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Managing With Profits in Run-off: Managing the estate, fair distributions for policyholders and policyholder communications

Nick Rowley
Gary Rowe
Dan Diggins
Kevin Arnott

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Introduction

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With Profits Funds in Run-off

Volumes of new with profits business in the UK have fallen to very low levels, and this, coupled with high levels of with profits maturities, means that most UK with profits funds are either closed or in run-off.

The run-off of with profits funds presents new challenges for with profits firms, and steps may need to be taken to ensure that the funds run off in an orderly manner and that policyholders are treated fairly.

A working party was established to consider these challenges and how firms might meet them.

Managing With Profits in Run-off Working Party

The working party has c25 members and its work has been undertaken through 4 working groups covering the following topics:

1. Managing risk in the estate, capital thresholds for distributions and the form of estate distributions
2. Fairness and policyholder communications
3. Day-to-day management of with profits funds in run-off
4. Potential actions in run-off (closure, conversion etc)

The working party conducted an extensive survey on how firms manage with profits funds in run-off. This has provided valuable insights on industry practice.

Managing With Profits in Run-off Working Party

The working party has prepared a paper setting out its views on managing with profits funds in run-off and the insights from the industry survey.

This is available on the Institute and Faculty of Actuaries website at :

http://www.actuaries.org.uk/life-insurance/pages/management-and-run-profits-funds

Scope of this Workshop

This workshop focuses on the subjects considered by working groups 1 and 2:

- Managing risk in the estate and capital thresholds – Dan Diggins
- Form of estate distributions – Nick Rowley
- Fairness for with profits policyholders – Gary Rowe
- Policyholder communications – Kevin Arnott

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Managing risk in the estate and capital thresholds

Dan Diggins

Managing risk in the estate

- Philosophy
- Risk profile
- Risk appetite
- Management actions

Philosophy

- Objectives of closed funds and funds open to new business can differ eg
- Closed funds
  - Providing policyholder protection in relation to benefit security
  - Minimising the tontine effect that can occur with the run-off of closed funds
- Open funds
  - Maximising policyholder returns and
  - Providing policyholder protection in relation to benefit security

Philosophy

- Uses of the estate
  - offer benefit security to policyholders
  - support a real-return seeking investment strategy
  - provide a resilient source of income in the form of shareholder transfers to shareholders
  - enhance benefits to policyholders
  - facilitate smoothing
  - provide financing for new business

Risk profile and risks facing funds

- For open funds equity price risk remained the top risk faced, whereas the top risks to which closed funds are exposed are fixed interest risk and corporate bond credit risk.
- Market risk most prevalent before and after hedging but slight shift away from equity risk towards corporate bond spreads
- With the extensive use of hedging it was expected that there would be a shift in the top risks from economic risks before hedging to demographic risks after hedging. However, whilst there was some evidence of such a shift, the economic risks dominated both before and after hedging

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Risk profile and risks facing funds

- Risk appetite between proprietary and mutual firms seems to differ with the exposure of mutual with-profits funds to a fall in equity prices post hedging seemingly far greater than that of funds in proprietary companies
- A number of the proprietary firms had taken steps to hedge the economic risks in the fund but had not yet taken action to de-risk longevity risk
- A number of firms have taken action to de-risk longevity risk
- Fundamental change in longevity risk exposure following budgetary announcement on annuities

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Risk profile and risks facing funds

- Risks vary by business type and the mix of business typically changes over the lifetime of the fund as the different parts of the business run off at different rates
- However, many funds have mature profile and did not anticipate change in risk profile in the foreseeable future
- For those funds that did anticipate a change in risk profile the key differences were expense risk, longevity

Risk appetite

- Over recent years there has been significant development by with-profits funds in defining, and improving, their risk appetite frameworks, which has been driven by regulatory and market requirements
- An effective risk appetite framework should provide a common framework that allows senior management and the board to communicate, understand and assess the types and level of risk that they are willing to accept with explicit boundaries within which management is expected to operate when pursuing the business's strategy

Risk appetite

- A number of key areas to consider in defining the risk appetite
  - The investment mix of the fund should be aligned to the risk strategy and capital planning strategy.
  - Clear ALM framework which could include an approach to hypothecation strategy
  - Multiple stakeholders - beneficial to have separate risk appetite statements policyholders and shareholder perspective
  - Consider distribution plan where appropriate

Managing the estate

- The majority of firms actively manage the estate of their with-profits funds.
- However, whilst the estate is typically defined as the excess of assets over realistic liabilities there is no consensus view on the definition of realistic liabilities and a number of definitions are currently used.
- It will be interesting to see whether the implementation of the Solvency II reporting regime forces a greater consistency of definition of the estate in future.

