

## Management Actions: Myth or Reality?

Institute and Faculty of Actuaries Working Party

November 2006

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### Introduction

- The Management Actions working party was established by the Life Board of the Actuarial Profession
- Broad remit to investigate and consider the use of Management Actions in with profits funds
- Our brief is to consider the general use of Management Actions in models and in reality
- We have carried out a survey and received responses from 19 Actuarial Function Holders in respect of 29 large with profits funds

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### Agenda

- Introduction
- What is fairness from a policyholder's perspective?
- Governance arrangements
- How realistic are realistic balance sheets?
- Conclusions

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## What is fairness from a policyholder's perspective?

Focus on 3 key actions:

- Equity Backing Ratios and future bonus rates
- Asset share charges
- De-risking

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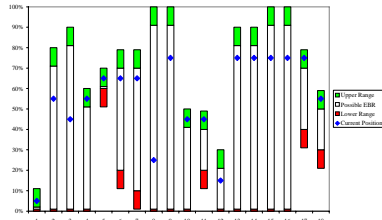
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## Range of Equity Backing Ratios



- 59% model changes in the EBR in base RBS...what about the rest?
- 76% of these allow EBR to fall to zero...is this fair?

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## Range of annual bonus rates

- 62% model changes in regular annual bonus rates in base RBS
- Most allow rates to fall to zero, but few are currently zero
- 17% fall to zero without allowing for annual management charges

An assessment of Target Final solvency	Target Final Bonus %	Risk Free Yield
✓	x	x
✓	✓	x
✓	x	✓
x	✓	x
✓	✓	x
✓	x	✓
x	✓	x
x	x	✓
x	✓	x
x	✓	✓
✓	x	x
✓	✓	x
x	✓	x
x	x	✓
x	✓	x

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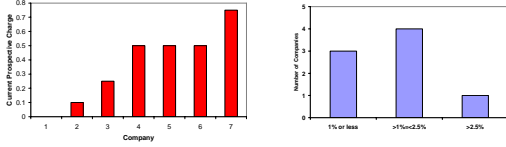
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## Prospective charges for asset shares

Current prospective charges\* Limits on maximum prospective charges



•9 out of 29 firms currently operate prospective charges

•Wide range of maximum charges

\* In addition one firm has a range from 0-0.75% depending on product, another firm states the charge is up to a max of 5% of asset share

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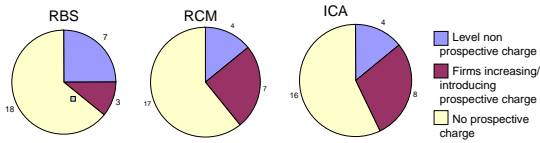
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## Prospective charges: Allowance in RBS / RCM / ICA<sup>(1)</sup>



•Majority of companies have no prospective charges – less so for ICA

## Retrospective charges:

• Not common, discouraged by FSA – but can help make charging fairer?

(1) As best can be determined from survey responses

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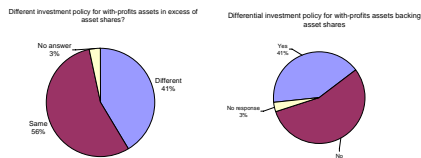
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## Derisking – asset hypothecation

- Becoming more common
- Is it fair across all policyholders?
- How should surrender values be calculated?



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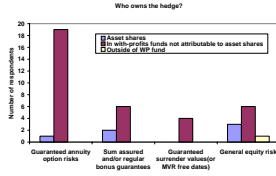
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## Derisking - hedging

- Most firms are hedging GAR risk
- Many firms are hedging other guarantee risks
- Who owns the hedge?



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## Governance arrangements

The survey asked questions both about actions already taken and about contingent actions assumed in RBS/RCM/ICA calculations. The main points arising were:

- 69% of companies took legal advice in respect of the actions already implemented, but only 48% have taken advice in respect of contingent actions
- In approximately 50% of cases advice was also sought regarding the fairness of the actions

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## Governance arrangements

Other points arising from the survey were:

- With few exceptions companies reviewed policyholder literature before deciding on management actions
- None of the companies undertook any customer research before taking/setting actions
- Only half of the respondents have published details of contingent actions in their PPFMs
- The majority of firms retain discretion over the taking of actions in future

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## Governance arrangements

- Companies have sought formal approval to proposed management actions from key office holders (e.g. WP Actuary, AFH, Compliance Officer, Executive Directors, etc.)
- This suggests that, depending on circumstances, companies are satisfied that actions such as reducing annual bonuses to zero, changing asset mixes (including reductions in EBR), reducing allocations of past miscellaneous surplus etc can be regarded as legal and fair

