Institute
and Faculty
of Actuaries

Working Party Report

The Management of With-Profits Funds in Run-off

7 November 2014

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1 Introduction

1.1.1 An Institute and Faculty of Actuaries working party was formed to look at the management of with-profits funds in run-off. The aim of the working party was to equip those who manage with-profits funds with evidence-backed information and recommendations on how to manage the funds going forward.

1.1.2 The areas in the management of with-profits funds which the working party focussed on were around four broad topics as described below.

- Risk, Capital and Distribution. Considered under this topic were how companies assess and manage risk in the estate, the setting of capital requirements to determine when distributions can be made, and the benefits and drawbacks of different forms of distribution from the estate.
- Customer outcomes. As part of this topic the working party considered fairness, customer outcomes (likely as well as potential), the balance of risk and reward for customers and customer communications.
- Managing the fund in run-off. This looked at how management of the fund might need to change as it runs off, including consideration of investment strategy, bonus philosophy, smoothing and guarantee charges.
- Actions that could be taken in run-off, including outsourcing of administration, mergers and consolidations, and conversion to non profit.

1.1.3 In order to investigate these topics, the working party issued a survey to 37 companies which manage with-profits funds in the UK, including both those open and closed to new business, and received 34 responses in respect of 59 funds. Responses were anonymous, but analysed by whether funds were open, closed, small large and by ownership.

1.1.4 The paper discusses first the history of with-profits funds in the UK and some current issues, and then goes into the areas covered by the topics outlined above. Within each section, the survey results are discussed, drawing out any particular areas of interest in the responses, ending with conclusions and recommended good practice.

1.1.5 Managing risk in the estate, capital requirements and managing capital are covered in Sections 3 and 4 respectively. Section 5 discusses distributions from the estate, and fairness and policyholder communications are discussed in Sections 6 and 7. Sections 8 to 13 deal with managing the estate in run-off, and cover bonuses, investment strategy and charges. Conversion of with-profits funds is discussed in Section 14. The paper concludes with ideas and recommendations for future research.

1.1.6 Different sections of this paper have been authored by differed groups within the working party, so the views expressed in this paper are not necessarily the views of all members of the working party. The members of the working party are listed in section 16.

1.1.7 Any feedback or questions on the paper should be directed to:

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2 History of With-Profits in the UK

2.1 Introduction

2.1.1 With-profits business was historically a significant part of the UK life insurance market, but recent years have brought challenges and changes to the business. With-profits business accounted for 42% of total new business in 1985 (measured as Annual Premium Equivalent premium income), but this declined to 5% in 2013.

2.1.2 Although new business has declined, there remain £224bn of with-profits assets under management in the UK as at the end of 2013, representing savings in more than 17 million policies. This clearly represents a significant proportion of the savings market. The changes in the market for with-profits, including the closure to new business of a number of with-profits providers and changes in regulation, means that it is timely to look at the way in which funds, including those closed to new business, are operating.

2.1.3 This section looks briefly at the history of with-profits in the UK, and current issues and developments, in order to set the context of the research, survey results and recommendations presented in the rest of the paper.

2.2 History of with-profits

2.2.1 With-profits business in the UK has its origins in the late 18th and early 19th century. With-Profits policies generally started as whole of life policies with a high protection element. They developed into fixed term endowment and pensions policies. 'With-profits' policies give policyholders the eligibility to participate in the surplus arising on all, or a part of, the insurer's long term business.

2.2.2 Given the long history of with-profits business, as might be expected, products and how they are managed have evolved over time, influenced also by changes in technology. As different with-profits funds had different origins and history, the management of with-profits business, which historically was not codified, typically varied between funds.

2.2.3 A key element of with-profits business is discretion in determining payments. Other elements commonly associated with UK with-profits business include smoothing of payouts, the provision of guarantees (which may be increased through the addition of regular bonuses), pooled investments, and the sharing of profits between policyholders and shareholders (if any).

2.2.4 Products have developed from conventional with-profits policies, which may not have charges or underlying investments explicitly stated, to unitised with-profits products, which offer greater transparency of charges, investments and smoothing, although discretion and the eligibility to participate in surplus remain.

2.2.5 This move to transparency and clear communication has been reinforced by the regulatory environment, including the requirement to publish, and report on compliance with, Principles and Practices of Financial Management ("PPFM") for with-profits business.

2.2.6 Additional regulatory requirements, designed to promote stronger governance, have also been introduced, including the establishment of independent With-Profits Committees or advisory arrangements, to ensure the interests of with-profits policyholders are appropriately considered in the firm's decision making process, and the role of With-Profits Actuary, who is required to advise the firm on the exercise of discretion.

2.2.7 Realistic balance sheets have also been introduced, to provide an explicit and consistent assessment of with-profits liabilities, with an allowance for management actions. As well as more transparency, realistic balance sheets were introduced to give a better recognition of the expected cost and the risk of guarantees.

2.2.8 A useful picture of the with-profits market up to 2009 is provided in C. D. O'Brien's paper "The U.K. With-Profits Life Insurance Industry: A Market Analysis", published by the British Actuarial Journal.

2.3 Recent developments

2.3.1 Given the extent and nature of the discretion in the management of with-profits business, various potential and actual conflicts of interest can arise in the management of the business, including between shareholders and with-profits policyholders, between with-profits policyholders and non-profit policyholders within the same fund, between with-profits policyholders and the members of mutually-owned firms, between with-profits policyholders and management, and between different classes and generations of with-profits policyholders, for example those with and without guarantees. Practices and regulations have developed over time to manage these conflicts of interest. This has included work on defining the interests of stakeholders in inherited estates.

2.3.2 In 2008, the Treasury Select Committee carried out an enquiry into inherited estates. This report welcomed a reopening of the debate about the fundamental design of the regulations for with-profits funds, recommended more transparency on smoothing, looked at the funding of new business, particularly in the context of reattributions, and viewed the charging of mis-selling compensation costs to the inherited estate as inappropriate. The report also criticised the charging of shareholder tax to the inherited estate, and recommended that With-Profits Committees have an explicit role to ensure with-profits funds are run in accordance with the principle of Treating Customers Fairly[1].

2.3.3 The risk/reward balance of with-profits business was altered for proprietary funds by the publication by the Financial Services Authority ("FSA") in July 2009 of P09/13, which changed the way certain expenses of compensation and redress are charged to with-profit funds run by proprietary firms.

2.3.4 The Aviva reattribution received High Court approval in September 2009. This Scheme gave payments to with-profits policyholders who surrendered any future interest in the funds' surplus. Between a special bonus previously paid and the reattribution payment, 70% of the Inherited Estate of the funds affected were allocated to customers[2]. This was the last significant reattribution in the UK. In September 2008 Prudential announced that it was not proceeding with a reattribution[3].

2.3.5 The FSA published its with-profits regime review in June 2010. This review looked at whether firms appropriately manage their commitments to with-profits policyholders and treat them fairly. The report also included a view on the reattribution process. This review identified sector-wide areas of concern around:

- the governance of with-profit funds, and in particular independent challenge provided by With-Profits Committees, and
- policyholder communications, and whether these provide sufficient comprehensive, timely and clear information so policyholders can take a reasonable view of the risk and reward balance of their policies.

2.3.6 In March 2012, the FSA published 'Protecting With-Profits Policyholders', which looked at the fair treatment of policyholders, conflicts of interest, the terms on which firms should write new business, Market Value Reductions (MVRs), strategic investments, excess surplus, reattributions and the role of independent judgement including With-Profits Committee and other aspects of corporate governance.

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[1] Source: House of Commons Treasury Committee Inherited Estates: 12th Report of Session 2007-2008 www.publications.parliament.uk/pa/cm200708/cmselect/cmtreasy/496.496.pdf

[2] Source: Aviva press release 18 September 2009 "High Court hearing approves Aviva reattribution deal"

[3] Source: Prudential press release 27 June 2008 "Prudential decides not to proceed with a reattribution of its Inherited Estate"

2.3.7 The 'with-profits' Memorandum of Understanding between the Financial Conduct Authority ("FCA") and Prudential Regulation Authority ("PRA") published in April 2013 sets out how the FCA and PRA will co-operate in the supervision of insurers with policyholders who hold with-profits policies. The publication of this reflected additional co-ordination needed between the two newly established regulators because the returns on with-profits policies are affected by actions taken at the discretion of insurance companies, "which give rise to issues of both fairness to policyholders and the safety and soundness of insurers"[4].

2.3.8 In March 2014, the FCA published 'Mutuality and with-profits funds: a way forward'[5], which gave mutual with-profit providers which are facing declining levels of with-profits business, or which already have with-profits funds in run-off, but which have a viable business plan, a new option to continue to write new business, subject to a regulatory waiver. The PRA also published a supervisory statement on the PRA's expectations regarding the with-profits mutual waiver process at the same time[6].

2.4 Current issues and developments

2.4.1 The Solvency II requirements which will be implemented on 1 January 2016, in particular the capital specifications, may also cause firms to re-visit the way they manage with-profits funds. Further consideration will be required with respect to the application of new Solvency II developments such as Own Risk Solvency Assessments (ORSAs) and Quantitative Reporting Templates (QRTs) to with-profits business. More guidance is expected on this from the FCA and PRA.

2.4.2 The FCA's current thematic review into the fair treatment of long-standing customers is looking at whether historic products are being operated in a fair way and whether firms are adopting strategies which could exploit existing customers will include with-profits policies and funds within its scope.

2.4.3 The FCA is also looking at with-profits governance in its 2014-15 plan. This will include a review of whether firms have effectively implemented changes made to with-profits rules in 2012, and looking at the adequacy of firms with-profits governance arrangements.

[4] Source: With-profits, Memorandum of Understanding www.fca.org.uk/static/fca/documents/mou/mou-with-profits.pdf
[5] Source: www.fca.org.uk/your-fca/documents/policy-statements/ps14-05
[6] Source: 'Mutuality and with-profits funds: a way forward' www.bankofengland.co.uk/pra/documents/publications/policy/2014/mutuality114.pdf

2.4.4 The introduction of minimum quality standards for workplace pensions will introduce new governance, more transparency and a focus on delivering value for money for workplace pensions, including those invested in with-profits.

2.4.5 The with-profits 'brand' remains out of favour with consumers. Which?[7] continues to voice its concern that FCA rules allow companies to use discretion in such a way as to benefit shareholders rather than looking after policyholders' best interests, and is campaigning for the rules surrounding corporate governance and accountability of with-profits funds to be strengthened[8].

2.4.6 Given the changes in with-profits business, as new business declines, the change in regulator and the continuing scrutiny on the management and governance of with-profits funds, this paper considers a number of areas of the management of with-profits funds in run-off. The paper discusses the results from a survey of industry practice in relation to with-profits, insights gained from those results and, where appropriate, recommendations of good practice.

[7] A UK consumer body
[8] Source: http://www.which.co.uk/money/savings-and-investments/guides/with-profits-funds-explained/

3 Managing Risk in the Estate

3.1 Introduction

3.1.1 This section considers the topic of managing risk in the estate. Focus is placed on the risks borne by the estate rather than those borne by the asset shares although it is recognised that risks borne by the asset shares can have an impact on the risks borne by the estate. Section 9 of the report considers the investment strategy for with-profits funds and the investment strategy backing asset shares in particular.

3.1.2 Historically, many with-profits funds were managed as a single pool of assets with no distinction made between assets backing asset shares, hedging assets and assets held in the estate (which are relatively recent concepts in the evolution of with-profits). However, in recent years, the appetite for bearing certain types of risk in the estate has reduced for many funds and this has led to firms adopting consciously different strategies to manage the various parts of their funds.

3.1.3 With this in mind the survey that the working party conducted focussed on the following areas:

- The definition of the estate
- The philosophy adopted by firms for managing the estate
- Key risks borne by the estate both before and after hedging and considering how this might vary by certain defining features such as the type of firm, the status of the fund etc.
- The likely changes in the risk profile of the funds
- Actions taken now and in future by firms to manage and mitigate risks

Comments on each of these areas are set out in this section of the report.

3.2 Managing risk in the estate

3.2.1 Philosophy for Managing the Estate

3.2.2 It was expected that firms would have a policy for managing the risks borne by the estate and that there would be a stated risk appetite in relation to this. The results of the survey supported this expectation. See section 4 for further details.

3.2.3 In addition, it was expected that the stated purpose of the estate would have an important influence on the risks borne by the estate.

3.2.4 Use of the Estate

3.2.5 The estate can have a variety of intended uses depending on the nature of the fund. For example the estate can be used to

- offer benefit security to policyholders
- support a real-return seeking investment strategy
- enhance benefits to policyholders
- facilitate smoothing
- provide financing for new business

3.2.6 It might reasonably be expected that the approach taken to manage the estate could be different for each of these uses.

3.2.7 Risk Profile

3.2.8 The risks to which funds are exposed may vary according to the business written in the fund, 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.

3.2.9 Conventional life business was typically written for a clearly defined period of time and the run-off of this business can be 'lumpy' but predicted relatively easily. For example, there were many mortgage endowment products sold in the UK during the late 1980s and early 1990's. It is expected that many of these products are either very close to maturity or have already matured. This trend can be observed across the UK insurance industry. In contrast, life bonds, mostly written as whole of life products, have a date of exit which is less predictable leading to a less predictable and potentially longer term run-off profile.

3.2.10 Pensions business is typically written to a specified retirement age irrespective of the remaining duration of the policy and these contracts tend to have a greater degree of optionality attaching (e.g. early retirement, late retirement etc.) and so the run-off of this business has tended to be smoother than for life business. The duration of pensions business also has the potential to be longer than that of most life business for the same reason.

3.2.11 Actions to Manage and Mitigate Risks

3.2.12 Firms have taken a variety of management actions in the management of their with-profits funds. These typically appear to vary according to whether the firms are proprietary or non-proprietary in nature, whether the funds are open or closed to new business and by size.

3.2.13 The duration of the liabilities in the fund and the nature of those liabilities appears to determine the range of actions. Management actions can be categorised as:

- business as usual activities that many firms adopt as part of the everyday operation of the funds. Such actions might include varying bonus rates, varying charges and amending the investment strategy
- more strategic, one-off actions such as the sale of non-participating business or the early payment of long-term whole of life business with a view to releasing the expense reserves within the fund etc.

3.2.14 Management actions are discussed further below.

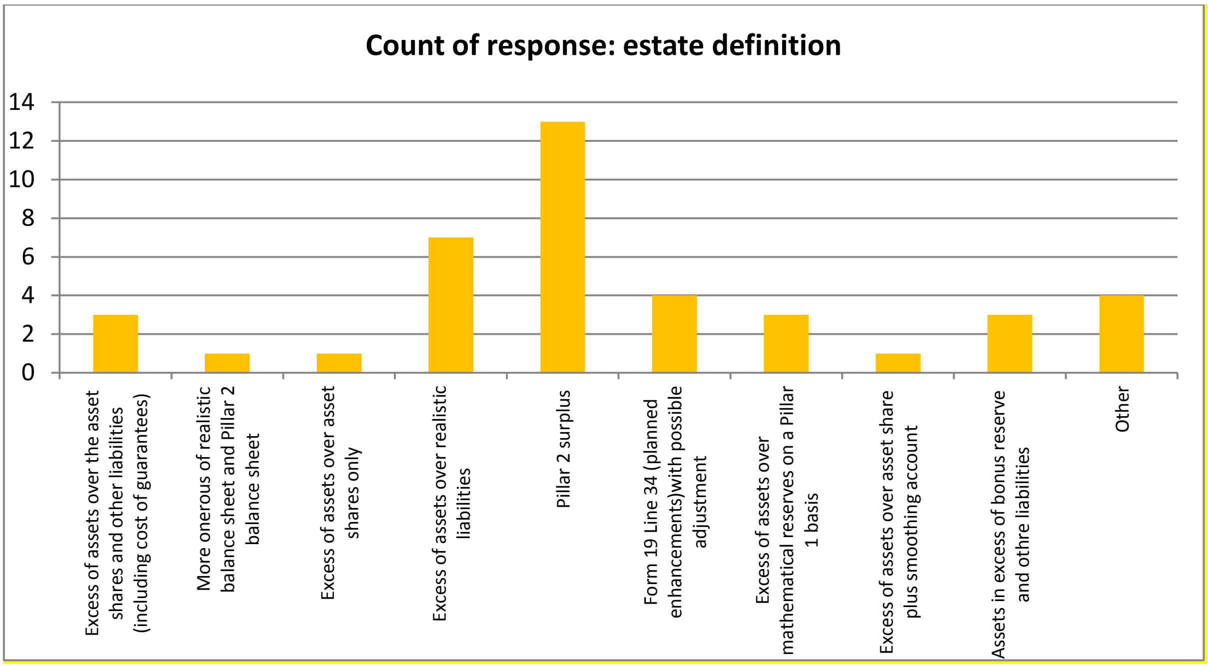
3.3 Insights from the survey

3.3.1 Definition of the Estate and the Philosophy for Managing the Estate

3.3.2 In order to have a strategy to manage risk in the estate, it is helpful to have a clear definition of the estate. Interestingly, the survey showed that there was no consensus to the definition of the estate and instead the responses received indicated that firms are using a number of different definitions of the estate to manage their with-profits funds. Firms typically define the estate as the excess of assets over realistic liabilities, however, a number of definitions of realistic liabilities were used. These included:

- Asset shares – before any planned enhancements and before any augmentation to the asset shares (e.g. from estate distribution),
- Liabilities including an allowance for guarantees/ future guarantee costs
- Form 19 line 34 – planned enhancements, Form 19 line 34 – planned enhancements adjusted for tax position etc.

3.3.3 The most commonly used definitions can be seen in the graph below:



3.3.4 Philosophy for managing the estate

3.3.5 It was expected that firms with open funds may adopt a different approach to managing the estate from closed funds. Those expectations were supported by the survey findings.