Management actions

- Range of actions being taken including:
  - Reducing risk in the assets backing asset shares
  - Reducing asset risk in the estate
  - Using derivatives to manage Guaranteed Annuity Options (“GAO”s)
  - Using derivatives to manage other risks
  - Internal delta hedging
  - Longevity swaps
  - Outsourcing administration services
  - Sale of non-par business / changing terms in PPFM

Management actions – prioritised list

Open funds	Closed funds
1. De-risking the estate 2. Using derivatives to manage non-GAO risks 3. Reducing risk in the asset shares 4. Delta hedging 5. Using derivatives to manage GAOs	1. Reducing risk in the asset shares 2. Outsourcing of administration services 3. De-risking the estate 4. Delta hedging 5. Other *

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Form of estate distributions

Nick Rowley

What is a Distribution?

Any action taken that reduces the fund's estate is a distribution. This could include:

- A higher risk investment strategy
- Changing the bonus or smoothing philosophy
- Reducing expenses charged to asset shares
- Introducing additional guarantees.

These are the nature of "indirect" distributions.

This session focusses on "direct" distributions, typically entailing:

- Enhancements to asset shares; and/or
- Additional regular or final bonuses.

What Might Policyholders Expect?

- Security of benefits is key, BUT not at an excessive level
- Any distribution should reflect the contribution made by policyholders to the estate, e.g. guarantee charges
- May be preferable to refund guarantee charges first
- This means that a distribution from the estate is of the nature of a windfall
- As a consequence, there is no single correct form for the distribution, and a number of approaches could be adopted
- Given this, perhaps a form of distribution that treated policyholders consistently is most capable of being deemed fair.

Desirable Features of Estate Distributions

- Consistent with regulations, PPFM and Court Schemes
- Applied consistently across all policyholders
- Demonstrably fair
- Straightforward to implement
- Easy to explain to policyholders
- Creates a tangible benefit for policyholders
- Consistent with any establish practices (unless unfair)
- Limits possibility of financial strain for the fund.

Estate Distributions – Some Challenges

- Reflect policy size or fixed?
- Treatment of guarantees?
- Include surrenders?
- Reward for loyalty?
- At exit or over lifetime?
- Reflect duration?
- What is the shareholders' share?
- How to treat new business?
- What about overriding guarantees?

