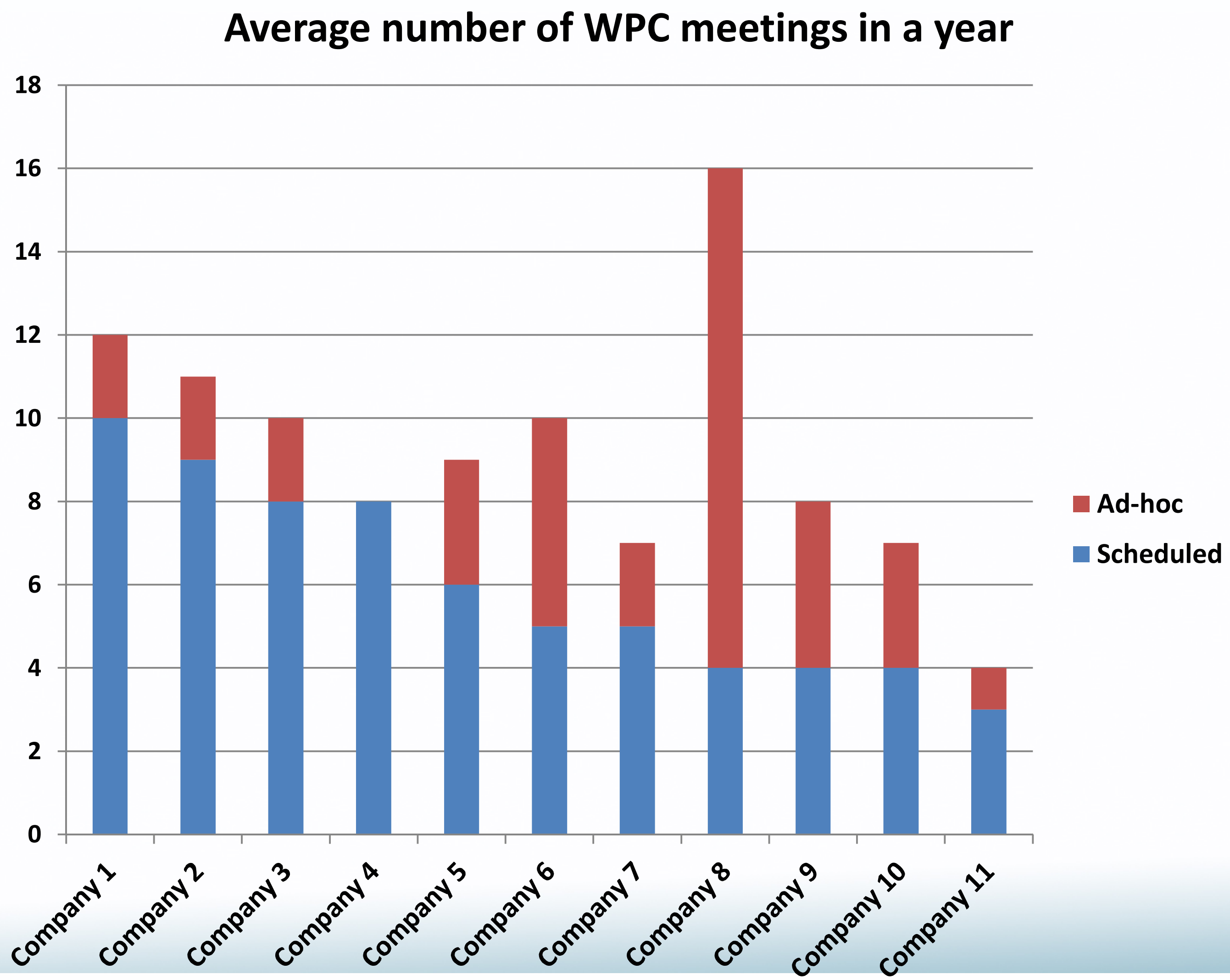
Frequency of WPC meetings



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