3.3.6 Firms managing closed funds typically had two key objectives underpinning their philosophy towards managing the estate. These are:

- Providing policyholder protection in relation to benefit security
- Minimising the tontine effect that can occur with the run-off of closed funds

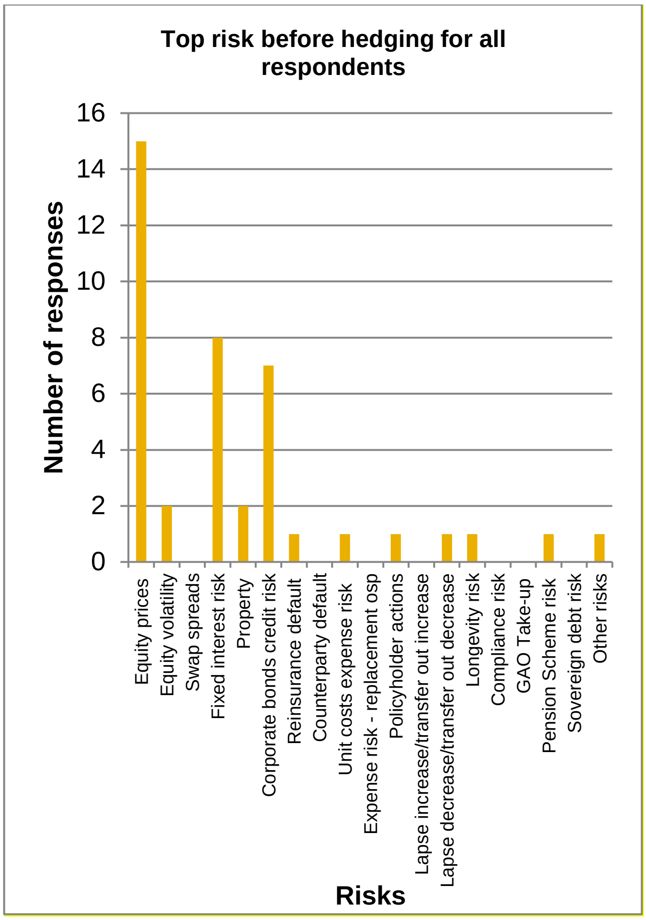
3.3.7 In contrast, firms managing open books displayed different priorities including

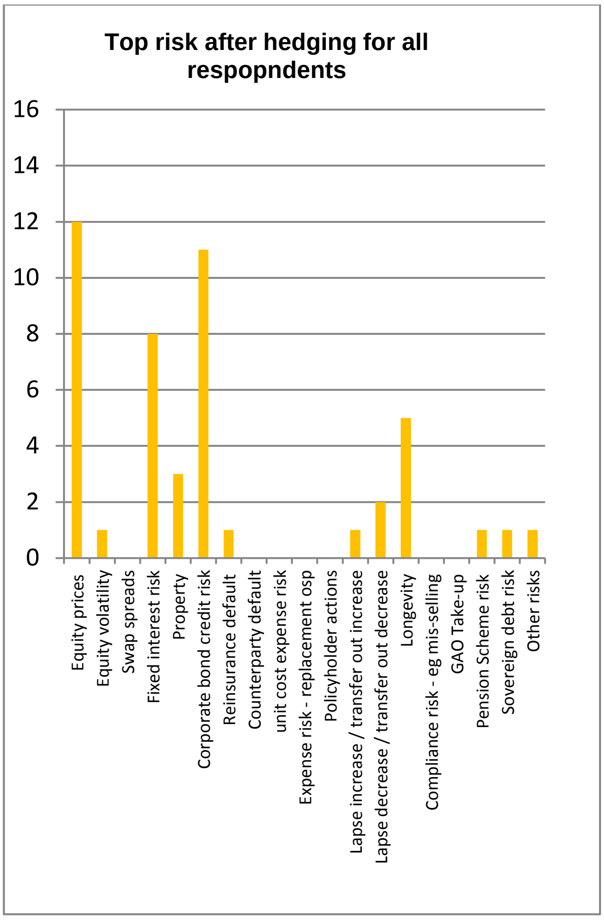
- Maximising policyholder returns and
- Providing policyholder protection in relation to benefit security

Hence, the key difference in philosophy between those managing open and closed funds could be articulated as open funds use the estate to support an investment strategy that seeks to maximise policyholder returns, whereas closed funds are more focussed on minimising the tontine effect that can occur with the run-off of closed funds.

3.3.8 Key risks borne by the estate

3.3.9 Firms were asked what they considered to be the top risks to which their fund(s) were exposed before and after hedging. The responses are outlined below in this section.





3.3.10 Market risks were the most prevalent both before and after hedging with circa 34 respondents indicating that market risks were their top risk.

3.3.11 Equity-related risks (prices and volatility) remained the top risk post hedging. This is perhaps not surprising given the strategies that many firms use to protect their funds from severe equity market falls. For example, some firms purchase out of the money put options (or put spreads) as a cost-efficient approach to protect their fund against severe equity falls and to manage the quantum of economic capital that they are required to hold. Such a strategy would necessarily leave the fund exposed to a degree of equity price falls post hedging.

3.3.12 However, there was some 'noise' in the survey results with some apparently anomalous responses.[9]

3.3.13 Despite the noise in the survey results, there appeared to be two notable trends within the data:

- There were 17 funds for which equity-related risks were, before hedging, considered to be the funds' top risks. This reduced to 13 funds after allowing for hedging. In contrast, there were 7 funds for which corporate bond credit risk was, before hedging, considered to be the funds' top risk, and this increased to 11 funds after allowing for hedging. Hence, within the market risks there was a slight shift away from equity-related risks (prices and volatility) towards corporate bond-related risks. This is presumed to be a result of hedging activity.
- Secondly, there appeared to be a shift away from economic risk towards demographic risk post hedging. Prior to hedging only 2 funds indicated that demographic risks were their top risks. Post hedging this number increased to 8, with 5 firms stating that longevity risk would be the top risk facing the fund post hedging and the remaining 3 firms indicating that lapse risk would be their highest risk.

However, whilst there was some shift in the top risks reported by the survey participants, economic risks dominated both pre and post hedging.

3.3.14 It was noted that the risk profile for open funds differed from that of closed 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. This is perhaps unsurprising given the usual practice of revising the investment strategy on closure of a fund, with many closed funds adopting a less aggressive and more predictable investment strategy following the fund's closure.

3.3.15 There were also apparent differences in risk appetite between proprietary and mutual firms. The exposure of mutual with-profits funds to a fall in equity prices post hedging seemed to be far greater than that of funds in proprietary companies. Nine mutual funds stated that equity price risk was the top risk post hedging whereas only 3 proprietary funds cited equity price risk as being their top risk.

[9] There were some 41 responses to the pre-hedging section of this survey and 47 responses post hedging. Also there was one respondent that indicated policyholder actions (excluding lapses) as their top risk pre-hedging whist there were no such entries post-hedging. It was unclear why this might be the case.

3.3.16 The reasons for this could be:

- Proprietary firms may be more focussed on restricting the extent of the fund's downside risk, given the requirement of shareholders to support the fund in the event of burn-through
- Many proprietary firms are larger than many of the mutual firms and this may enable the proprietary firms to support a more diverse skill set amongst their resources. In particular they may be more readily able to support an Asset Liability Management team
- Proprietary firms may face fewer restrictions in the use of derivatives

3.3.17 Five firms stated that longevity risk is top risk after hedging. A number of firms have taken action to reduce the longevity risk within their with-profits funds over recent years.

3.3.18 Post hedging four proprietary firms cited longevity risk as their top risk whereas only one firm suggested that longevity risk was their top risk pre hedging. This was interpreted as meaning that 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. Alternatively, there are a number of actions that could be taken by management of firms to reduce their exposure to longevity risk that four firms had not yet taken.

3.3.19 It is worth noting that the survey was performed before the recent budgetary announcement that removed the obligation for future vesting policyholders to buy an annuity with their vesting funds. The removal of the requirement to purchase an annuity has the potential to significantly change, over time, the risk profile of the with-profits funds managed by the survey participants.

3.3.20 Anticipated changes in risk profile

3.3.21 Most respondents did not expect a significant change in the risk profile of the fund over the next five to ten years. This is probably because a number of the respondents had funds which have a relatively mature risk profile. A number of these responses were caveated to the effect that the overall exposure to the fund's risks will decrease as the fund runs off. This may be viewed particularly important by some of the proprietary companies because one objective of these firms is likely to be managing the with-profits business in a self-sufficient manner such that the quantum of shareholder support required is kept to a minimum.

3.3.22 However, a number of firms did expect the risk profile of their funds to change over the next five to ten years. The response included:

- increase in longevity risk
- decrease in longevity risk
- increase in expense risk
- decrease in expense risk
- increase in equity risk.

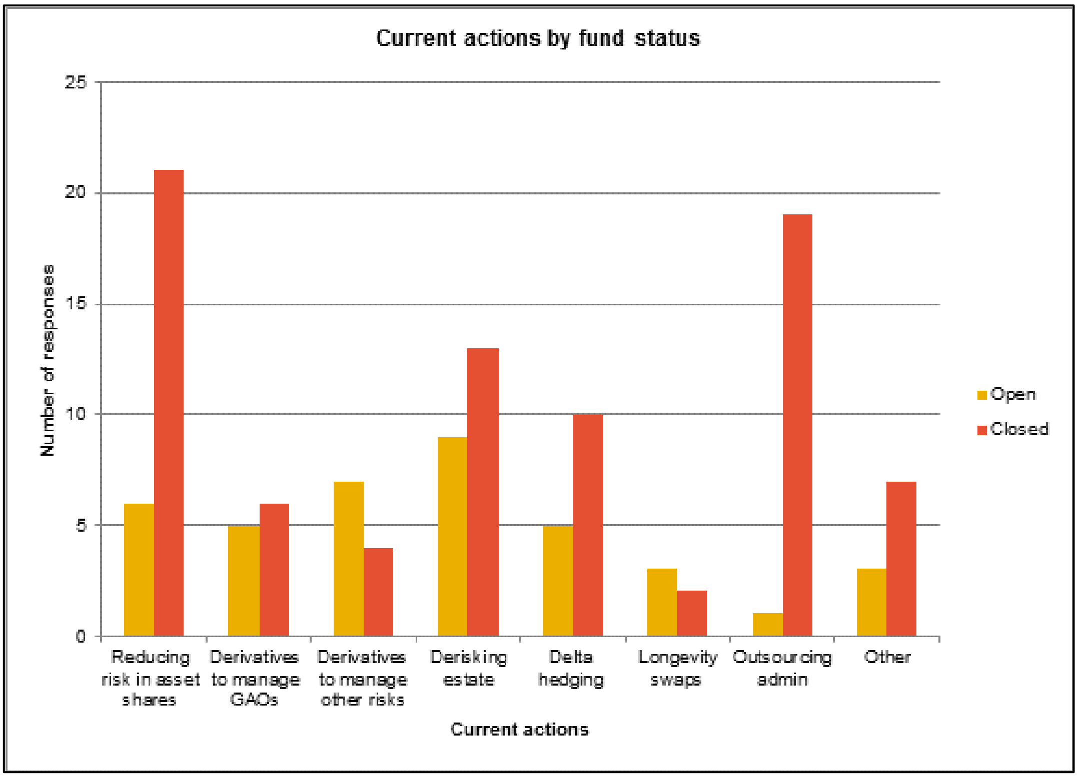
In addition, a number of firms are anticipating implementing actions to de-risk their asset portfolio and in particular decreasing the level of equity risk and property risk.

3.3.23 Actions taken now and in future by firms to manage and mitigate risks

3.3.24 Participants were asked to describe the actions that they take to manage, mitigate or reduce the risks to which their funds are exposed. The responses indicated a 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
- Other actions including the sale of non-participating business and changing some of the more restrictive practices written into the current PPFM

3.3.25 The responses indicated that larger companies were typically managing their fund's risks more actively than the smaller companies.



3.3.26 The graph above shows the responses analysed by fund status (open/closed).

3.3.27 There are some expected differences in approach between open and closed funds. For example, it might reasonably be expected that closed funds would adopt a more conservative investment approach than open funds, in an attempt to prudently manage the run-off of the estate during closure and to avoid either tontine or exhaustion of the estate.

3.3.28 It might also be expected that firms seek to out-source their administration services on cessation of new business as a means of increasing the variable proportion of the fund's cost-base and ease pressure on per policy expenses in context of a contracting book of business in-so-doing.

3.3.29 Overview of actions favoured by open and closed funds by priority

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

*Other actions included the sale of non-participating business, realising the value of the in force business asset and removing certain contract terms such as no-MVR spot guarantees

3.3.30 The following points should also be noted:

- No proprietary company indicated an intention to outsource administration services.
- Only two closed funds indicated that they had plans to implement a longevity swap which was interesting given the perceived exposure to longevity risk that a number of these funds indicated they had.
- Only one open fund indicated that they planned to out-source their administration services.
- No mutual companies chose delta hedging and only one proprietary company chose longevity swaps.

3.4 Conclusions and recommended good practice

3.4.1 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 interested to see whether the implementation of the Solvency II reporting regime forces a greater consistency of definition of the estate in future.

3.4.2 Unsurprisingly the philosophy for managing the estate and the risks to which the estate is exposed is inextricably linked to the status of the fund. The focus for closed funds tends to be providing policyholder with benefit security and minimising the tontine effect whilst the focus for open funds tends to involve maximising policyholder returns whilst both open and closed funds use the estate to provide policyholder protection

3.4.3 With the extensive use of hedging in with-profits funds, 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.

4 Capital Requirements and Managing Capital

4.1 Introduction

4.1.1 This section considers how with-profits funds determine their target level of capital. A minimum level of capital is required to meet regulatory requirements, however, with-profits funds may hold an excess above this minimum level to meet their own internal risk appetite. With-profits funds also tend to make greater allowance for the use of management actions within their capital assessment, compared to non-profit funds, and this is also explored. The target capital management policy directly influences the estate distribution planning which is discussed in the next section.

4.2 Capital requirements and managing capital

4.2.1 Regulatory capital requirements

4.2.2 UK with-profits funds currently assess their regulatory capital requirement based on both the Pillar 1 and Pillar 2 assessments. The Pillar 1 assessment is publicly disclosed and for larger with-profits funds is calculated as the greater of the traditional prudent prospective valuation approach (peak 1) and a more realistic approach usually based on asset shares plus a stochastic assessment of the cost of guarantees (peak 2). Pillar 2, or the Individual Capital Assessment ("ICA"), is not publicly disclosed and is an individual assessment by the firm of the capital required such that it is 99.5% confident that over a one year period assets will be equal or greater than liabilities. The PRA also may also issue firms with Individual Capital Guidance ("ICG"), effectively an additional capital requirement, which the PRA applies over and above the ICA. For the majority of large UK with-profits funds the Pillar 2 requirement is currently the more onerous.

4.2.3 The forthcoming Solvency II regime will replace the current regime and for most with-profits funds could be considered closer to the current Pillar 2 assessment than Pillar 1.

4.2.4 Risk appetite

4.2.5 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.

4.2.6 The risk appetite framework sets the with-profits fund's risk profile and forms part of the process of development and implementation of the business plan, risk strategy and capital planning. 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. It should also act as a continuous feedback cycle to refine and develop strategies and management decisions.

4.2.7 The risk appetite statement is the written form of the aggregate level and types of risk that with-profits funds are willing to accept and/or avoid in order to achieve their business objectives. This should be easily communicated to and understood by all stakeholders, and should consider the interests of both policyholders and shareholders, where relevant. It should help to shape the risk culture of the company and should consider all risks under normal and stressed conditions.

4.2.8 There is currently no standard definition of risk appetite in any regulatory guidance, yet this forms an essential part of risk management practice within the UK and will receive increasing focus as Solvency II is introduced. The Financial Stability Board issued a set of principles in November 2013[10] which included a definition of a risk appetite statement specifically aimed at systemically important financial institutions (SIFIs). This also made it clear that these principles could be applied to non-SIFIs in a proportionate manner appropriate to the nature, scope and complexity of the activities of the financial institution.

4.2.9 Risk appetite is often made up of qualitative and quantitative statements. Examples of qualitative statements are "We do not want longevity risk" or "We will accept and maintain interest rate risk". Examples of quantitative statements are: "We want to maintain the excess capital with a 1 in 20 event and still cover the ICA".

4.2.10 Risk appetite – specific considerations for with-profits funds

Direct application of a risk appetite framework can be considered more complex for with-profits funds when compared to say a shareholder owned non-profit fund. For example, with-profits funds may adopt separate investment strategies for assets backing asset shares, guaranteed liabilities, capital requirements and the estate. Additional complexity arises from considerations such as the likely desire from shareholders to minimise burn through risk (for this purpose the point where the estate has been exhausted and it is necessary for the

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[10] Principles for An Effective Risk Appetite Framework, The Financial Stability Board, 18 November 2013.

shareholder or the main fund to inject capital to pay guaranteed benefits) or the application of capital support arrangements.

4.2.11 The development of a risk appetite for a with-profits fund is likely to uniquely reflect the structure and history of the fund, any estate distribution strategy and the range of relevant stakeholders. A number of key areas to consider in defining the risk appetite are listed below:

- The investment mix of the fund should be aligned to the risk strategy and capital planning strategy. The fund should have a clear Asset Liability Management (ALM) framework. This could include an approach with a clear hypothecation strategy for the different types of liabilities within the fund, notably asset shares, cost of guarantees, capital requirements and the estate.
- There can be multiple stakeholders to consider in a with-profits fund – especially for 90:10 funds where the risk of shareholder burn through is prevalent. It is likely that the fund should aim to be self-supporting and also be able to maintain a fair and stable run-off with estate distributions. It will also need to reflect any prescribed requirements arising from Schemes of Demutalisation, where relevant. It may be beneficial for the with-profits fund to develop separate, yet fully aligned, risk appetite statements from the position of both policyholders and shareholders.
- Where the with-profits fund is distributing the estate, it is important that the risk appetite framework considers the estate distribution plan and the extent to which any surplus distributed to existing policyholders can be reclaimed under stress. Additional considerations may include the risk of estate distribution profiles which create tontine effects.
- It is imperative that the risk appetite framework appropriately considers, in a transparent manner, the modelling and application of management actions under the relevant stresses. This process will assess the type, level and the severity of the management actions that will be needed in the base case and also in stress scenarios. This is particularly important when defining a risk appetite because it will allow a with-profits fund to accept certain risks in the base case with a strategy to mitigate under stressed conditions. Management actions will be discussed in more detail below.

4.2.12 Management actions

4.2.13 Over the last decade, with-profits funds have increasingly used management actions as a tool to manage capital – both on a regulatory and on an internal basis. There are a number of management actions that with-profits funds use within the capital requirement modelling which can be categorised as follows:

- *Within the base working capital calculations (possibly modelled dynamically for each stochastic simulation):* For each of these management actions algorithms are used to replicate decision making under each scenario together with range bands or step restrictions. This dynamic behaviour can encompass many areas such as bonus policy, investment strategy, application of market value reductions and charges for the cost of guarantees.

- *Within additional capital assessments carried out for stress events, for instance Pillar 1 Peak 2 Risk Capital Margin, ICA or Solvency II SCR:* Examples of this include the removal of past asset share enhancements, removal of future smoothing, lessening of the range bands and the step restrictions in the algorithms so that reversionary bonuses do not decrease to zero and Equity Backing Ratio ("EBR"s) reduce at a slower pace.

4.2.14 The list of management actions in each category should aim to protect the balance sheet against the key risks that the fund is exposed to. The management actions that can be taken should be articulated in the PPFM or Scheme documents underlying the with-profits funds.

4.2.15 It is necessary for the Board to be fully engaged and embrace the management actions that will be taken in the base case and in stress scenarios to protect the fund. Having a strong and effective list of management actions can enable the with-profits fund to manage volatility and ensure a stable estate distribution.

4.2.16 The modelling of management actions should be consistent with how these actions would be applied in practice. UK with-profits funds are required to undertake an annual retrospective assessment to confirm this or clearly understand why the action predicted by the model was not taken. Modelling capability may restrict the ability to model complex combinations or the hierarchy of actions, particularly under severe stress conditions, and therefore there is likely to be some level of pragmatism required.

4.3 Insights from the survey

4.3.1 A large number of funds responded that they use the coverage of the regulatory capital requirement as their target level for the estate. It appears from the responses, shown in the table below, that this was primarily the Pillar 2 ICA measure. Whist this approach provides a defined framework for funds to assess the target level of estate; it does not necessarily provide policyholders (or other interested parties such as advisers) with direct access, as the ICA is not publicly disclosed. It will be interesting to see whether funds reconsider their approach through the transition from Solvency I to Solvency II (which will be publicly disclosed when this is introduced).