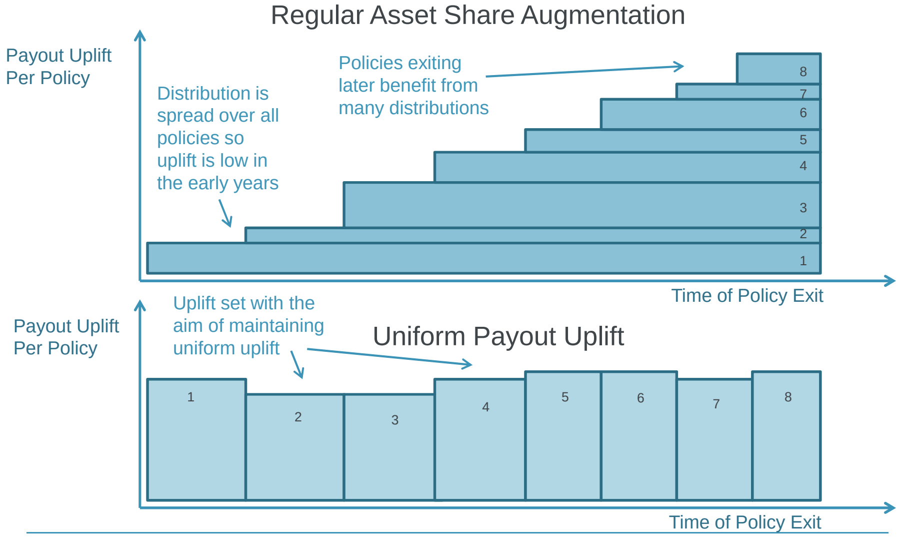
Estate Distributions – Some Options

i. Permanent asset share augmentation (but no bonus)
ii. Temporary asset share augmentation (but no bonus)
iii. Special regular bonus (plus asset share augmentation)
iv. Special guaranteed final bonus (plus asset share augmentation)
v. Temporary additional final bonus (plus asset share augmentation at exit) – a payout uplift only guaranteed on exit.

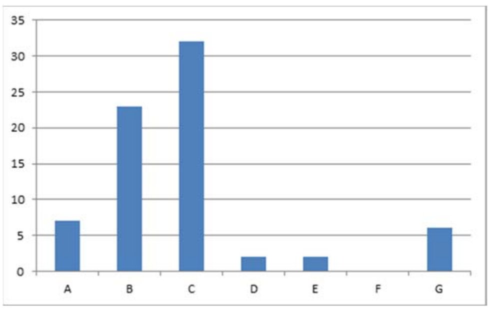
Options without any bonus will have no impact on payouts driven by smoothing or guarantees.

How will these options work for a fund in run off?

Estate Distributions – Avoiding a Tontine



Estate Distributions – Industry Practice



A. One-off enhancement to asset shares
B. Regular enhancements to asset shares
C. Enhancement to maturity and surrender claims
D. Increases to the level of guarantees (e.g. additional special bonus)
E. Indirect distribution (e.g. refunding charges to asset shares)
F. Immediate cash distribution
G. Other, (including no distribution, the enhancement of investment returns).

Conclusions

There is no single correct form for distributions from the estate – there are a number of potentially fair methods.

Some methods are better than others – need to take care that the approach adopted does not disproportionately favour one group of policyholders to the detriment of another.

Good practice would entail:

- A comprehensive analysis of the options and their effects on different groups of policyholders and shareholders
- Proper consideration of this matter by the firm's governing body, With Profits Committee and With Profits Actuary
- Documenting the agreed approach in a Distribution Plan.

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Fairness for with profits policyholders

Gary Rowe

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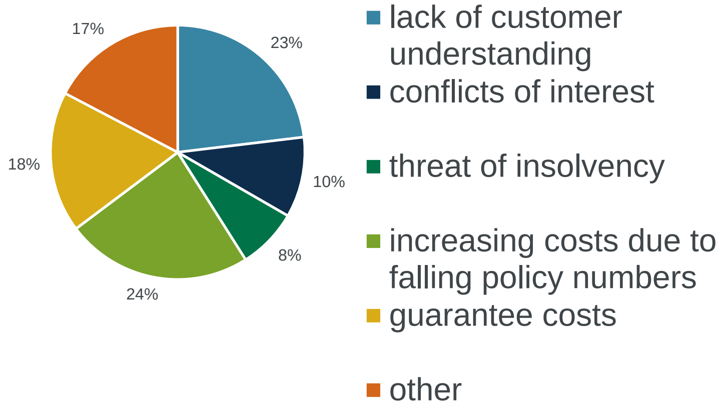
Challenges to fair treatment

Next ten years



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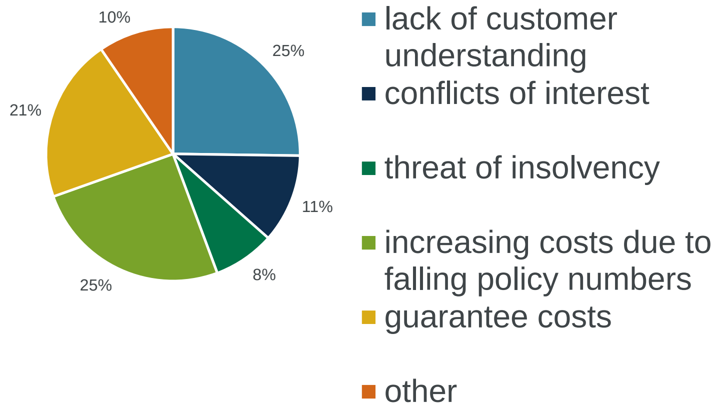
Challenges to fair treatment

And beyond



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Constraints to fair treatment

- Customer understanding
  - –Should the preferred approach be compromised by what you can explain?
- Over prescriptive regulation (largely mutuals)
- Increasing costs due to falling policy numbers
- Capital held back to support the tail
- Embedded past practice
- Lack of models.