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## Governance arrangements

**We suggest that emerging best practice for the governance of management actions should include:**

- Seeking advice regarding the legality and fairness of both actual and contingent actions
- Reviewing all policyholder literature before setting any contingent management actions
- Assessing the financial implications of the proposed actions on both policyholder and firm and documenting these clearly
- Ensuring the Board has formally approved both actual actions taken and any contingent actions assumed in the RBS/RCM/ICA calculations

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## Governance arrangements

**The working party has also identified some potential weaknesses in the approaches currently being adopted:**

- None of the companies surveyed conducted any customer research before implementing/setting management actions. Customer reaction, once they realise the impact of management actions on their policy proceeds, is therefore uncertain and this may lead to reputational issues in the future.
- Although many firms have set contingent actions in the majority of cases these have not been widely published. Furthermore, almost half of the firms surveyed stated that they had not clearly defined the circumstances in which the actions would apply. This raises concerns over whether contingent actions will be capable of being implemented in practice and how Board members have satisfied themselves that they would implement them in the circumstances envisaged

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## Governance arrangements

### Points for discussion:

- Do companies have mechanisms in place to ensure that the actions being assumed in RBS/RCM/ICA calculations can and will be implemented in practice?
- Are Boards fully engaged in the process of agreeing to contingent actions and do they understand the implications?

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## How realistic are realistic balance sheets?

### A great deal of progress has been made over a short period of time

- RBS developed from private submissions in mid 2002 to FSA Returns by end 2004
- PPFM
- Rapid development required
- Existing actions needed to be codified
- New actions developed or clarified so that they could be included in the RBS
- Increased focus on actions under extreme conditions for the RCM and ICA
- All in the context of volatile equity markets and falling gilt yields

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## How realistic are realistic balance sheets?

### What would an ideal world look like?

- All actions modelled
- Consistency between actions in stresses and base RBS
- Upside actions as well as downside modelled
- Consistent results varying only as a result of genuine differences in the intended management of the WP funds
- To achieve this all conceivable scenarios would need to be considered with resulting actions approved and included in PPFM
- Are there reasons other than practicality for not achieving this ideal?

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## How realistic are realistic balance sheets?

### Survey results – modelling constraints

- Almost all funds are constrained by modelling limitations
- Difficulties cited were – modelling future solvency (24), hedges (14), bonuses (12), EBRs (9), smoothing account (10)
- About half of the funds have plans to improve the modelling of management actions over the next 12 months
- Survey revealed a wide range of sophistication of modelling of actions

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## How realistic are realistic balance sheets?

### Survey results – Completeness of actions

- The majority of funds model all the actions that they might take in the scenarios encountered, but most identify areas where improvements could be made
- Reasons given are:
  - Modelling constraints
  - Only modelling the actions needed to demonstrate sufficient solvency
  - It is not possible to anticipate the actions of future boards in all conceivable future scenarios and get agreement to and communicate these actions
- If we had produced realistic balance sheets in 2000 would we have modelled the actions taken since and the future actions now included?
- About a third of funds do not model upside actions (increasing EBRs etc.)

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## How realistic are realistic balance sheets?

### Survey results – RCM and ICA vs Base

- Half of funds assume actions in the RCM that are not taken if the same scenario is encountered in the base RBS
- Can be easier to gain agreement to action of the company in one specific scenario
- Similar considerations to attempting to model all actions

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## How realistic are realistic balance sheets?

### Survey results – Consistency and Guidance

- Only two Actuarial Function Holders felt that consistency had been achieved
- ...but less than half would welcome further guidance
- ...and almost all those that did expressed reservations about the value that further guidance would add
  
- Most respondents found the presentation of estate distribution as a liability unhelpful and potentially misleading

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## How realistic are realistic balance sheets?

### Conclusions

- Wide range of sophistication of modelling of management actions
- Results are unlikely to be comparable given differences in modelling and completeness of actions covered
- Not all actions are modelled – solvency can be demonstrated without this
- Current rules and guidance do not force consistency
- PRU says that actions *may* be modelled but does not require it

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## How realistic are realistic balance sheets?

### Points for discussion

- Could recommend that all firms should model all actions they intend to take dynamically in all scenarios including upside
- But what would this achieve? This might introduce more risk by further removing discretion and limiting innovation
- This would require significant systems development that could be disproportionate to the benefits
- Better to encourage continued development of models to better understand the business and the implications for risk and customer impact of the actions firms might take

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## Conclusions

- Work in Progress!
- Thanks to the members of the working party for their hard work so far
  - Iain Baker
  - Tim Bunch
  - Gavin Coates
  - Adrian Fuller
  - Matthew Lee
  - Jonathan Pears
  - Ben Rowe

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