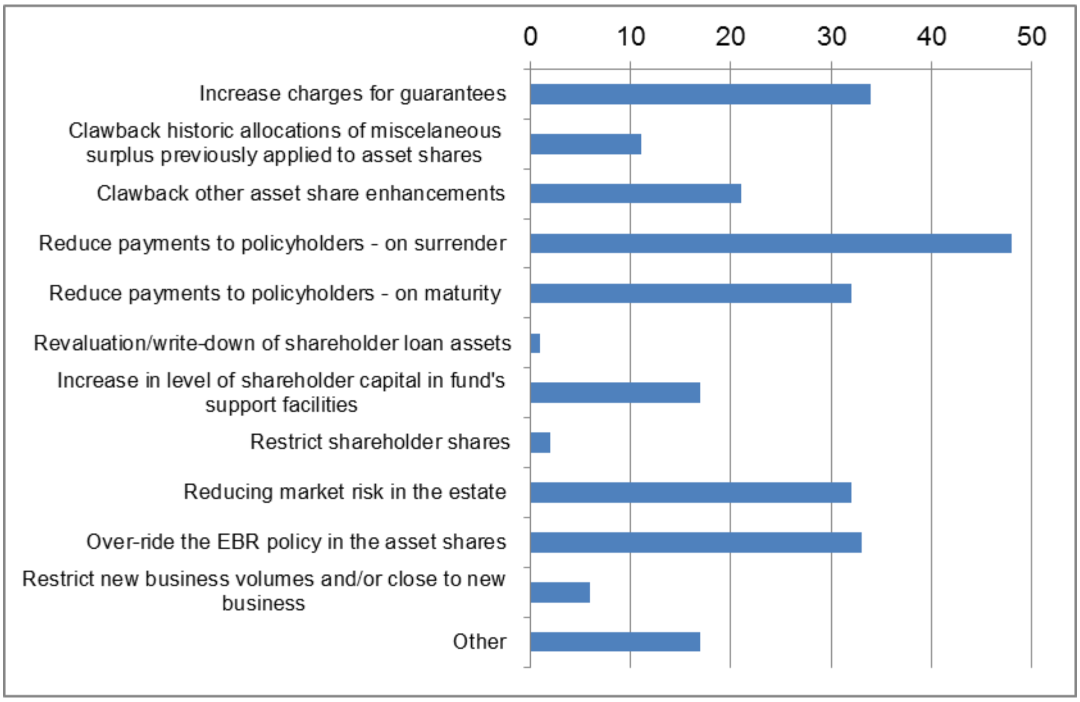
Category	Frequency
Based on regulatory capital requirement (mainly ICA)	28
Strict and Closed (i.e. as defined within Schemes)	4
Risk based metric (not directly related to regulatory capital)	8
Other	13
Total	**53**

4.3.2 A small number of firms have prescribed rules on their target level arising from Schemes established on demutualisation or transfers of business. The 'other' category included firms using internal Economic Capital measures or more complex multi-year risk based capital assessments.

4.3.3 Firms were asked how their target metric for the estate related to the risk appetite of the with-profits fund. For those funds that provided a response to this question the majority operated risk appetite frameworks with direct reference to the measure provided in their answer shown in the table above, often specifying an explicit range or buffer around a central target.

4.3.4 A significant proportion of firms (42%) did not provide a response to this question, which could be considered surprising given the increased focus on the development of risk appetite frameworks within the UK over recent years. As firms are required to submit comprehensive information on their risk appetite with the Solvency II Own Risk and Solvency Assessment ("ORSA"), it will be interesting to see the extent to which firms focus on how this specifically applies to their with-profits funds and management of the estate, rather than their overall business.

4.3.5 With-profits funds use a wide range of management actions should these be required to maintain surplus levels, as shown in the table below:



4.3.6 These actions could be categorised into those that directly result in a reduction in asset shares, and therefore payouts, and those that affect the management of the estate. The survey results show that funds are willing to consider both types.

4.3.7 Large funds are more likely to use the management actions of increasing charges for guarantees, claw back other asset share enhancements and over-ride the EBR policy in the asset shares, than the medium or smaller funds. There appeared to be similar use of management actions between proprietaries and mutuals, with the only distinct differences relating to shareholder support or entitlements, which are obviously not available to mutuals.

4.3.8 The survey found that an estate distribution plan existed for most with-profits funds but that this was less apparent for open mutual funds. This result is perhaps unsurprising given the current debate on the ownership of the excess capital position of mutuals that have both non-members (holding products other than with-profits or some other membership entitlement) and with-profits policyholders.

4.3.9 Respondents were asked to identify how capital would be used if an excess capital position was identified. The most common action (and preferred by open funds responding) was to apply a temporary uplift to asset shares but, interestingly, a significant choice in open funds was to re-risk the fund, normally by increasing the market exposure through the equity backing ratio. The actions which were specifically related to closed funds were not identifiable from the responses to the survey.

4.4 Conclusions and recommended good practice

4.4.1 The capital management policy and practice of with-profits funds should align to the risk appetite and estate distribution strategy. Whilst regulatory guidance on a range of specific with-profits issues has not yet been published, it is highly likely that Solvency II will require consideration of this under the ORSA.

4.4.2 The survey demonstrates that a wide range of management actions are used within the capital assessment calculations. It is recommended that management ensure, as far as possible, that these are clearly understood by all stakeholders, including the Board and policyholders through key documents such as the PPFM. It is also important to avoid complex tolerance levels within actuarial models which trigger management actions, if these would not be applied in practice.

4.4.3 The risk appetite framework for a with-profits fund should consider the interests of all stakeholders, including where relevant the different interests of policyholders and shareholders.

4.4.4 The complexity of with-profits funds is likely to prevent the simple application of a risk appetite framework developed solely for a non-profit fund. However, it is also important the specific with-profits considerations do not result in the development of overly complex tolerance limits, as mentioned above.

4.4.5 With-profits funds currently use a variety of metrics to determine the target level of their estate. Whilst the survey highlights use of the Individual Capital Assessment capital requirement as the most popular approach, this does not necessarily imply consistency, as it is likely that differing levels of coverage ratios are used for this purpose. It will be interesting to see whether the introduction of Solvency II leads to more or less uniformity in how firms determine their target level of estate.

5 Distributions from the Estate

5.1 Introduction

5.1.1 The previous two sections discussed how with-profits firms manage the risks in their funds' estates and how they set capital requirements for the purpose of managing capital in their funds. Having followed these processes the Board of such a firm may come to the conclusion that it is appropriate to make a distribution from the fund's estate. This section sets out the factors that might be considered in determining how that distribution is to be applied to the benefit of the fund's policyholders and the resultant form that the distribution might take.

5.2 Making distributions from the estate

5.2.1 What is an estate distribution?

5.2.2 In its widest sense, any management decision that leads to a reduction in the size of the estate (relative to the capital requirements) is a distribution. Thus, the following actions might be considered to represent distributions from the estate:

- Adopting a higher risk investment strategy (for asset shares or the estate)
- Changing the philosophy for Regular Bonuses (to give rise to higher Regular Bonuses)
- Changing the smoothing philosophy (e.g. writing off past smoothing losses)
- Reducing the level of expenses charged to asset shares;
- Introducing additional non-contractual guarantees
- Waiving the right to apply policy deductions (e.g. Market Value Reductions)

5.2.3 However, whilst these would all serve to distribute surplus from the estate, these actions might be described as "indirect distributions", and whilst recognising that such options are available to with-profits firms, the discussion in this section focusses on "direct distributions" from the estate, the primary forms for which are:

- Making enhancements to asset shares
- Declaring an additional Regular Bonus
- Declaring an additional Final Bonus

Where firms do, however, choose an indirect form of distribution from the estate, the Board will need to ensure that the actions taken treat policyholders fairly and are compliant with relevant requirements.

5.2.4 Policyholders' expectations

5.2.5 It is reasonable for policyholders to expect that surplus from the estate will be made available for distribution in accordance with the firm's established practices and relevant regulatory requirements. It also reasonable for policyholders to expect that the Board would not make a distribution from the estate if it was expected to reduce the security of policyholder benefits to an unacceptable level.

5.2.6 Where charges for guarantee costs have been applied to asset shares, policyholders have effectively contributed to the estate, before allowing for any guarantee costs. Given this, policyholders may expect that the allocation of any distribution from the estate will reflect their contribution to it. As a consequence, firms may elect to refund the present value of charges that had been deducted from the asset shares of remaining in force policies to those policies, prior to commencing distributions from the estate.

5.2.7 The benefit of taking this step is that all in force with-profits policyholders will, as a result, have made no contribution to the estate. This is self evident in that all of the policy cashflows will be accumulated in determining the asset shares, and the estate is the value of the fund's assets in excess of its liabilities, including asset shares.

5.2.8 This could lead to the view that no group of policyholders should reasonably expect to receive a share of any estate distributions made that is greater than that of other groups of policyholders.

5.2.9 In addition, other than the need to treat customers fairly, there are no specific rules governing how such distributions should be made, and in particular, how the distributions should be allocated to policyholders.

5.2.10 Thus, whilst policyholders <u>as a whole</u> should expect to benefit from estate distributions, no <u>individual</u> policyholder should have expectations for the extent to which they will participate in such distributions. Thus, whilst the value of an individual's expected future distributions is not zero, it cannot be quantified.

5.2.11 Given that policyholders have not contributed to the estate and should have no quantifiable expectations for the extent to which they would participate in an estate distribution, it would seem that an allocation that treated all policyholders consistently is most capable of being deemed fair.

5.2.12 How should the estate distribution be allocated to policyholders?

5.2.13 Firms will need to consider how the estate distribution is to be allocated between policyholders.

5.2.14 Whilst the firm may have concluded that in force policyholders have not contributed to the estate, and hence no individual policyholder can have a clear expectation of the extent to which they would participate in a distribution from the estate, it might still be considered appropriate for the estate distribution to be targeted at a specified group of policies, e.g. a product group or a cohort of business for which the policy performance has fallen short of expectations. In effect, the distribution is being used to supplement the policy performance to compensate for poor investment returns.

5.2.15 Given the "windfall" nature of the distribution, the Board may wish to use its discretion to allocate at least a part of the estate distribution to a specified group of policies, as outlined above, although such an allocation would need to be considered to treat all policyholders fairly.

5.2.16 In the absence of such a "targeted distribution", the Board would probably look to allocate the estate distributions using a uniform approach that treated policyholders on a consistent basis. However, given the windfall nature of the distribution and the wide range of discretion that can be applied, there are a number of such "uniform" approaches that could be adopted, each of which might be considered consistent and fair.

5.2.17 Particular questions to be considered are:

- Should the allocation reflect policy size (payment of a fixed amount to policyholders, regardless of policy size, would also treat policyholders consistently)?
- Should policies with payouts that are driven by guarantees benefit from the distribution?
- Should the benefit of the distribution be granted regardless of the form of exit, or is it appropriate to allocate the estate distribution to maturities and deaths but not surrenders?
- Should the distribution reward loyalty, for example reward those policyholders remaining after closure who are bearing the risks post-closure?
- Should the benefit of the distribution be provided at policy exit or during the policy lifetime?
- Should the allocation made reflect the completed duration in force of the policy?
- Are any past statements, past practice on distributions or Scheme requirements relevant?

5.2.18 Clearly, the chosen method for allocating the distribution could have significant implications for the share of the distribution provided to individual policyholders. In particular, the chosen method may result in the benefit received being a function of when the policy exits the fund, e.g. increased benefits for polices that exit at a later date than others.

5.2.19 Desirable features of estate distributions

5.2.20 To assist firms in deciding how to allocate estate distributions to policyholders, a list of the desirable features of estate distributions has been prepared and this is set out below:

a) Distributions should be consistent with the requirements of relevant regulations, the firm's PPFM and any relevant Court Schemes.

b) Unless there is a valid reason for doing otherwise (e.g. to target a group of policyholders), distributions should be applied consistently across all relevant policies.

c) Distributions should be demonstrably fair.

d) The form of the distribution should be straightforward to implement, preferably through existing processes and systems.

e) The distribution should be easy to explain to policyholders.

f) The distribution should result in a tangible benefit for policyholders.

g) Where relevant, shareholders should receive their fare share of distributions made, in accordance with established practices for allocating distributions of surplus from the fund.

h) The distribution should be of a form that limits the possibility of it becoming an unwelcome financial strain on the fund.

5.2.21 Possible forms of estate distributions

5.2.22 Whilst recognising, as mentioned above, that there are many forms that an estate distribution could take, the primary forms of the distribution are expected to be an asset share enhancement and/or an additional Regular or Final Bonus. Cash payments have sometimes been considered but are rarely used because of tax considerations, policy conditions and the need to maintain capital within the fund. There are a number of approaches that could be adopted and the primary potential approaches are described below:

(i) A permanent uniform addition to asset share (but no bonus). This could be achieved by enhancing investment returns allocated to asset shares. This will benefit all policyholders other than where payouts are driven by guarantees or smoothing.

(ii) A temporary uniform addition to asset share (but no bonus). The addition could be recovered in adverse circumstances and hence would not be guaranteed until policy exit. Again, this will not benefit policyholders where payouts are driven by guarantees or smoothing.

(iii) A uniform Special Regular Bonus (with a corresponding asset share enhancement). This would benefit all policyholders (provided smoothing limits were adjusted where necessary).

(iv) A permanent (guaranteed) uniform addition to Final Bonus (with a corresponding asset share enhancement). This would benefit all policyholders.

(v) A temporary uniform addition to Final Bonus (with a corresponding asset share enhancement at the point of exit). The addition would only apply for a specified period or until a specified amount of additional bonus had been paid and hence would not be guaranteed until policy exit. In effect, this would provide an uplift to all payouts on exit.

5.2.23 There are variants of approaches (iii), (iv) and (v) without any asset share enhancement. These variants would most likely provide limited or no benefit to surrendering policies.

5.2.24 As indicated in the descriptions, the method chosen can have a significant impact on the extent to which policyholders benefit from the distribution. In particular:

- Methods (i) and (ii) only provide benefit to those policyholders with payouts driven by asset share. This might be considered fair as policyholders with payouts driven by guarantees are already receiving more than asset share. However, just because the policy benefits exceed asset share, this does not mean that the policy has necessarily performed well for the policyholder (indeed, the reliance on guaranteed benefits might indicate that this is the case) and therefore excluding such policies from the distribution might be considered unfair.
- The variants referred to in 5.2.22 and 5.2.23, provide limited benefit to surrendering policyholders. This might be considered fair as the distribution would then reward those who retain their policies to maturity. However, given that the policy terms permit early surrender, it might be considered unfair to exclude surrendering policies from the distribution.

5.2.25 The distributions that provide asset share enhancements for all policies (methods (i) and (ii)) or guaranteed bonuses for all policyholders (methods (iii) and (iv)) will, for a given aggregate distribution amount, provide a lower level of bonus for policyholders (as the distribution is being applied to the benefit of all policyholders as opposed to just those that exit the fund) compared to the uniform payout uplift (method (v)).

5.2.26 Whilst the asset share enhancements and guaranteed bonuses for all policyholders sound desirable, their impact on policyholders exiting in the short term would be low. In addition, each successive distribution would be similarly applied, serving to build up layer upon layer of additional benefit for those policyholders in force for the longest periods, effectively creating a tontine. This would not necessarily result in the distribution being targeted at longer term policies, as it is related to duration in force since the commencement of distributions as opposed to duration since policy commencement. Policies that have been in force for a long time that exit in the early years of a distribution programme could receive limited benefit.

5.2.27 In contrast, as the payout uplift (under method (v) is not guaranteed and hence only applies to exits in the short term, it could be set at a level that is expected to be broadly maintained as the fund runs off, avoiding the potential tontine. The policies that remain in force for longer would be expected to benefit from distributions made in the future. However, following this approach could result in lower levels of payout uplift in the future if the rate of emergence of surplus for distribution was too low or if non-trivial levels of new with-profits business were written. Nevertheless, this approach would be expected to spread the estate distributions more uniformly across the fund's policies, both during each year and over time.

5.2.28 It is expected that firms will select their preferred form of distribution after having assessed the merits of each potential method relative to assessment criteria such as that set out in 5.2.20.

5.2.29 For proprietary firms, the shareholders' interest in the distributions made from the estate may depend on the form of the distribution and/or how it is implemented. For instance, the shareholders' interest in a fund's unitised with-profits business may be limited to the receipt of charges applied to asset shares, and therefore shareholders will only benefit from any estate distributed to unitised policies if it entails an increase in asset shares (other than any increase made immediately before policy exit, where the shareholder interest would be zero). Given this, careful consideration of the form of the distribution and its implementation is required in order to ensure that both policyholders and shareholders are treated fairly.

5.2.30 Implementing the estate distribution in practice

5.2.31 The size of the challenge of implementing the estate distribution is heavily dependent on the method selected to allocate the distribution to policies. For instance, applying a regular enhancement to asset shares (e.g. 1% per annum) is relatively straightforward to implement. The challenge is, depending on the firm's existing processes and systems, greater for methods such as the payout uplift.

5.2.32 Issues that may be encountered include:

- Ensuring that the distribution mechanism cannot be abused by policyholders through making increments or switches, or by effecting new policies, purely with the aim of benefitting from an uplift in payout on subsequent early exit. Linking the size of the uplift to the date of investment should address this.

- Determining how the allocated distribution should interact with guarantees, especially overriding performance and pension guarantees.
- Determining how the distribution is reflected in benefits when Market Value Reductions apply.
- Communication of the estate distribution to policyholders and other stakeholders.

5.3 Insights from the survey

5.3.1 The definition of 'excess surplus' from which distributions could be made, as might be expected, varies between companies. Aspects to be considered in the definition of excess surplus include whether to use Realistic Balance Sheet (RBS), Individual Capital Assessment (ICA) or Pillar 1 liabilities, treatment of the costs of guarantees, and whether any further liability amount should be included for any additional amounts to be paid to policyholders in line with their fair treatment.

5.3.2 The preferred approach to managing excess surplus again varies by fund status and size, and also by company type (proprietary or mutual), for some responses. The most popular top response is to distribute the surplus as a temporary uplift to asset shares, with re-risking the assets being the second favoured response. Other responses included a permanent uplift to asset shares, refund of historic charges, or enhancing policies when they become claims.

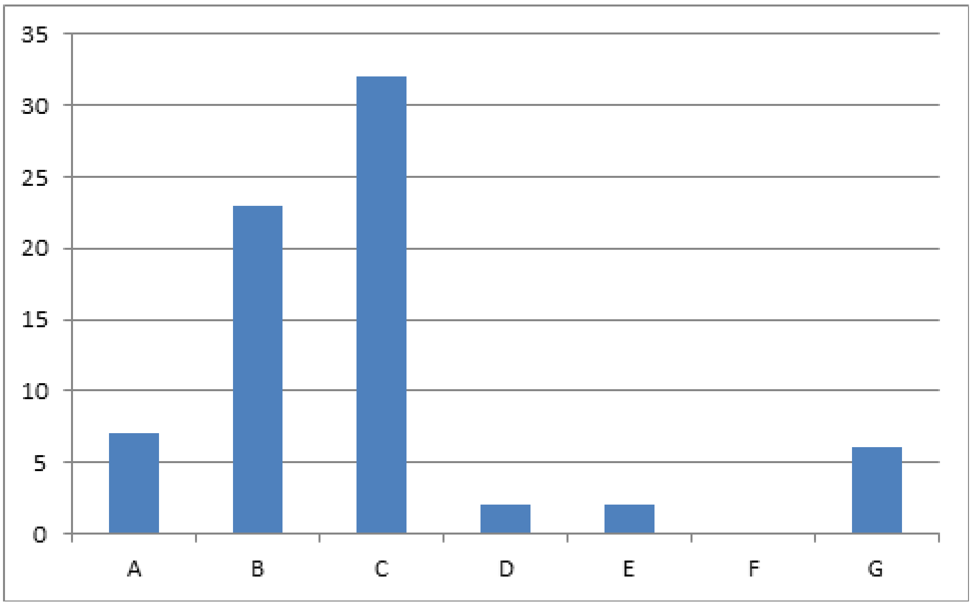
5.3.3 Not all firms have a distribution plan in place, with firms not in run-off, as expected, being the least likely to have a distribution plan. Of the 55 responses for this question, 3 closed funds did not have a distribution plan in place.

5.3.4 Restrictions on distribution plans mentioned include having large volumes of non-participating business. This was as much, if not more, of an issue for proprietary companies as for mutuals. Reserving for mis-selling was the next most significant issue, followed by reserving for long duration business and pension scheme liabilities.

5.3.5 When making distributions, the majority of respondents (48 out of 57 replies) would not consider it fair to target one particular group of policyholders. For respondents who would target one particular group, criteria for the group to be targeted was very varied. Criteria for choosing policyholders to be targeted for distributions included policyholders with small payouts, mortgage endowment policies, maturities and deaths, policies longer in force, and policies which had not benefitted from guarantees or who had already had guaranteed values reduced.