Past practice – some examples

- Investment strategy?
  - –When is it appropriate to move away from high equity?
- Data used for bonus setting
  - –If actual data is used, then average policy variation increases year by year as the number of policies falls
  - –So payouts are volatile without an external driver to explain it
- Distribution
  - –Asset share enhancements work well in stable funds
  - –But create a tontine like effect in run-off

Fairness

- Significant decisions will need to be made
  - –Distributions
  - –Wind up
- Potential conflicts of interest
  - –Policyholder – Policyholder
  - –Policyholder – Shareholder
  - –Policyholder – Management
- Strong and effective governance is key to fair outcomes
  - –Challenging and independent With Profits Committee
  - –Unfettered With Profits Actuary

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Policyholder communications

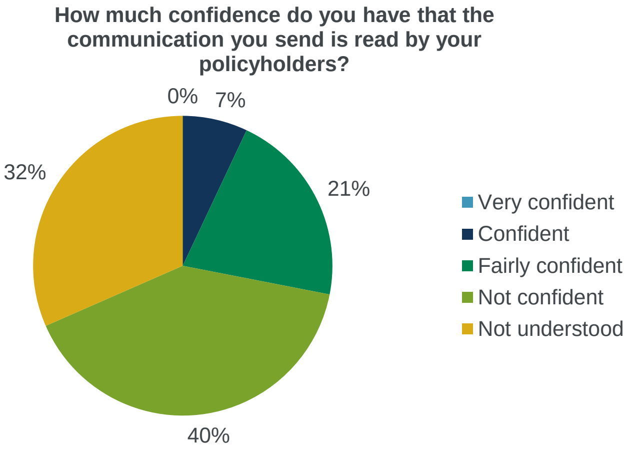
Kevin Arnott

The current position

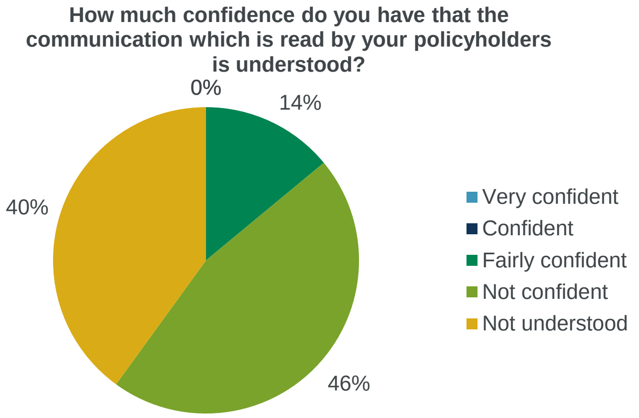
- A wealth of information is supplied to policyholders
  - Routine update information
  - Event driven information
  - Customer initiated information

…..but how well do we communicate?

Do policyholders read what they are sent?



Do they understand it?



A typical with-profits policyholder?

What can we do to improve matters?

- Some evidence that offices are trying to be “smarter” about communication
  - Applying ideas from “behavioural economics”
  - Improving “touch and feel” of documents
  - Introducing new channels
  - Improved “testing” of communications

Policyholder Engagement

- Communication is a two way process and it can be difficult to communicate with “unengaged” policyholders
- Policyholders decide whether (and when) to engage with their policy
- Once engagement is lost it can be difficult to get back

An opportunity? - Changes to the pension landscape

- Pensions is in the news and not only in the financial sections
- Significant public interest…a real opportunity for policyholders to reengage with their products?

Expressions of individual views by members of the Institute and Faculty of Actuaries and its staff are encouraged.

The views expressed in this presentation are those of the presenters.