5.3.6 Given that a targeted distribution to one group of policyholders was not generally followed, the survey asked about the form of made (or planned) distributions. The most popular form of distribution is enhancement to maturity and surrender claims only without enhancement to in-force asset shares, followed by regular or one-off enhancements to in-force asset shares only. Other forms include enhancements to investment returns, increases to the level of direct guarantee or indirect distributions (e.g. refunding charges to asset shares). Of the enhancements to asset shares, the majority of respondents said these would be temporary rather than permanent.

The responses are illustrated by the chart below, which shows the number of times each response was selected.



Key

A = One-off enhancement to in-force asset shares only

B = Regular enhancements to in-force asset shares only

C = Enhancement to maturity and surrender claims only without enhancements to historic in-force asset shares

D = Increases to the level of guarantees (e.g. additional special bonus)

E = Indirect distribution (e.g. refunding charges to asset shares or providing additional charges).

F = Immediate cash distribution

G = Other, which included responses that there were no plans to distribute, a combination of responses, removal of past charges and the enhancement of investment returns.

5.3.7 The fairness of distributions between different generations of policyholders was also mentioned elsewhere in the survey as one of the fairness issues hardest to resolve. This was reflected in the responses to the question on how estate distributions are allocated to different policyholders over time, and how fairness in distributions was achieved. Some companies made distributions which were constant over time, others that were expected to reduce. In judging on fairness, some respondents felt fairness was achieved by use of a common percentage uplift, others through the governance processes and expert judgement applied. Other responses mentioned compliance with the PPFM and with run-off plans. Fairness is discussed further in section 6.

5.3.8 Looking at how new business was treated in relation to distributions, for respondents who were open to new business, the majority treated new business identically to in-force business. Some companies applied a waiting period to new investments and increments to prevent anti-selection, although some respondents commented that they had seen no evidence of anti-selection. Some respondents excluded increments and/or new business from participation.

5.3.9 With regard to the treatment of hybrid policies, most respondents applied distributions to that part of the product that was invested in unitised with-profits only.

5.3.10 On the question of policyholders' expectations in relation to participation in estate distribution, the most common response included comments that current policyholders did not contribute to the estate, so had no expectation of any particular distribution. Some respondents would only distribute to policyholders in force when the fund was closed to new business. One respondent would give a higher weighting to policies longer in force, and Scheme requirements were also mentioned.

5.3.11 Most respondents did not include distributions in illustrations. Of the few that did, all were closed proprietary companies.

5.4 Conclusions and recommended good practice

5.4.1 Given the fact that, most likely, current policyholders have not contributed to the fund's estate and hence any benefit received from a distribution from the estate is of the nature of a windfall, it would be inappropriate to conclude that any single approach for making such distributions represented best practice. Rather, there are several approaches for allocating distributions from the estate that might be considered fair.

5.4.2 The survey performed showed that using the distribution to apply a common percentage uplift to claims was the most popular approach amongst firms making distributions. Although less popular, a number of firms also used estate distributions to enhance asset shares.

5.4.3 Regardless of the approach selected, good practice would entail:

- A comprehensive analysis of the different options and their effect on the fund and different policyholders and shareholders (the discussion set out in Section 5.2, including the suggested desirable features of an estate distribution set out in 5.2.19, are designed to assist in such an analysis)
- Proper consideration of the matter by the firm's governing body, including, if applicable, its With-Profits Committee, having considered the advice of its With-Profits Actuary

5.4.4 To support this process, given that it is a difficult concept with different interpretations possible, a firm should have an agreed definition of fairness, and how it is to be achieved. The definition may well vary between firms/funds, as it will be dependent on the circumstances of the firm and each fund, any Schemes in place and past communications to policyholders, for example. This would also help with clear communications to policyholders, and an appropriate approach to illustrations.

5.4.5 Finally, it is recommended that:

- A distribution plan should be in place, particularly for all funds in run-off
- Although most respondents did not feel that tontine effects were, or could become, an issue, this should be monitored
- Solutions could be looked at for areas which firms felt were, or could become, restrictions on distribution plans. These include dealing with non-participating business, mis-selling reserves, Industrial Branch business, mis-selling reserves and pension schemes

6 Fairness

6.1 Introduction

6.1.1 This section discusses fairness for with-profits funds in run-off, current practice and explores constraints on fair treatment.

6.1.2 Fairness is, inevitably, a subjective view. There is no "right" way to determine fairness and no regulatory definition. For proprietary companies, the potential conflict of interest between policyholders and shareholders need to be managed. For mutual companies, there may not be the shareholder/policyholder conflict to consider, but there could also be a potential conflict of interest between the interests of management and of customers. During run-off, the intergenerational conflicts, such as those which would affect investment strategy and distributions, become increasingly important.

6.1.3 Further, concepts of fairness also change over time. In the past, it was not uncommon for surrender values for with-profits policies to be on a prudent basis, compensating the fund for the customer "breaking the contract". This view is not the norm today. In the same way, it is possible that approaches developed now to treat customers fairly may not be considered fair in the future. However, it is always difficult to judge past actions by the standards of the day.

6.1.4 There may be constraints on the way with-profits funds are managed that restrict the ability to carry out the preferred approach to achieve fairness. These may include well established past practice or system constraints. Practices that have developed over many years, which are appropriate for a stable fund, may be inappropriate in run-off. Clearly, if the cost of changing an approach to achieve a fairer outcome outweighs the benefits, then a proportionate view should be considered.

6.1.5 The text book issues confronting a with-profits fund in run-off would include:

- Investment freedom;
- Fixed costs being shared among a dwindling number of policies;
- How and when to distribute the estate; and
- The tontine effect.

6.1.6 All of these have to be considered against the backdrop of a lack of customer understanding of the way with-profits funds work and an ever increasing scepticism towards the financial services industry.

6.1.7 Key to ensuring fairness is strong governance. Non-Executive Directors and independent With-Profits Committees can help provide a perspective and rigor that helps provide insight. Further, the With-Profits Actuary should be a key part of the decision making process.

6.2 Do current practices need to be reconsidered?

6.2.1 The introduction of Principles and Practices of Financial Management ("PPFM") in 2004 was an opportunity to document and make public the management approach, but also to reassess practices and formalise them. For those funds that were still open at this time, the approaches set out were consistent with a stable fund.

6.2.2 Since then, the market for with-profits products has been largely curtailed and many funds are now in run-off. The management approach set out in the PPFM may need to be reviewed at some point during run-off. Some examples are as follows.

6.2.3 The setting of final bonuses usually considers the actual policies due to mature in deriving the asset share and, hence, the final bonus to apply to those policies. As the volume of policies in a particular cohort declines, movements in the average asset share, may be more related to changes in the mix of maturing business than the investment returns. The resulting changes in final bonus rates may be difficult to explain and contrary to customer expectations. In this case, reassessing the groupings of policies or moving to a bonus setting approach which uses hypothetical policies that represent the portfolio more widely may be appropriate. This would, of course, have implications for the extent of smoothing over time. Alternatively, the inherent volatility in bonus rates could potentially be managed through communication or some other means.

6.2.4 It may be the practice to divide the running costs of the fund by the number of policies in order to derive the expenses deduction in the asset share calculation. Unchecked, this could lead to rising charges to the asset share as the fixed costs are spread over fewer policies. Aside from managing the cost challenge at source or outsourcing (as discussed in section 10.6.2), the fund might consider charging part of the running costs to the estate or spreading the fixed costs more widely over non-profit business. Charging overheads to the estate does not solve the problem as, ultimately, the estate will be distributed. The intergenerational impact would need to be considered if this approach is adopted.

6.2.5 A fund may have an approach for the investment strategy for asset shares that fully reflects the size of the estate. A strong fund might, therefore, adopt a high risk investment strategy on the grounds that, over the long term, this will deliver higher returns for customers. As the outstanding term for the majority of customers reduces, the validity of this approach may need to be questioned. Clearly, this is less of an issue for funds that hypothecate assets to asset shares based on outstanding term.

6.2.6 Finally, but not exhaustively, consideration will need to be given to the estate. The possible methods for distributing the estate are discussed in section 5. However, communicating distributions to customers may be challenging. Some funds make statements in their PPFM that customers should not expect distributions from the estate; these funds may wish to consider whether they need to revise these wordings.

6.2.7 At some point, it will be necessary to decide when it is time to wind up the fund. If the ongoing operation of the fund effectively destroys value, then wind-up would be the fairest approach. At present, the main way to achieve this is through a Court Scheme. This could be prohibitively expensive and alternative regulatory approaches may be needed. Some Court Schemes already in place (e.g. for a past demutualisation) may already include provisions for the wind-up of a fund when it falls to a predefined size.

6.3 Are there constraints on fair treatment?

6.3.1 One of the major issues will be the level of customer understanding. Policyholder expectations are intricately linked with their understanding of the company's circumstances, the policy features as well as the economic and regulatory environment. Without the necessary understanding, it is a challenge to manage policyholders' reasonable expectations and take steps that the firm believes to be fair to policyholders whilst still being able to fully explain them. Companies struggle to find a balance between giving customers sufficient information so that they are aware of any decisions affecting their policies and fund, but not so much that it creates unnecessary confusion. Companies will need to decide whether the ability to communicate to customers restricts the range of actions available, or whether to choose the best approach and then try to communicate it.

6.3.2 Conflicts of interest need to be carefully managed so they do not impact fair treatment. The With-Profits Committee and With-Profits Actuary regimes are designed to challenge company decisions from a policyholder perspective. Fair treatment is most likely where these governance arrangements are strong and effectively used, and where the scope of the With-Profits Committee and With-Profits Actuary are not constrained.

6.3.3 Embedded past practice may be considered to be unfair from some perspectives. For example, the same bonus rates may have always been used across a wide group of product types. It may be easier to target asset shares by declaring different bonus rates for the different product types. Does the intrinsic policyholder expectation of common bonus rates outweigh the inability to closely target payouts to asset shares?

6.3.4 Even if it were decided that different bonus rates were desirable, the cost of implementing change may be prohibitive. In any case, there is a limit to how far business can be segregated to better target asset share without losing the fundamental pooling necessary for the with-profits philosophy to apply.

6.3.5 Alternatively, the company may be satisfied in maintaining the single set of bonus rates for the product types. But, in run-off, changes in mix between the products may be an additional source of volatility in customer outcomes. As discussed above, the company will need to decide whether this volatility is appropriate.

6.3.6 Allied to this would be system costs. Clearly, the administration of products by knowledgeable staff is a valuable service to customers. However, many systems were bespoke developments for the products in question. Where these systems are wholly in relation to with-profits business (as opposed to unitised with-profits business being merely a further, albeit slightly more complicated, fund option on a unit-linked administration system) the cost per policy will steadily rise as the policies run off. It will be a trade-off between managing the ongoing costs and the potential service issues in migrating to an alternative system that may not be as appropriate.

6.3.7 Excessive regulation could be considered a constraint. This could take a number of forms. The capital requirements may defer distributions of the estate to an extent that may be unfair. This issue is at the crux of the two regulator approach and has, to a certain extent, been settled by the primacy of the PRA over the FCA, as discussed in the FCA/PRA With-Profits Memorandum of Understanding.

6.3.8 Some regulatory rules could be considered as not necessarily in customer interests. The requirement to write to customers at the point of formal closure may be an example. The rule perpetuates the belief that closure will dramatically alter the management of the fund. A strong fund that has effectively managed its cost base and has a defined approach to distributions would see little material difference in its management before and after formal closure. The requirement to write to customers may prompt irrational behaviour by customers that are not in their best interests and may force the fund to take action that would otherwise have been unnecessary. The costs of such an exercise, as with any costs in managing with-profits business, should be considered in the light of what value the mailing exercise provides to customers, given the costs are likely to be borne by policyholders.

6.3.9 For mutual companies, the regulatory position is only marginally clearer post Project Chrysalis. Uncertainty around this may cause issues for some funds.

6.3.10 Guarantee costs may affect the management of the fund disproportionately affecting, for example, investment freedom and distributions from the estate.

6.4 Insights from the survey

6.4.1 Unsurprisingly, many of the issues discussed above were raised through the survey.

6.4.2 The lack of customer understanding and dis-economies of scale were considered the greatest challenges. Issues relating to the solvency position (guarantee costs and capital held for the tail) were also concerns. The issue of conflicts of interest was more of a concern for proprietary respondents.

6.4.3 Over-prescriptive regulation was considered to be a constraint (mainly by mutual companies), as were the combination of past practice, systems and lack of models.

6.4.4 However, one question that raised a number of issues was the actions that would be taken if there were no constraints.

At one extreme these included the ability to set the investment strategy irrespective of solvency requirements.

More specific actions were the desire to be able to set more granular asset share charges to better target the guarantees that they support. Similarly, the ability to set more granular bonus rates by product and cohort. This highlights the concerns that systems and past practice may hinder the fund's ability to determine fair payouts and the desire to better target asset share.

Conversely, one respondent suggested replacing the existing asset share methodology. Whilst they did not indicate what they would replace it with, it is perhaps referring to the idea that an overly slavish adherence to asset shares undermines the fundamental with-profits approach. Clearly, in the extreme, adherence to asset shares would be indistinguishable from a unit-linked policy with guarantees.

One respondent considered that the ability to adopt hypothecation/life styling approach to investment management would be beneficial.

6.4.5 At a more global level, the desire to balance the interests of those exiting now with those that exit in the years to come was noted. This was more fundamentally summed up by one group of funds wanting to wind up and distribute the funds now.

6.4.6 In terms of testing whether management actions are considered fair, it is unsurprising that measuring payouts against asset share was the dominant approach. The use of estate measures and comparison of payouts against past payouts were reasonably popular. Some measure payouts against other investment media (such as the returns on deposit accounts).

6.5 Fairness and distributions from the estate

6.5.1 When asked whether particular groups of customers should/would be favoured in distributions, the overwhelming majority indicated that no particular group of customers would be favoured, as mentioned in 5.3.5.

6.5.2 A very small number of funds indicated that they might favour the following groups:

- Those with long durations in force;
- Those that had contributed the most to the estate (indicating that the first step from any distribution would be to refund asset share charges made);
- Mortgage endowment customers;
- Those with small absolute payouts;
- Those that had taken a cut to guaranteed benefits;
- Those not already benefiting from guarantees in excess of asset shares; and
- Maturities and deaths (over surrenders).

6.5.3 Some funds mentioned that they had indicated that certain groups would be favoured in their closure communications.

6.6 Conclusions and recommended good practice

6.6.1 Fair treatment for with-profits customers is far from straight forward and this is reflected in a significant amount of conduct regulation.

6.6.2 Individual firms will have developed approaches based on their past practice and communications with customers, but run-off will require these to be reappraised to confirm whether or not they remain appropriate.

6.6.3 There is no definitive approach to the management of with-profits funds that can be prescribed as the fairest approach. One area that may be, perhaps, described as best practice and would be strong governance.

6.6.4 The usual governance would be the Board acting on the advice of the With-Profits Committee, the With-Profits Actuary and the Actuarial Function Holder. Management may be constrained by conflicts, either through a responsibility to shareholders or personal conflicts (personal objectives and bonus arrangements may be at odds with fair treatment). Fair treatment of customers is most likely where these conflicts are openly declared and proposals considered in that context. Non-executive members of the Board, independent members of the With-Profits Committee, the With-Profits Actuary and the Actuarial Function Holder all provide the scope for challenge and insight. A balanced approach to the fair treatment of customers is most likely where these individuals can provide unfettered input to the decision making process. Where With-Profits Committees or With-Profits Actuaries are constrained to merely providing an opinion on management's preferred approach, rather than actively providing advice on the matter in hand, it is more likely that the conflicts will not be completely resolved and one might question that the outcome will best balance the company and customer outcomes. As discussed above, the spectrum of fairness is wide, but there is quite a difference between a decision being deemed "not unfair" and being deemed "fair".

7 Communications

7.1 Introduction

7.1.1 This section of the report considers communication to with-profit customers and discusses the results of the survey including considering developments in behavioural economics, the life-cycle of communications, communication design and delivery and customer testing.

7.1.2 Communication of the with-profits proposition to customers takes many forms – regular bonus statements, PPFM and CFPPFM, one-off mailings in respect of reconstructions such as Part VII transfers, information on investment performance, reports by With-Profits Committees. Communication takes a variety of approaches, commonly physical communications such as letters are required, but companies are also increasingly using digital media such as websites and email. In short, there are many ways in which companies communicate with the customer, no two do it in quite the same way and a number may have different approaches within the same company. Brand communications also may affect the way with-profits business may be viewed by customers.

7.1.3 Regulation and the inflexibility of legacy administration systems govern a large amount of what can be communicated to customers and in what manner. Given these constraints the survey looked at how successful the industry believed it is being at connecting with customers to ensure they understood the key elements of their with-profits policy and whether customers were armed with the right information to take the appropriate actions.

7.1.4 The survey focused on the following key communications questions:

- what are the challenges of communicating with customers who may have little understanding of the product
- what are the triggers or events that should cause a communication to customers, and consider:
  - to whom such communications should go
  - what would be most effective
  - what actions customers would be expected to take in respect of this
  - to what extent current COBS rules are an impediment to good communication

7.2 Developments in Behavioural Economics

7.2.1 Given the increasing focus on behavioural economics by both the FCA and the industry to better engage with customers it is useful to look at some behavioural economics techniques to see if there are approaches that can be used to positively drive customer engagement.

7.2.2 We live in a world with an increasing amount of information which puts pressure on the amount of time we have to filter though the options and make a decision. Behavioural economics has identified several approaches that take the way the brain works to make a decision and seeks to design simple approaches to replicate the complex decision making process in a number of different applications. Behavioural economics recognises that customer decisions may not be completely rational and may be influenced by other factors, so better or more communication or financial education alone may not be sufficient to ensure customers act in their best interests.

7.2.3 After several attempts to apply the techniques to with-profits customer communication, it was clear that there could be some value from the study of behavioural economics but any such study would require further time and resource.

7.3 Why initiate communication with customers at all?

7.3.1 In many cases with-profits insurers communicate with customers in line with legislative requirements e.g. annual statements and pre-retirement communications. But should compliance with regulation be the only reason for communication to with profit customers?

7.3.2 Regular communication has potential benefits for both insurer and customers, including:

- It will remind customers of the existence of the policy and should assist with maintaining up to date contact information. The benefit of this arises at claim date as it will reduce the need for tracing exercises and limit the number of claims that remain unpaid. A significant volume of untraced customers and outstanding claims will create particular difficulties for funds in run-off as they aim to distribute any excess surplus fairly over the lifetime of the fund.
- With-profits insurers will also hope that regular communications will maintain the customer's understanding of the product and allow them to assess the impact of any external influences (e.g. economic factors or regulatory changes) upon the satisfaction of their needs.
- It provides insurers opportunities to sell other products, including non-insurance products, to customers

7.3.3 The changes in retirement options arising from the 2014 Budget are a clear example of the need for insurers to communicate clearly to ensure customers can make appropriate decisions on how to use the benefits of their policies. Another important question is to what extent the actual or potential impact of being in run-off should be communicated.

7.3.4 However insurers will only be truly successful in achieving these objectives if these communications manage to maintain the customers' engagement throughout the lifetime of the policy.

7.4 Communication and engagement

7.4.1 Customer engagement is not a well-defined concept. It is rather like a hippopotamus, hard to describe, but easily recognisable. The general characteristics of an engaged customer which are relevant to this discussion are that they understand their product and when necessary proactively engage with communication from the insurer.

7.4.2 From the insurers perspective an engaged customer is easier to successfully communicate with than an unengaged customer and good communication plays an important part in maintaining engagement.

7.4.3 Customer engagement varies during the life cycle of a product. It is reasonable to assume that a customer was engaged with their product at the point of sale. They may be able to explain why they needed it and how it would fulfil that need.

7.4.4 However, with-profits products are usually long term and as time passes customers often forget the information they received at the point of sale and pay limited attention to statements and other communications sent by the insurer. During these "middle years" engagement is often at its lowest.

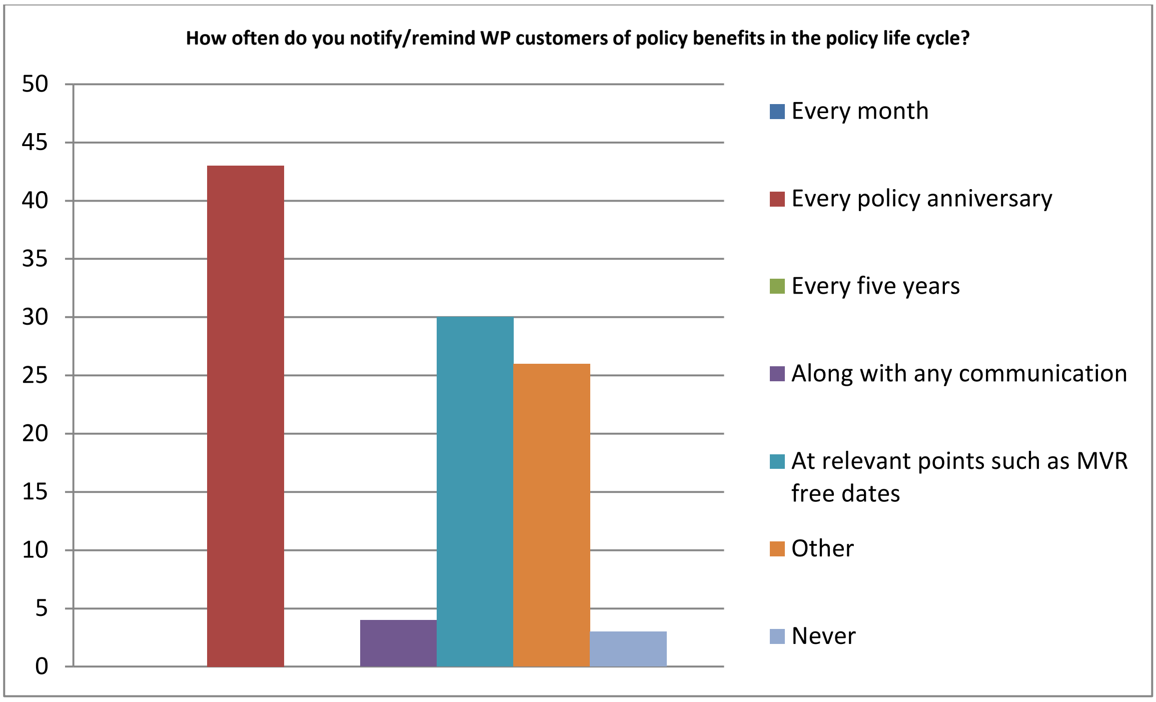
7.4.5 As the product approaches the time for the benefits to be taken the customers level of engagement increases. They are interested in the outcome of their policy but may have inaccurate expectations due to the limited attention they paid to their product in the "middle years".

7.4.6 The choice whether to engage with their product or not is the customers not the insurers who cannot force customers to engage.

7.4.7 Good routine communication can help maintain customer engagement and this leads to a virtuous circle. The more engaged customers are the easier they are to communicate with and so they become better informed and more engaged.

7.4.8 Poor routine communication can damage customer engagement if they are difficult to understand, do not contain useful information for customers, or contain information that the customer considers to be irrelevant.

7.4.9 The survey looked at what was the normal practice in reminding customers of their benefits and if offices were thinking of changing this in future. Regular communications with customers offer a key opportunity for maintaining engagement. The responses indicated that this normally occurred as part of the annual statement process or when other key communications were sent such as letters advising customers of MVR free dates.

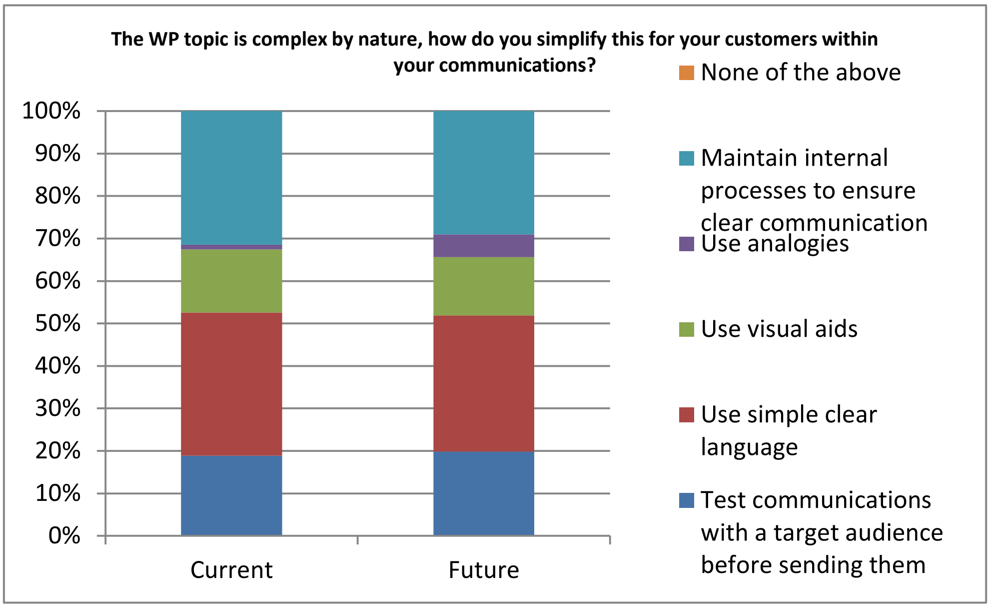


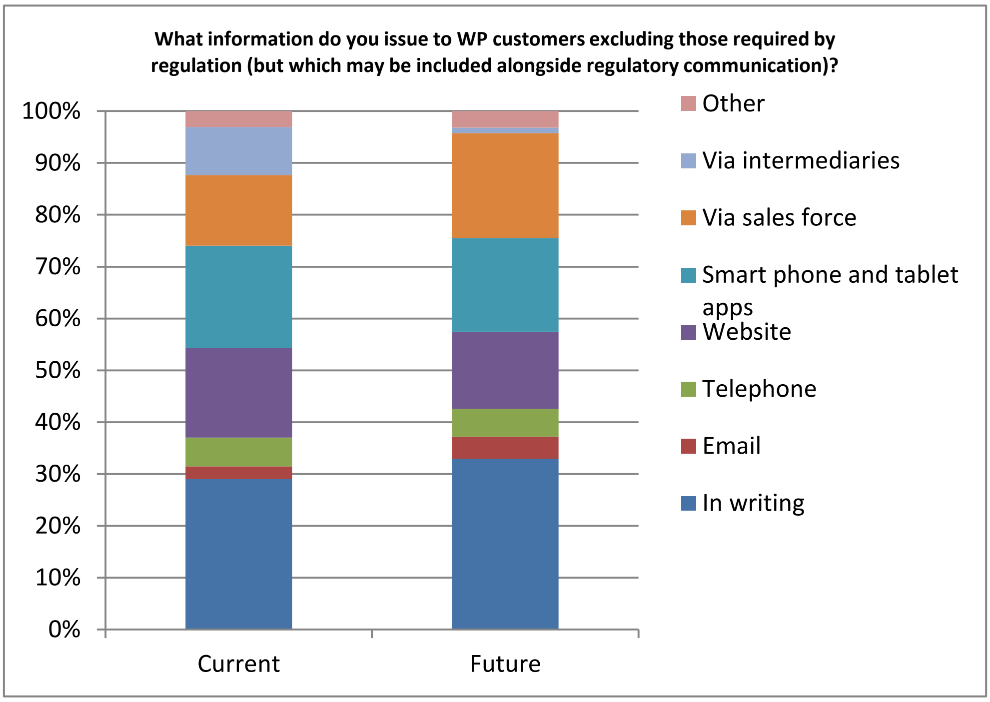
7.5 The life cycle of communications

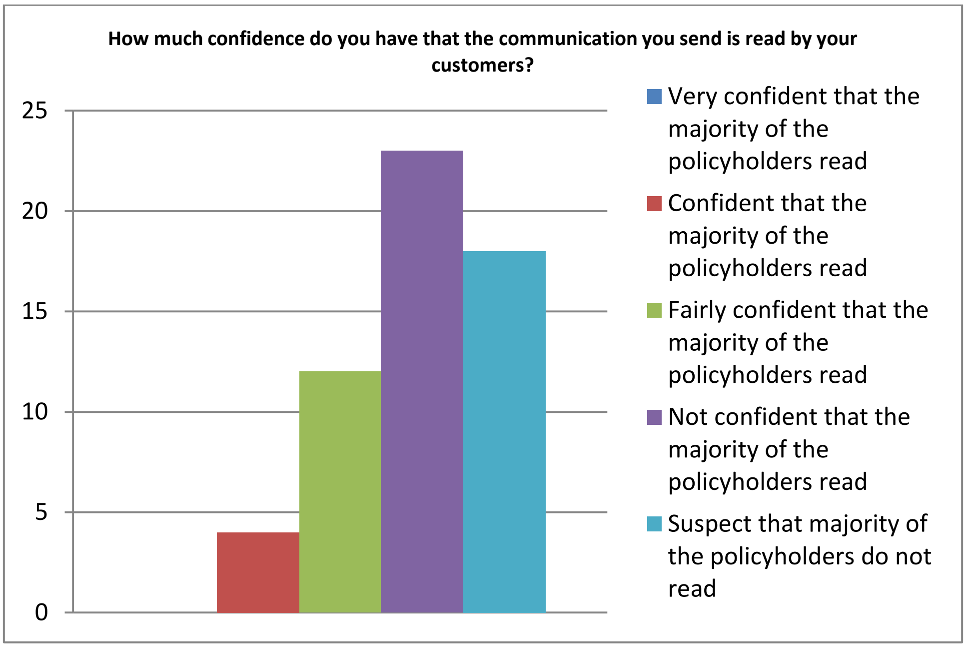
7.5.1 The communication life cycle starts with point of sale material which is highly regulated and not considered further in this paper as this will not be a significant issue for funds in run-off.

7.5.2 Insurers need to be prepared to respond to customers' queries at any time during the lifetime of the policy. The majority of these requests will be answered by a standard response such as provision of a surrender value or projection of future benefits. The same techniques that are applied to regular communications should also be applied to one-off communications to maintain engagement and assist the customer to understand the information provided.

7.5.3 The annual bonus statement (required under COBS 16.6.3) is the document received most frequently by the customer and would therefore be expected to have the most impact on customers' engagement. Insurers are taking a number of different actions to simplify and improve the messages relating to the with-profits nature of the contract and yet the vast majority have little confidence that the statements are read by customers.







7.5.4 Insurers may continue to develop different techniques to develop statements to encourage engagement but a number of survey responses suggested that expanding the statement content to include surrender values or projections of benefits would also be of use. The Irish regulators have recently introduced a requirement (Consumer Protection Code (March 2012) - Section 6.16) for annual statements to include information on premiums paid, investment returns, charges and an annual valuation. This requirement applies to all types of investment although it might be considered more appropriate for investments other than with-profits

7.5.5 In considering any developments to improve the annual statement it is necessary to include an assessment of the benefit against the additional cost involved. Funds in run-off will be aiming for costs to reduce in line with the policy run-off and will therefore wish to avoid significant development costs. Industrial Branch business issued prior to 1 July 1994 is a good example in that annual statements are not required by regulation and yet a significant volume of business (mainly whole of life) remains in force and may not have received any communication for more than 20 years. Re-engaging with these customers would assist with managing the run-off of the fund but the difficulties and costs involved may be prohibitive.

7.5.6 Regulation also requires with-profits insurers to notify customers of changes to PPFM with changes to Principles requiring 3 months advance notification (COBS 20.4.2). Respondents to the survey indicated that some relaxation of these rules would be of benefit to insurers without significant detriment to the customers in that:

- Flexibility in the means of communication would reduce costs and potentially improve customer engagement

- Further clarity on the type of changes covered by this rule e.g. some changes may have a significant impact on the way the fund is managed without being of relevance to customers as they have no direct impact on policy pay outs.
- It would be useful to be able to offer customers the opportunity to opt-in/out of PPFM communications (provided the tools were available to support it).

7.5.7 This brings us to the end of the policy life cycle and the final routine communications prior to the pre-determined claim date (e.g. retirement “wake up” letters or pre-maturity letters). Clear communication at this point of the life cycle will have a significant impact upon the customer’s satisfaction with the performance of the policy but will also give the insurer a guide to the success of his previous communications in achieving ongoing engagement. Given the perceived lack of engagement with annual statements should more be done in the final communications to explain the performance of the policy?

7.6 Design and delivery

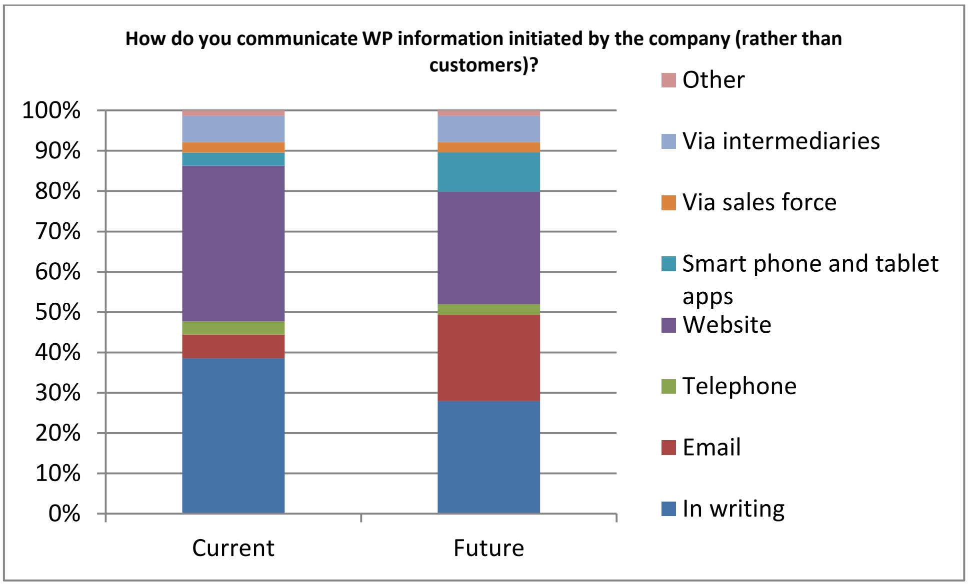
7.6.1 The presentation of a communication, font, number of colours used and its length are far more influential than perhaps a wholly “rational” observer might assume.

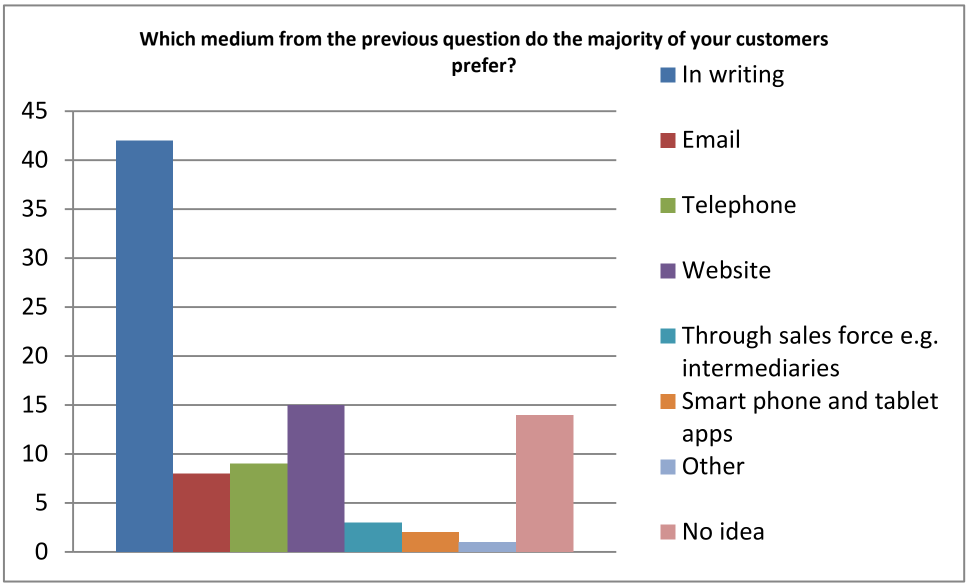
7.6.2 This is not an area of expertise of the Working Party but firms should consider taking specialist advice if they are not already doing so.

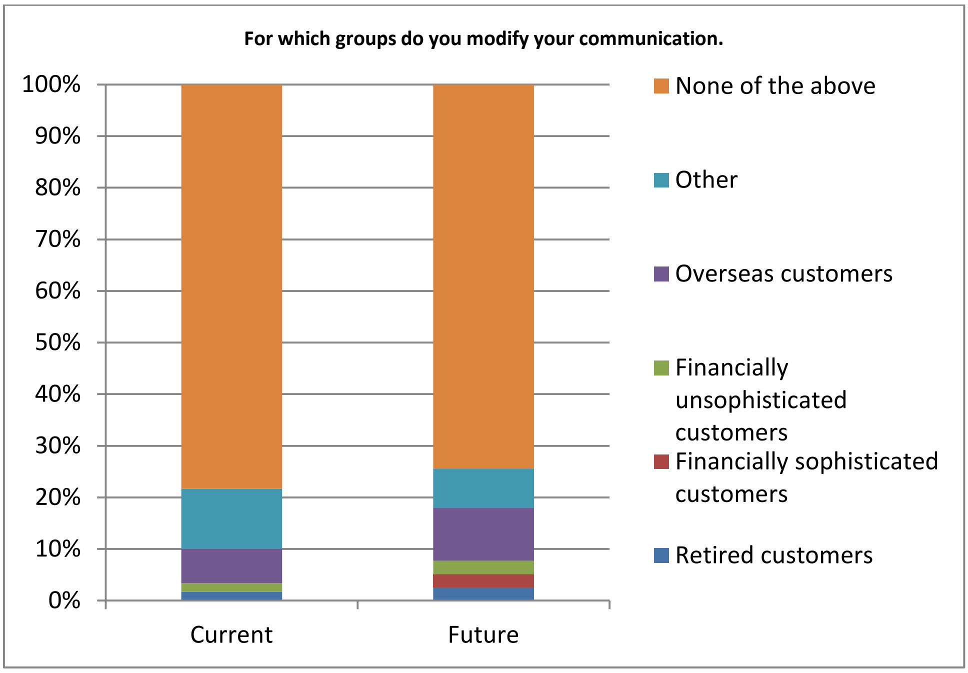
7.6.3 Whilst today there are many forms of communication which simply were not available at the point of sale the survey shows that the bulk of communications are still sent to customers by post although many firms also provide non customer specific information on their websites. The survey also indicated that some firms are considering other forms of communication including e-mail.

7.6.4 The responses to what form of communication customers preferred showed that in general firms believe that customers are happy with the methods of communication used although it was interesting to note that only a third of firms supplying information through websites thought this was the customers preferred approach.

7.6.5 The approaches adopted may simply reflect the fact that it may be expensive or difficult to move from the traditional communication approach of by letter and the requirements in the COBS rules for certain information to be provided in writing. Other media e.g. e-mail could also be classified as in writing.

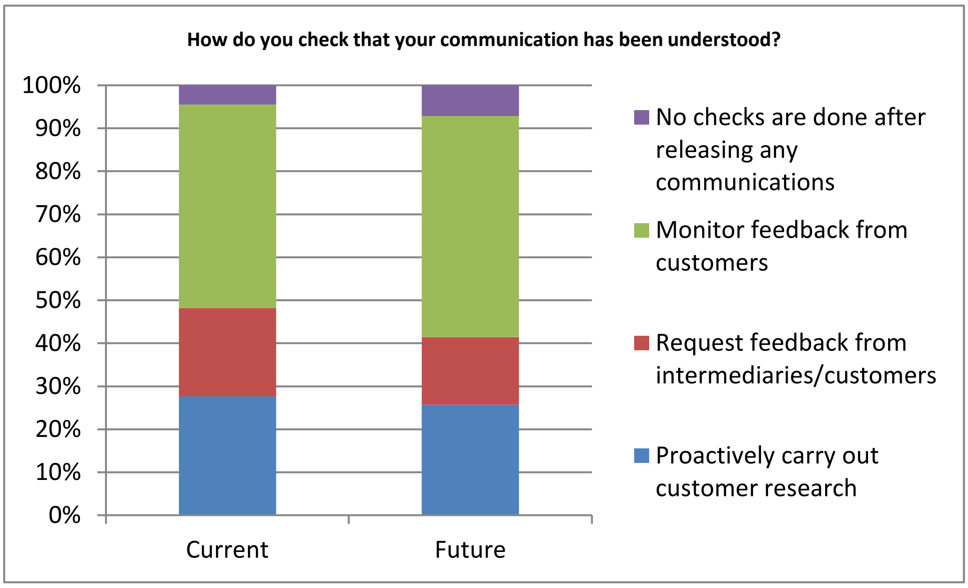

How do you communicate WP information initiated by the company (rather than customers)?
100%
90%
80%
70%
60%
50%
40%
30%
20%
10%
0%
Current
Future
Other
Via intermediaries
Via sales force
Smart phone and tablet apps
Website
Telephone
Email
In writing


Which medium from the previous question do the majority of your customers prefer?
45
40
35
30
25
20
15
10
5
0
In writing
Email
Telephone
Website
Through sales force e.g. intermediaries
Smart phone and tablet apps
Other
No idea



7.7 Testing - How do we know if we have achieved our communication objective?

7.7.1 The majority of the respondents were not confident that their policyholders understand the communications or suspect that they do not. In fact, none were confident that their policyholders understand their communication. It is encouraging that most respondents check the level of understanding of their communication albeit reactively by monitoring complaints logs and policyholder feedback, few do proactively carry out policyholder research to ascertain the level of understanding prior to undertaking the communication.



7.8 Opening the communication

7.8.1 The first challenge insurers face in communicating with their customers is to get them to actually open the communication – whether this be a physical letter or via email. Many insurers felt that it is an all too common occurrence is for the customer to ignore the communication altogether and so this is clearly a challenge. This is not just an issue for insurers, but is a wider issue with the financial services sector.

7.8.2 It is a difficult problem to address - the work by the FCA[11] highlighted ways in which communications could be differentiated to get over this initial barrier and insurers would do well to look into alternative and creative approaches.

7.8.3 Perhaps one of the key issues with-profits customers face is that for many regular communications it is not clear what action the customer is expected to take as a result. Regular bonus statements, though intended to keep customers abreast of the performance of their policy, probably fail to do so as they communicate in a way which is very difficult for the layman to understand. PPFMs and CFPPFMs whilst proving to be valuable exercises for firms in articulating more clearly the manner in which funds will be managed are inaccessible to most customers due to their use of technical terms and in some cases jargon.

7.8.4 A combination of the negative press many insurers have, coupled with customers uncertainty on what they may find when they open an envelope may lead many of them to taking no action and firms therefore find ourselves in the situation where despite regular communication with customers, they still do not seem to be able to avoid the surprise at the end when pay outs fail to live up to expectations.

7.9 What does it all mean? What am I supposed to do?

7.9.1 Annual statements provide customers with several distinct pieces of factual information including

- Bonus declaration as required by regulation
- Investment return of the fund
- Asset share enhancements

7.9.2 Although a with-profits 'expert' will be able to interpret the information provided this will be difficult for many customers.

[11]Applying Behavioural Economics at the Financial Conduct Authority – April 2013

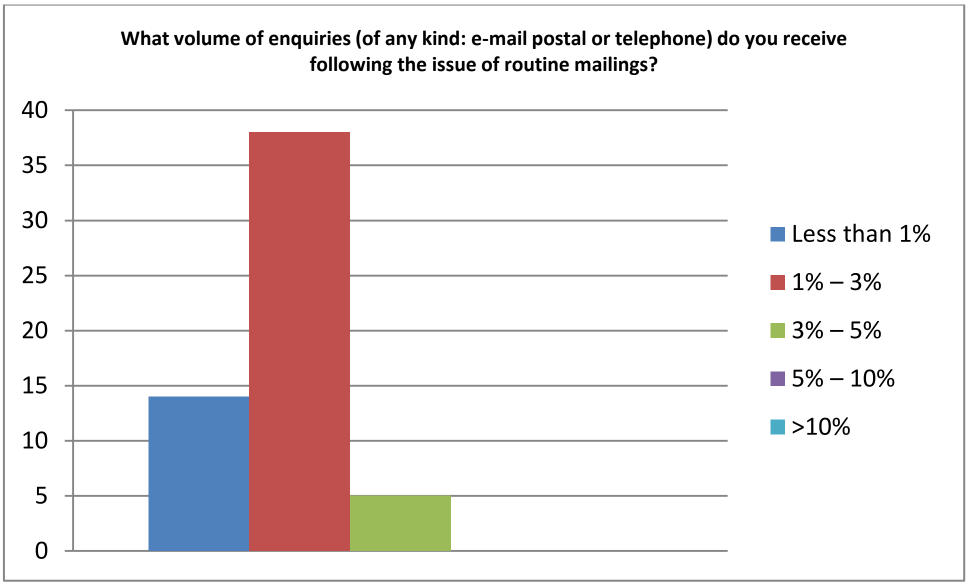
7.9.3 Provision of a surrender value would illustrate the current impact of recent performance but would not include allowance for the impact of guarantees or the potential impact of being in run-off. Provision of a projected benefit amount would help to resolve the problems associated with guarantees but will introduce the difficulty of explaining changes in projected values over time.

7.9.4 However this will not solve the problems associated with the impact of the run-off since the insurers need to maintain discretion over future distributions which will limit their ability under FCA rules to incorporate anything into the projections.

7.10 What happens afterwards?

7.10.1 The research suggests that at most 3% of policyholders raise enquires following routine communication; this figure is very low and would suggest a reactive method of checking understanding may be inadequate.

7.10.2 The low level of confidence amongst respondents that the communications are read is a matter of concern but it comes as no surprise that a complex topic is hardly read or understood by those that read it.

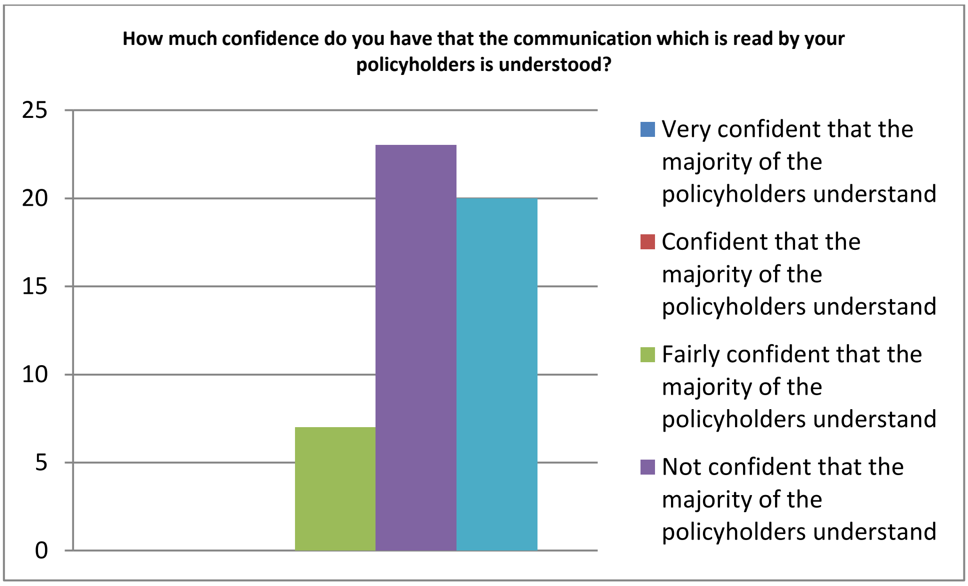


7.11 Better next time?

7.11.1 Like all processes communication requires a feedback loop so that what works well and what does not can be understood, and appropriate action taken.

7.11.2 The survey looked at how firms know whether their communications have been successful and asked a number of questions around this topic, as well as whether the COBS rules, in particularly 16.6.3 and 20.4.2, were helpful in meeting the information needs of customers.

7.11.3 As already alluded to, generally speaking the majority of firms suspected or thought that the communications sent were not read by customers. Of more concern, an even greater majority of firms thought that even when read the communication was not likely to be understood by the customer.



7.12 Conclusions and recommended good practice

7.12.1 Currently the level of engagement with customers and the communications that are sent are generally failing to meet their aims.

7.12.2 This is a very broad statement, but in our view the majority of with-profits customers continue to remain ill-informed about their investment and there will inevitably be more "surprises" for them as policies mature.

7.12.3 In order to improve the connection with customers, companies need to challenge themselves in respect of each type of communication by considering:

- What actions are customers going to take?
- What actions can they take?
- What actions should they actually take?

7.12.4 Thinking through these three questions in respect of each and every communication sent to with-profits customers may enable them to better engage with customers, potentially leading to fewer, better targeted communications.

7.12.5 But companies can only do so much, in order to achieve better communication with, and to better inform customers. If some of the regulatory constraints imposed on the industry can be removed, then companies would have the freedom to communicate with customers in a more engaging and creative way – and now is the time to do this. The 2014 budget has placed pensions on the front pages of newspapers for all the right reasons, and it has a profile with customers not seen in a generation. There is a clear need for customers to re-engage with pension customers given the increased flexibility they will have in respect of their pension savings in the future, and an excellent time to reinforce the key messages about their with-profits products. This regulatory impetus, coupled with the use of digital media in particular, may enable companies to re-engineer their approach to with-profits customer communications.

8 Determining Payouts and Bonus Strategy

8.1 Introduction

8.1.1 This section details the methodology changes that may need to be considered for the determination of payouts and bonus strategy of a with-profits fund in run-off.

8.2 Determining payouts and bonus strategy

8.2.1 One of the potential consequences for a fund in run-off is that the mix of business within the fund changes significantly over time. As a result of these changes the cross subsidies between different groups of policyholder, and between policyholders and the estate will also change over time. It would therefore be expected that the methods used to determine payouts would be kept under regular review to ensure that the resulting payouts remain consistent with the fund's principles for setting payouts against asset shares.

8.2.2 The introduction of any revised practices will be to the benefit of one group of policyholders, to the detriment of another. In making such changes, companies therefore need to consider fairness not only in terms of comparison with asset share but also in terms of expectations created by past practice and past documentation.

8.2.3 Perhaps the most obvious change in the approach to setting payouts may be setting the level of annual bonus to provide a capital benefit in order to maintain investment freedom or to facilitate earlier distribution of the estate. Estate distribution is discussed in more detail in section 5.

8.2.4 The desire to make changes to payout methods should however be tempered by considerations of the costs involved with implementation, since funds in run-off need to maintain close control over the expenses incurred.

8.2.5 The following section explores some of the more detailed issues faced by insurers and possible mitigating strategies that may become successful. Different funds may be in different situations, both over time and across companies, and hence not all issues or strategies will be appropriate in all circumstances.

8.2.6 The survey set out to identify how far funds in run-off had gone towards changing their approach to setting payouts and bonus strategy, see section 8.12 for more detail.

8.3 Determining the optimal annual bonus strategy

8.3.1 Assessment of the bonus rate supportable over the longer term would be expected to underlie the declaration of annual bonus. However, companies are able to exercise considerable discretion in setting the actual rate within the guidelines included in the PPFM. Should closed funds in run-off exercise this discretion in a different way to those that are open to new business?

8.3.2 Closed funds should be considering plans for distribution of any surplus over time in a way that reduces the possibility for a tontine, balanced against the need to run the fund within risk appetite. Declaring lower annual bonus rates, or indeed declaring no annual bonus, will limit the increase in guarantee costs and facilitate earlier distribution of surplus. Therefore it might be expected that closed funds would move towards payment of final bonus in preference to annual bonus.

8.3.3 However, any decisions on reducing annual bonus need to achieve a balance between early distribution of surplus and the expectations created by previous communications with customers. Reducing the annual bonus component will increase the potential for higher ultimate payouts but policyholders may prefer a guaranteed amount now over an uncertain amount payable later.

8.3.4 This differs from open funds who might give more consideration to the 'headline impact' of annual bonus declarations upon their future sales potential and provide a higher proportion of payouts in the form of annual bonus.

8.3.5 Prior to the final claim payment, the level of annual bonus is likely to be given considerable focus by the customer since information on annual bonus is more generally available than that on final bonus. Generic annual bonus details will be published in the press and policy specific information will be provided within the policyholder's annual statement.

8.3.6 Annual statements showing reductions in the level of bonus should be accompanied by explanations for the reduction, including detail of the potential benefits to payouts as described above. However, it is likely that a proportion of policyholders will complain about the change and there will be an increased risk of poorer persistency. As a consequence any adverse impact on the fund must be appropriately monitored and managed.

8.4 Fairness between different policy types

8.4.1 Historically, a single rate of annual bonus would typically be declared in relation to a single contract type or a group of policies that cover a wide range of contract types. Whatever the reason for the existing practice, the fund may benefit from changing its approach for the future.

8.4.2 The supportable level of bonus on particular contract types might start to diverge so that the introduction of an additional rate of annual bonus may improve the fairness between groups of policyholders within the fund. By introducing an additional series any cross subsidies between the diverging contract types will effectively be removed. Whilst this will be of benefit to the policyholders providing the cross subsidy, it will be a change from past practice. Companies should therefore consider implementing any changes in stages.

8.4.3 Possible reasons for reducing the number of bonus scales are considered in section 8.5 below.

8.5 Determining payouts when asset shares are not available or data is sparse

8.5.1 The detailed practices involved in the determination of final bonus will clearly have an impact upon the resulting payouts. The significance of which will depend upon the nature and distribution of the business to which the practices are being applied.

8.5.2 Consequently funds in run-off may need to keep their detailed practices under regular review in order to ensure that they continue to satisfy the fairness principles of the fund as described in the PPFM.

8.5.3 In line with the regulator’s rules, the main principle will be for payouts to equal 100% of asset share over the long term. However policy alterations, data input error and unusual features mean that there will always be instances where asset shares will not be available.

8.5.4 In an open fund these circumstances are unlikely to form a large proportion of the business and it may be appropriate to combine the bonus series with another suitable series.

8.5.5 As funds run off the overall amount of data would be expected to reduce, leading to increasingly volatile experience and potential for a greater proportion of the business where asset shares are not available. Whilst the basic justification for the fund’s current approach for determining payouts should still apply in theory, the potential for small volumes of business may suggest alternative methods should be considered.

8.5.6 The fewer policies modelled the closer the policies become to a unit linked contract therefore when assessing a potential change to the modelling approach the relative importance of:

- ensuring a close connection between the total payout and total asset share, and
- the desire for stability in payouts

should be considered due to the resulting impact upon the cross subsidy between policies. The fund needs to decide what payout methodology it is trying to achieve; is it aiming to pay out asset share or to smooth payouts over time?

8.5.7 The distribution of payouts in comparison with the target range may initially be used as an indication of the appropriateness of the current methodology but, as the volume of claims reduces, each claim will form a larger proportion of the total and the probability of failing to satisfy the target range may increase. The impact of this reduction in volume of claims on the target range will be influenced by the extent of smoothing applied within the fund.

8.5.8 Similar considerations may also be applied to the possibility of including additional types of contract within the model points used to set final bonus in order to increase the volume of data available. Conversely action may be required to separate out the bonus scales in order to reflect significant differences in experience. The practical problems associated with obtaining relevant data and the cost of system changes to implement separate scales may frequently outweigh any improvement in the final bonus declaration.

8.5.9 At the point when data becomes sparse it may be considered appropriate to base the final bonus calculations on hypothetical data in order to remove the volatility in the results. These hypothetical policies will need to be carefully selected so as to represent the typical nature of the contracts sold within each bonus series. This methodology will tend to result in smoother payouts but will impact on payout ratios also.

8.5.10 Similarly, to reduce costs and assist with the lack of data, combining contract types for the determination of annual bonus rates may be appropriate.

8.5.11 Any changes to the methodologies adopted would need to be compliant with the PPFM and thus changes may trigger an amendment to the PPFM that will need to be internally approved by all relevant parties and subsequently disseminated to policyholders.

8.6 Lumpy maturity profile

8.6.1 Historic peaks in sales volumes naturally feed through to emerging maturity profiles and impact bonus strategy. This lumpy profile means that choices in managing the fund may look different before and after a block matures. In defining bonus strategy, focus on data that drives a few key maturity dates may mean that other maturing periods may be overly weighted towards these dates.

8.6.2 Forecasting and identifying key changes in maturity profile will allow a better consideration of time points when current methodologies may need to be reviewed. This will allow the reviews to take place (and implement changes if necessary) before the issue arises. This is particularly important where changes in PPFM practices may require notification and annual newsletters or mailings might provide a cost effective way of informing policyholders of changes.

8.6.3 A lumpy maturity profile also gives rise to peaks of risk exposure such as maturity guarantees and, if these are material, consideration should be given to hedging out these peak risks. This is particularly an issue for closed funds where the solvency of the fund can rest on market performance and levels at a few critical maturity dates.

8.7 Growing shift towards whole of life and pension policies

8.7.1 Historic bonus approaches that focused primarily on endowment bonus calculations with small volumes of whole of life payouts are seeing a shift as endowments mature and whole of life policies are ageing.

8.7.2 The increasing proportion (and hence importance) of long term policies (pensions and whole of life) in a typical fund raises issues regarding management and assessment of data quality issues on older policies in bonus assessments. The use of sample policies (which has been more prevalent in older products) is a natural vehicle to ensure that consistent bonus levels are applied across similar policies, and is a practical way to manage data quality issues. It allows for the pooling of risk and smoothing of experience, which are core tenets of with-profits business. On the other hand the use of sample policies for small groups of policy will introduce a greater risk of deviating outside the target range and failing to pay 100% of asset share.

8.7.3 However, the use of asset shares for the Whole of Life business introduces a number of complex questions. As Whole of Life policies age there comes a point when the charges to asset share outweigh the growth; hence the asset share starts to reduce whilst the guaranteed benefits either remain the same or increase. For these policies it may be appropriate to consider alternative methodologies that reflect the value placed upon these policies for valuation purposes.

8.8 Growing shift towards paid-up policies

8.8.1 Continuing participation in profits following conversion to paid up was a requirement under the personal pension legislation. Combining this with the restrictions on cashing pensions suggests that funds in run-off may have a relatively large volume of paid up pension policies on the books and it is feasible that the volume of paid up policies exceeds that of premium paying at certain terms. In fact as the fund declines, paid up policies may dominate premium paying policies across other lines of business as well.

8.8.2 Funds should therefore consider whether this justifies the introduction of separate scales based on asset shares using the appropriate data. Consideration will need to be given to the inclusion of a third variable such as premiums paid when applying final bonus scales.

8.8.3 In recognizing the significance of paid-up policies, and before altering asset share calculations, companies may wish to review the way expenses are incurred, allocated and shared between different types of policy.

8.9 Dominance of low value policies

8.9.1 Smaller value policies may have been designed for sales and expense models which are no longer viable today, and as policies run-off, diseconomies of scale mean that even larger policies are unable to sufficiently cross subsidise the rest of the portfolio.

8.9.2 Where asset shares can be calculated (not always the case due to data quality issues), it is entirely plausible to have negative asset shares due to the size of expense charges relative to premiums.

8.9.3 An approach will need to be devised to address these issues that is pragmatic, reflects the underlying cash flows of the fund and reflects fairness and due consideration to expectations the policyholders may have. Approaches to consider might be:

- Repopulating Asset Shares with a revised (positive value)
- Adjusting Asset Share charges to ensure they develop in a way that supports bonus calculations, underlying fund cash flows and policyholder expectations
- Using a Bonus Reserve Valuation approach
- Using a sample policy approach

8.10 Ensuring smoothing cost is neutral upon wind-up of the fund

8.10.1 Ideally at the end of the life of a fund in run-off the smoothing position should be in a cost neutral position. This ensures there is no tontine effect or conversely an outstanding cost to the estate on wind-up of the fund; effectively ensuring a fair distribution to policyholders and shareholders (if applicable).

8.10.2 As a consequence, companies in run-off will need to keep their smoothing practices under regular review in order to ensure that they continue to satisfy the fairness principles of the fund as described in the PPFM; particularly where the run-off of the business results in peaks and troughs in the profile of payouts. Policyholder expectations and past practice will need to be considered before taking any action.

8.10.3 Shortening the smoothing cycle will increase the chance that the final smoothing cost is cost neutral. However, it will have a knock on impact to the final bonus scales which will be more volatile from year to year.

8.10.4 A reduction in the level of smoothing will also help to ensure smoothing is cost neutral upon wind-up. However, this will be against the practices that policyholders have become accustomed to. This reduction in the level of smoothing could be as a consequence of reducing the level of investment risk within the assets held; this would naturally lead to a reduction in the level of smoothing required.

8.10.5 The smoothing account (if held) in a fund in run-off would require closer monitoring than if the fund were still open to new business. Along with the closer monitoring, methodologies will need to be formulated and acted upon if the smoothing account exceeds certain predefined limits. These methodologies should be actively managed so they are appropriate for each stage in the life of the fund in run-off.

8.10.6 Bonus strategy may assume inter-generational smoothing which will need to be reviewed, in practice, in a run-off situation. In particular any significant build-up of, or deficit in, a smoothing account will need to be considered from a bonus strategy stand point in terms of how the smoothing account balance is distributed amongst the remaining policies and run-off.

8.11 Consideration of fairness in changing bonus strategy

8.11.1 Any changes to bonus strategy need to consider policyholders' reasonable expectations. A forward looking assessment of bonus strategy, particularly incorporating shifting product payout profiles, will allow a smooth transition. Special bonuses allow a step change without creating permanent persistent changes, although they need to be properly communicated to policyholders.

8.12 Insights from the survey

8.12.1 Of the funds that are in run-off approximately 50% have changed their bonus strategy, the majority shifting away from regular bonus to final bonus.

8.12.2 There were numerous reasons given for the changes but, they generally related to financial strength or distribution of the estate. Some respondents indicated that whilst the poor solvency position of the fund may have initiated the change, they now consider it appropriate to continue with the approach over the longer term even though they have experienced improvements in solvency.

8.12.3 Only a minority of funds said that their bonus strategy had changed to take into account prospective changes in the mix of business, or peaks of maturities, as the fund runs off. There was surprisingly little variation in that percentage when analysed by size, open/closed, proprietary/mutual and in run-off/not in run-off.

8.12.4 For those funds that had made changes, there was quite a variety of ways in which strategy had changed according to survey respondents, including:

a) Data quality: A move away from actual business model points to specimen sample policies to deal with data quality
b) Lumpy profiles: Accelerating mid-year terminal bonus rate changes to pass asset prices on to peaks of maturing policies before they leave
c) Smoothing: Change to period over which smoothing is applied.
d) Reducing annual bonus: Bonus strategy has evolved over the past years to bring annual bonuses down to a sustainable level and to introduce an element of final bonus.
e) Enhancing Payouts: Distribution Factor (% of Surplus) used to determine level of estate distribution increased to ensure large volumes of maturities over the last few years received their fair share of the estate.

8.12.5 Fewer companies than expected have taken action (or expect to take action) with regard to changing their approach for determining payouts on whole of life and paid up policies. A small proportion of funds are expecting to, or have already taken action to, calculate asset shares for these policy types.

8.12.6 Historically, for whole of life policies the most prevalent methodology used by the survey respondents was to apply the same rates that applied to other policy types. For paid up policies, the majority of companies base bonuses on those of premium paying policies. The expectation is that methodologies for whole of life and paid up policies will need to be reviewed in light of their growing prominence within funds in run off.

8.12.7 A large number of respondents expected to review the level of granularity for setting their final bonus scales (some having already done so). Unfortunately the survey results do not indicate whether the respondents expect to increase or decrease the granularity.

8.12.8 There is evidence of companies changing their smoothing practices (or expecting to change their practices in time), presumably in order to help converge to the end date (i.e. reduce the smoothing cycle to ensure the cost of smoothing is zero at the point the fund winds-up).

8.13 Conclusions and recommended good practice

8.13.1 Whether bonus strategy needs to be changed and what changes are required will depend on the specific fund in question. Regular reviews and consideration of whether changes are necessary should be performed, in particular identifying key future points in the fund's composition that may result in a change being appropriate.

8.13.2 Along with changes to bonus strategy, funds should consider how they will determine payouts as the composition of the in force policies within the funds evolves. Action may be needed in the short term to ensure sufficient and appropriate data/systems are in place for the long term.

9 Investment Strategy

9.1 Introduction

9.1.1 This section covers the investment strategies for with-profit funds (asset shares, estates, and cost of guarantees) in run-off. The assumption is that a fund in run-off would, within the constraints of policyholder expectations, wish to adopt an investment strategy that would enable as much as possible an even distribution of the free estate over the remaining life of the fund.

9.2 Determining the optimal investment strategy for a fund in run-off

9.2.1 A potential strategy for funds in run-off is to hedge out unrewarded or poorly rewarded risk as much as possible so that the fund's risk capital can be focused on risks that are either well rewarded or unhedgeable. Such a strategy would be a matching strategy, i.e. one where a mix of equities, property, fixed income assets and a smaller proportion of other assets are held within asset share.

9.2.2 To match the cost of guarantees, a mix of cash, options, swaps, swaptions, futures, notional short equity positions could be held to quasi match guaranteed annuity options and maturity guarantees.

9.2.3 Cash/other matching assets can also be held to match the fund's capital requirement's sensitivity to market movements.

9.2.4 There could also be a smoothing account that holds cash and a short equity position to reduce the cost of smoothing

9.2.5 After allowing for current liabilities (assumed to be matched with short dated assets) this leaves the balance of the fund, which can be distributed to policyholders over the remaining life of the fund.

9.2.6 If these additional distributions are to be in the form of a stable percentage additional allocation to asset shares, then investing these excess assets in line with assets shares would enhance the fund's ability to maintain stability. Similarly, if alternative methods of distributing these surplus funds are to be applied, then regard should be given to investing these assets in assets that are similarly linked to the parameter/s driving the distribution strategy.

9.3 Measuring the solvency of the fund

9.3.1 The fund's ability to take risk and distribute surplus is driven by the size of the free assets relative to the size of the fund. The discount rate used to determine the value of the liabilities, and hence the free assets, is therefore an important matter for consideration.

9.3.2 Much work has been carried out by the profession in addressing the discount rate for liabilities for both insurance companies and for pension funds. The working party refers actuaries to that work and those working parties to address these issues. In this paper the particular importance of adopting the correct discount rate for a with-profits fund in run-off is highlighted.

9.3.3 A discount rate that is too conservative would understate the solvency position of the fund; inhibiting the risk appetite of the fund as well as the distribution of the estate over time.

9.3.4 Higher than risk free discount rate capitalises future risk margins that have not yet been earned and is at odds with the theories of financial economics. So the choice of discount curve has an important role to play for a fund in run-off where a fair distribution of the estate and fair evolution of the investment strategy is being sought.

9.3.5 The Solvency II debate highlights this conundrum. Is the risk free rate gilts or swaps based? If it is swaps based is it, for the UK, LIBOR or SONIA based? At the time of writing this paper gilt rates are higher than swap rates at the long end whilst the converse is true at the short end. There is a good argument for adopting a "cheapest to deliver" risk free discount rate that uses the higher of the two.

9.3.6 If LIBOR is adopted actuaries should be aware of the potential dislocations (such as those during the financial crisis) that can take place between assets on deposit earning LIBOR/LIBID and the obligation to pay LIBOR on the floating rate leg of a swap.

9.3.7 If a gilt or SONIA discount rate were to be used then the obligation to pay LIBOR on the floating leg of the swap introduces a mismatch.

9.3.8 Solvency II introduces the concept of a matching adjustment. Is there an argument for discounting liabilities at this higher rate? For bonds in asset share that are traded perhaps not, but for with-profits funds in run-off there can be a high proportion of bonds being held in the long term to match maturity guarantees. Policies with GAOs attaching are in effect deferred annuity contracts and these lend themselves to cash flow matching. Hence taking credit for a matching adjustment could have a meaningful impact on the way that a fund is run-off.

9.4 An increased case for hypothecation

9.4.1 Hypothecation is a widely accepted way of managing the investment risks in a with-profits fund whilst managing the different needs across classes of policyholders. A simple hypothecation strategy would involve a company using fixed interest assets of appropriate term to match the guaranteed liabilities reducing the overall risk profile of the fund.

9.4.2 For a closed with-profits fund in run-off, the need for hypothecation might be greater than normal. This might arise due to several reasons, the most prominent of which might be lower capital requirements for the fund allowing timely distribution of capital to policyholders.

9.4.3 Increased hypothecation in a closed fund might be an easier way of managing risk in the portfolio rather than run the risk of a more extreme action in the future such as unitisation or a court process.

9.4.4 The extent and moneyness of guarantees in the fund would be a significant factor to take into consideration to determine the level of hypothecation to use. The reduction of the capital strain of high guarantee products is potentially an acceptable reason for greater hypothecation if the strain impedes the usage of capital for more productive risk taking elsewhere.

9.5 Matching of financial guarantees with replicating assets

9.5.1 An open fund might be more tolerant of running with a lower degree of matching on the basis that any rewards or losses can be shared across an ongoing policyholder base.

9.5.2 Hence, an open with-profits fund might find it acceptable to partially hedge, say, its maturity guarantees against equity market falls through delta hedging or even not hedge them at all. It may do this because it has formed the view that the costs saved by not fully hedging out these risks are less than the additional costs it will pay by not hedging. For example, a delta hedge involves hedging a convex liability with a linear asset. Periodically the delta position will need to be rebalanced and there will be both a trading cost and loss because the change in the mark to market of the asset will be less than the change in the value of the liability. The potential cost of this strategy needs to be compared to the time value in a hedging instrument such as an equity put.

9.5.3 A fund that is in run-off ought to be aware of the materiality of the unhedged risks it is taking and, where there is a comprehensive internal model (e.g. one stressing equity volatility), these risks are capable of measurement. A fund in run-off is more likely to have a need to hedge out these risks to help reduce its capital requirement and to focus its risk capacity on areas unable to be hedged or where there is a good return on capital potential.

9.5.4 Interest rate risk may be considered to be an unrewarded risk and, depending on the in-the-moneyness of both maturity and annuity option guarantees, a fund in run-off is more likely to refine its interest rate risk management by moving to a more closely matched position. Hypothecation will have a role to play here. Perhaps because of the generally unrewarded nature of the risk, most funds whether in run-off or not have hedged any GAO liabilities of a significant nature. Initially GAO hedges were effected through then at-the money swaptions or, swaptions struck at, say, 5%. These swaptions are more exposed to interest rate volatility than the liabilities they are hedging, hence they introduce a volatility exposure. Funds in run-off are more likely to want to avoid this risk by matching the duration of the annuities with long dated gilts or swaps and hedging out the guaranteed cash option by holding out-of-the money payer swaptions.

9.6 Lumpy assets such as property and strategic holdings

9.6.1 With historically high returns, property assets complement any investment strategy. However, lumpy assets are clearly of added concern for a with-profits fund in run-off. For portfolios of direct property holdings the fund could progressively sell these off but, in doing so it ought to have regard to which property it sells. The obvious choices are those properties that are most marketable and hence liquid. This however means that surviving policyholders are exposed to a less liquid pool of, presumably, less attractive properties. Ultimately of course the portfolio would lose its diversification and become exposed to the performance of a small number of properties.

9.6.2 One option is to switch to a pooled property portfolio with an asset manager. Ideally this would involve an in specie transfer of the assets. In practice though the asset manager will pick those assets that are of the right quality and fit for the fund and the rest would need to be sold. For BLAGAB business there could be tax implications around such a transaction, but the fund ought to be managing any tax liability so that it is spread evenly across the different generations of maturing/vesting policies.

9.6.3 A second option would be to move into property investment trusts. These benefit from being liquid as they are traded on an exchange. It also means that they are subject to the supply and demand of the market and these shares trade variously at a premium or discount to net asset value. The managers of an investment trust will also employ a degree of leverage that will also vary too over time. This is likely to give rise to the need to increase the market risk capital allocated to these assets

9.6.4 Investing in property indices could be another option but the derivative market for property indices is not liquid enough for this to be a viable solution.

9.6.5 One or more of these properties might be the firm's own premises or used regionally by the firm. Here sale or sale and lease back arrangements could be a solution.

9.6.6 Other lumpy assets can include strategic holdings such as businesses associated with the firm. For a large open fund, a strategic participation might be a legitimate part of long term business strategy to achieve diversification. There are several issues surrounding strategic holdings such as the nature of the holdings (e.g. regulated or unregulated), allowance in the capital requirements and in the case of investments in subsidiaries, any double leverage. However, these issues are not unique to a closed fund in run-off.

9.6.7 As with property, the concentration of risk to strategic holdings also becomes more significant in run-off. If these holdings were previously part of a long term strategy, they might also no longer be appropriate due to the closed nature of the fund. Divestment from these holdings will need to be made before they become disproportionately large and with due regard to their illiquid nature.

9.7 Liquidity requirements

9.7.1 Unlike a fund open to meaningful volumes of new business, a fund in run-off will, over time, become progressively unable to rely on premium receipts and asset maturities to provide a pool of liquidity.

9.7.2 In addition regulatory requirements such as EMIR and central clearing increase the need for cash availability within a fund. Funds in run-off arguably have a far greater need to model these liquidity requirements. Funds invariably post collateral under any OTC derivatives that they hold. Typically this is in the form of cash or gilts. Future derivative transactions will be required, under EMIR, to be cleared through a central clearer and for initial and variation margin to be posted. Whilst initial margin can be posted as cash or gilts, variation margin has to be posted as cash.

9.7.3 The amount of collateral that needs to be posted will be path dependant, but funds in run-off need to take particular care in having a liquidity plan that explores the potential liquidity requirements of any derivatives held especially where these are long term hedges. Prospectively mapping what these might be on both a best estimate basis and a range of worst-case scenarios will highlight specific actions that might need to be taken to meet these liquidity requirements. If these are likely to result in the need to reduce a fund's exposure to other assets it would wish to hold such as equities then alternative strategies ought to be explored. For example, rather than hold a long dated swap it might be better to hold long dated gilts, cash and equity futures for part of the portfolio to achieve a similar result but, perhaps, with a better outcome in respect of collateral requirements. Clearly, the outcome of adopting such an approach needs to be appropriately reflected in asset shares.

9.7.4 If a central clearer is likely to be used then the fund will need a clearing broker to place transactions with the clearer and to manage the collateral arrangements. Firms should address the possibility that the commercial interests of their clearing broker may wish to terminate the arrangement they have with the fund. This can usually be arranged with a relatively short notice period but it could be possible that a replacement cannot be found. In this circumstance any derivatives would be unwound. If these are held for hedging purposes then the risk position of the fund would increase and the solvency of the fund could be jeopardised. This "wrong way risk" can be eliminated if a fund held physical assets for hedging e.g. gilts in the previous example and held its risky assets synthetically such as equity futures in the previous example. This arrangement would result in the fund defaulting to a de-risked position on the termination of a fund's central clearing arrangements ("right way risk").

9.8 Modelling requirements

9.8.1 Compared to an open with-profits fund, a fund in run-off might have a greater need for modelling the portfolio. In particular, there are more considerations in a closed fund for instance due to fluctuations arising from lumpy maturities and guarantee costs, avoiding undue volatility and thus jeopardising the position of the remaining policyholders without the benefit of new business stabilising the mix.

9.8.2 A closed fund also needs greater modelling capabilities in order to be able to flexibly assess various methods of bonus and estate distribution that treat customers fairly. Modelling is likely to be helpful in assisting with the evaluation of different investment and bonus strategies taking account of the particular characteristics of the fund. Asset-liability modelling can identify how large an equity backing ratio is acceptable, now and as the fund runs off, whilst keeping the risk of insolvency within a specified small percentage.

9.9 Credit risk

9.9.1 For with-profits funds that contain any bonds, the credit risk is taken on by the policyholder. Credit risky bonds do not generally exhibit smooth rates of default and instead the back end of the risk can be volatile and lumpy. Credit migration over time will also occur and the asset credit mix will change as the shorter dated bonds mature. This means the relative capital requirements for the fund will increase over time. This might not be the best use of capital for a fund in run-off.

9.9.2 For a fund in run-off, assets might be required to be sold off unexpectedly as the fund runs off and volatility of claims increases. This would make any usage of liquidity premium unjustifiable.

9.9.3 There is no long dated credit option market and hence the only possible alternatives are short dated strategies such as collars but credit derivative strategies also bring along basis risk. Credit default swaps and options on indices exist in the market but the basis risk on these might be too large.

9.9.4 There might be cases where bonds are in the fund to back annuity liabilities sitting in the with-profits fund. Currently it is possible for annuity portfolios to be sold at a discount rate greater than risk free. If this is possible then there is a running cost for with-profits policyholders in not disposing of any saleable annuity portfolios. Such a disposal would also remove longevity risk and remove liabilities that probably exceed the run-off of the portfolio.

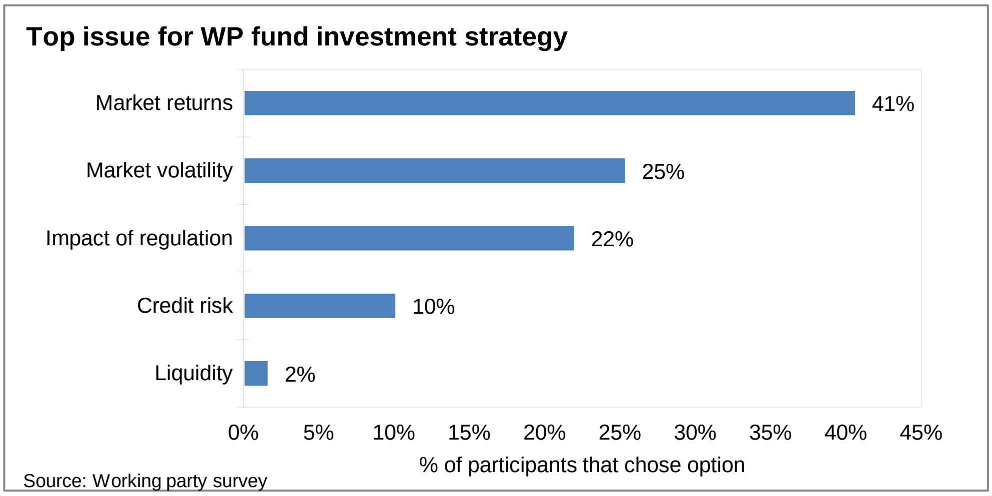
9.10 Other investment issues for funds in run-off

9.10.1 Private equity is not a well-suited asset for a closed fund for a number of reasons. These investments typically have a life of up to 10 years. In the early years these investments require a series of calls for cash and there is no flow back of cash until the later years. In the interim it is difficult to place a reliable value on these investments and buyers can be hard to find if there is a requirement to sell a holding before the planned sale of the investments. Whilst offering good long-term investment prospects these assets would be less suitable for a fund that was divesting faster than any private equity investments that it holds pay off.

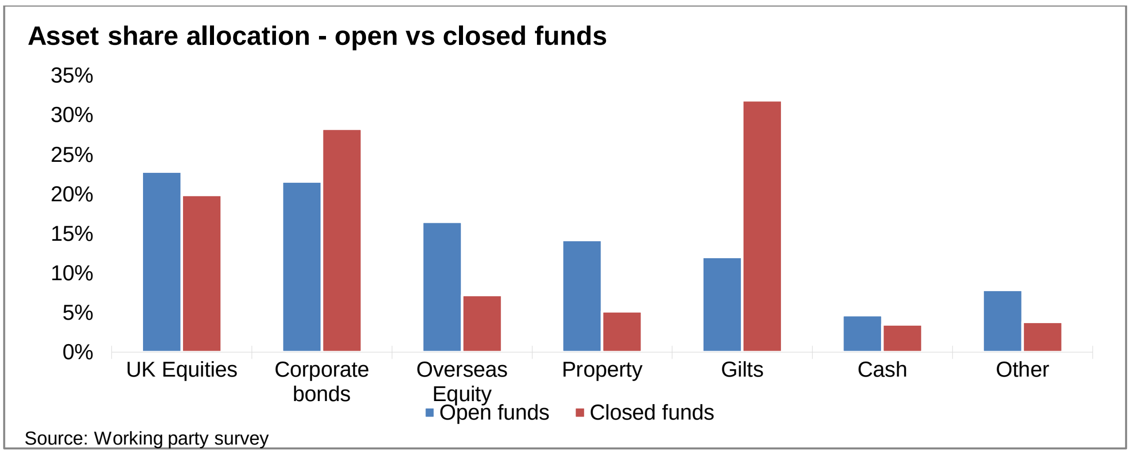
9.10.2 In-house asset management can become disproportionately expensive and consideration ought to be given to outsourcing areas of asset management expertise as each sector loses economic scale. Alternatives are to move to a passive, beta strategy through tracker funds or Exchange Traded Funds (ETFs), or to cut back on sector diversification e.g. overseas equity but this latter approach could be in conflict with policyholders' expectations.

9.11 Insights from the survey

9.11.1 A significant proportion of the respondents (almost one third) in the industry survey stated that they do not hypothecate assets suggesting that funds may be choosing to take more investment risk. This proportion was higher for open funds than closed funds suggesting those with new business are able to take the extra risk as new business allows them to diversify this risk.



9.11.2 In terms of risky assets closed funds appear to favour corporate bonds over equities and property. Funds in run-off also have a much greater propensity to invest in gilts. Closed funds probably invest more in gilts and corporate bonds with lower allocation to property and equity as these might generally have greater level of guaranteed benefits to duration match. The lower property investment suggests that closed funds are mindful of the lumpy/illiquid nature of these holding. The lower allocation to overseas equities is hard to explain. The survey also analysed results for companies based on whether the fund is small, medium or large although the survey analysis suggested that regardless of fund size, companies follow a similar investment philosophy.



10 Investment returns allocated to asset shares

10.1 Introduction

10.1.1 Investment returns are a major element in the accumulation of asset shares. Firms will have working practices which relate the returns earned on the assets of the with-profits fund (or sections of the fund, e.g. the benefit reserve) to the returns allocated to the asset shares. These practices would not necessarily change on closure but it would be expected that a firm would review its investment approach as part of a closure exercise.

10.2 Appropriateness of allocation approach under run-off

10.2.1 The investment strategy adopted would be expected to be reviewed on closure, particularly addressing the appropriateness of the level of the EBR, the amount of property exposure and generally the expected cashflows to be matched. This is discussed further in section 9 in the context of investment strategy. Generally, the approaches discussed there may be looked on as normal financial management processes that do not impact the calculation of the asset share but one of the approaches considered does merit further discussion in this section, see below.

10.3 Hypothecation of investment returns

10.3.1 Hypothecation of assets to different product groups in a with-profits fund is an established practice, with the hypothecation generally having regard to the features of the product group and the moneyness of its guarantees in particular. However, hypothecation in this way may be more attractive to a fund on closure as a means of facilitating a stable run-off of the fund.

10.3.2 The introduction of this approach would be subject to potential PPFM constraints, TCF considerations and conflicts of interest since future asset share returns would be expected to vary within each group.

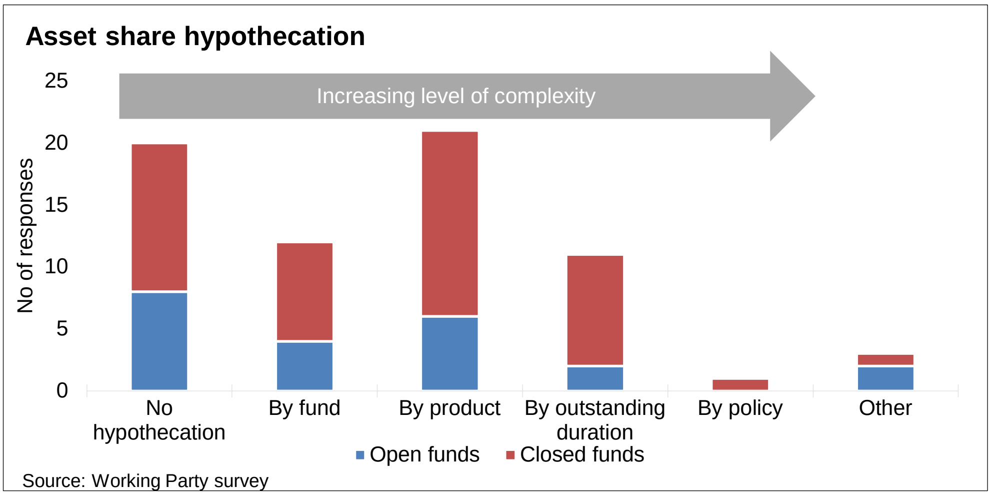
10.3.3 The insurer would also want to consider how easy it is to implement any changes into its relevant systems (e.g. models), and the cost of doing so.

10.4 Insights from the survey

10.4.1 Funds which hypothecate assets disclose the practice in their PPFM. Other funds may have wording in their PPFM which allude to this but others are silent.

10.4.2 The survey confirmed the wide use of hypothecation and also identified a range of metrics being employed, presumably to manage potential conflicts between groups.

10.4.3 There are several different approaches that companies use in hypothecating asset shares varying by complexity.



10.4.4 In the survey, 29% of participants do not hypothecate asset shares. However, this percentage varies between open and closed funds with 36% of open fund participants not choosing to hypothecate with that percentage only being 26% for closed funds. This might potentially suggest that open funds are more likely to take risks in their investment strategy as new business allows them to diversify these risks.

10.5 Tax considerations

10.5.1 Detailed considerations of tax are not considered in this paper, but it is believed that for many funds there will not be a material change in the approach to applying tax to asset shares in the event of closure. However, it would be expected that the value of deferred tax assets within the with-profits fund would need to be re-assessed on the basis that in run-off, they have a reduced value to the fund. However, to the extent that reliefs available to the fund may provide a tax synergy with another part of the firm's business, it may be expected that the with-profits fund would share in some of the benefit obtained.

10.6 Conclusions and recommended good practice

10.6.1 Whilst the allocation of investment returns is not an area that necessarily warrants changes when a fund enters run-off, it is expected that as part of closure some scrutiny would be needed to ensure ongoing appropriateness.

10.6.2 To the extent certain techniques, such as hypothecation, could secure a more orderly or fair run-off of the fund they could be considered. This is subject to wider fairness considerations, such as the nature of cross subsidies between groups and generations of policyholders in the fund.

11 Expense Charging

11.1 Introduction

11.1.1 This section outlines how the management of expenses may be impacted by declining volumes of new with-profits business, and the challenges this will bring to many funds. It draws on the results of the survey, where available, to assess the current state of industry practice.

11.1.2 There are two separate aspects to be considered when attributing and charging expenses to a with-profits fund. First, expenses incurred in managing the with-profits business have to be identified and attributed to the fund. Secondly, once those expenses have been attributed to the fund, they need to be charged to asset shares or borne by the estate in an appropriate manner.

11.1.3 The cost apportionment principles that determine which costs are (or may be) charged to a with-profits fund or other parts of the business or its shareholders will be outlined in the fund's PPFM. The principles will aim to ensure expense allocations are fair between different groups of policyholders, shareholders and different sub-funds where applicable. The principles applied are at the firm's discretion, but will be influenced and / or constrained by a combination of factors, including historic practice, prudential regulation, contractual charges, previous Court Schemes and wider fairness considerations.

11.1.4 A fund in run-off will face a different set of challenges around expense management than a fund able to write material volumes of new business.

11.2 Declining in-force portfolio reduces capacity to spread overheads

11.2.1 On a going concern basis, writing new business represents a mechanism to transfer the support of the estate from the current generation of with-profits policyholders to future generations. The addition of new business to replenish the fund allows overhead costs to be apportioned over a larger policy base. This acts to reduce overhead costs per policy, and thus acts as a mechanism to control unit costs. This is true whether the new business is with-profits or non-profit in nature (ignoring for the moment, any wider issues related to the balance between these classes in a with-profits fund).

11.2.2 Where a fund is closed to new with-profits business, or volumes of business are declining, this represents a challenge for cost control in the fund. In the absence of new business as an inter-generational transferral mechanism and to spread overheads, the declining policy base means policies with longer to run will bear an increasing proportion of overheads over time.

11.2.3 Fixed expenses and large one-off expenses may not be adequately covered by ongoing expense charges, leading to adverse tontine effects and poor policyholder outcomes.

11.2.4 Just as there is the possibility of a tontine effect that longer term policyholders benefit disproportionately from future estate distributions the converse is true in respect of one-off expenses. Serious consideration should be given to some sort of provision for ongoing but unknown one-off expenses as well as one-off costs incurred when closing down a fund e.g. by converting the policies to non-profit.

11.3 Implementing a sustainable solution to control unit costs

11.3.1 For a with-profits fund in run-off, proactive action must be taken to mitigate unit cost increases. There are a few broad categories of action to control expenses within the fund:

a) Outsourcing or other similar contractual arrangement to transfer expense risk to a third party (*);

b) Significant cost cutting activity (*);

c) Merge with another sub-fund in the firm (*);

d) Sale of the business to a third party;

e) New product innovation (with-profits but possibly also non-profit);

f) Restructuring activity e.g. conversion to non-profit, wind-up or unitisation via a Part 26 Scheme of Arrangement or other legal mechanism.

11.3.2 For the points marked (*), the solution may only be temporary, but this will depend on the terms and extent of the specific activity.

11.3.3 In theory, moving from in-house administration and service provision to a specialist third party provider enables a focus on core activities, with potential benefits including cost and efficiency savings, reduced overheads, lower operational risk, staffing flexibility and business continuity. Option a) provides a mechanism to "variablise" expenses and align the cost base with the run-off of the fund by utilising the access to scale synergies of specialist providers. It is probably impossible to fully transfer the expense risk entirely to a third party, particularly in respect of unknown future one-off costs.

11.3.4 Options b) and c) may only serve to delay the increase in per policy costs and asset share charges or the depletion of the estate. Whilst reducing overheads will result in short-term reductions in unit costs, unless the cost base is transformed in such a way that overheads are aligned with policy run-off, ultimately an adverse tontine will emerge. In addition, option c) may not be an effective solution unless the other sub-fund is transacting new business.

11.3.5 Whilst option d) provides a mechanism to access increased scale and spread costs across a larger policy base, on the assumption that the acquirer fund is not writing material volumes of new business, the business will ultimately encounter similar tontine issues, albeit they will be deferred to a later point.

11.3.6 Option e) may be difficult to implement given the apparent unpopularity of with-profits business and constraints on writing new non-profit business in a closed with-profits fund. However, depending on the overall structure of the company, if new (non-profit) business is actively written in other sub-funds of the company the with-profits business may benefit from a "halo effect" in the allocation of overhead expenses and potentially one-off costs.

11.3.7 Ultimately, a longer term solution along the lines of Option f) is likely to be required for closed with-profits funds to avoid future policyholder detriment.

11.3.8 The nature of the arrangements which could be applied to control unit cost is diverse and it is anticipated that the following themes would be found in practice**:**

a) Charges in line with service agreements i.e. agreements whereby expense risk is borne outside the with-profits fund.

b) A proportion of expenses charged to the estate.

c) A proportion of expenses limited by Court Schemes.

d) Future project and other one-off costs only charged to asset shares following approval by the Board.

e) Asset share charges limited to contractual charges (particularly for UWP business).

f) Limiting unit costs so they are in line with other sub-funds.

g) Expense increases limited to RPI.

All of c, e and g are of little value unless there is another party that can pick up any expense overruns

11.4 Insights from the survey

11.4.1 The survey considered how expenses are charged to funds and asset shares across the industry, the prevalence of outsourcing or similar arrangement, and the extent to which costs are expected to be fully absorbed by with-profits funds.

11.4.2 Responses to the survey indicated that, as anticipated (see 11.3.8), dozens of different expense charging mechanisms were in operation across the industry, which is testament to diversity of business and breadth of practice. The survey asked whether funds have arrangements in place to limit expense allocations i.e. in line with option a) above. The majority of funds did have arrangements in place to limit the allocation of expenses to the fund. As might be expected, this was more prevalent in closed funds. It was interesting to note that only one of the closed proprietary funds surveyed did not have an arrangement in place.

11.4.3 Larger funds were more likely to outsource, potentially reflecting an increased ability to negotiate favourable terms with relevant service providers and the availability of in-house expertise to oversee and manage potentially complex arrangements.

11.5 Conclusions and recommended good practice

11.5.1 As might have been expected, the survey highlighted a diversity of practice in the management of the expense base of funds in run-off, perhaps reflecting breadth of historic practice, structural differences between insurers and differing degrees of sophistication.

11.5.2 The survey has pointed out the prevalence of outsourcing activity, and cost control activity in the industry has been widely undertaken. However, these steps alone are unlikely to secure the fair and orderly run-off of funds. An increasing amount of strategic and / or structural change will be required to manage the cost base of funds in the medium term.

12 Charges for guarantees, capital and smoothing

12.1 Introduction

12.1.1 With-profits policies are likely to require significant capital support, especially in the early years, to set up statutory reserves which are likely to be in excess of asset shares. Capital may be required to smooth payouts, and in exceptional circumstances to meet minimum guaranteed payouts, and thus ensure that policyholders' reasonable expectations are met.

12.1.2 With-profits funds often deduct charges from asset share in respect of providing the guarantees under the contract, in order to provide an appropriate return on the capital employed in writing the contract or to build up the capital base.

12.1.3 The charging strategy must be clearly articulated in a plan approved by the firm's Board, described in the PPFM, and should be proportionate to the costs they are intended to offset. Planned deductions should not change unless justified by changes in the business or economic environment, or changes in the fund's liabilities as a result of policyholder optionality.

12.1.4 The guarantee charges could be prospective (e.g. a planned future charge on existing accrued asset shares), retrospective (e.g. a cut in accrued asset shares) or a charge on claims (e.g. includes elements of both prospective and retrospective charging). Fairness is paramount when considering each type of charging regime.

12.1.5 When a fund enters run-off, the changing dynamics of the fund amend the context for guarantee charging, meaning a change of approach may be required to treat policyholders fairly.

12.2 Loss of inter-generational subsidies in guarantee charging

12.2.1 When PPFMs were initially developed, there may have been limited consideration of any inter-generational subsidy of guarantee costs. The increasing sophistication of asset share calculations may have allowed better identification of any potential cross-subsidy effects. Due to a fund's profile changing when it enters run-off it may not be possible to continue any inter-generational subsidies that have historically been in place.

12.2.2 These are more likely to arise where the mix of business in the fund encompasses varying combinations of duration, moneyness of guarantees and historic practices of guarantee charging.

12.2.3 This could be the case if the mix of the business changes in run-off such that a smaller group of policies (with guarantees not biting) may effectively be at greater risk of bearing costs for policies (where guarantees are biting).

12.2.4 This situation could arise where the maturity of large tranches of endowment business leaves a larger proportion of longer-tailed products in the fund, potentially with valuable maturity or annuity rate guarantees.

12.3 Guarantee charging and restrictions from regulation, historic practice or fairness considerations

12.3.1 The amount by which guarantee charges can be increased could be constrained by specific regulations, for example INSPRU 1.1.188R and COBS 20.2. Any charge which levies more than the fair cost of the guarantee could be argued as unfair to the policyholder.

12.3.2 The existence of charge caps in the fund may also restrict the ability to charge the "fair" cost of the guarantee.

12.3.3 There may be circumstances where the estate and amount of capital provided from policyholder charges is insufficient to meet the future needs of the fund. In this case, guarantee or capital charges may need to increase, in order to protect the solvency of the fund and its ability to meet contractual claims.

12.3.4 In a similar manner to the discussion on expense charging, the expected cost of guarantees may or may not be fully met by those policies which gave rise to the cost. It could be met by the estate, or the risk could be pooled across a wider range of policies using an average charging method. Charges levied on policies with in-the-money guarantees will not contribute, as both the intrinsic and time value of the guarantee will be met from elsewhere in the fund. It may be that this will disproportionately affect policyholders in a closed fund, given that the experience is spread over fewer policies.

12.3.5 Where increased charges cannot cover the expected cost of guarantees, further management action may be needed to support the solvency position of the fund, or the inherited estate may need to be used to bear the cost. Closed funds in mutual and proprietary firms will have differing abilities to manage such conflicts, given the ability to provide support to the fund.

12.3.6 In some cases, guarantee charges could be introduced to in-force policies, subject to policyholders' reasonable expectations, and wider fairness considerations.

12.4 Insights from the survey

12.4.1 The survey considered how guarantee charges vary across mutual and proprietary firms, and by size and fund status. This can be used to assess the potential implications of closure set out above.

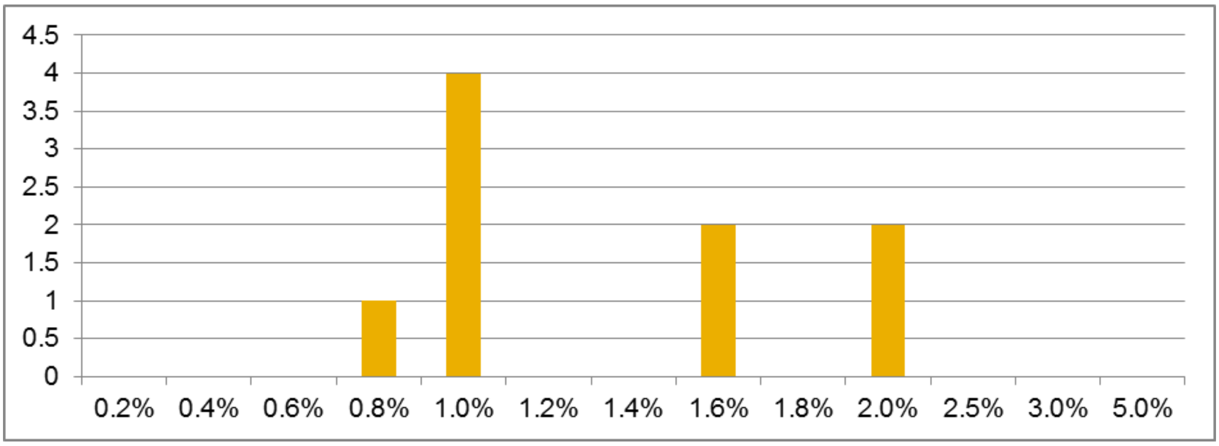
12.4.2 The survey found that less than half of funds explicitly levied charges for guarantees. There did appear to be a difference in philosophy between mutual and proprietary funds, particularly those which are closed. Closed funds in mutual firms were significantly more likely to not levy an explicit guarantee charge. The size of the fund did seem to be correlated to the likelihood of charging for guarantees.

12.4.3 Generally, it is not common practice to charge the full cost of guarantees to asset shares – particularly for closed funds, where there was not a single instance.

12.4.4 Medium and large open funds were more likely to charge the full cost of guarantees to asset shares, compared to small funds. The picture is a little less clear cut for open funds compared to closed funds. This makes intuitive sense, as the estate is expected to be transferred to a future generation of policyholders in open funds, with a more pronounced emphasis on the sustainability and self-supportability of policies.

12.4.5 The qualitative commentary revealed a range of techniques used to assess the cost of guarantees and the method for setting charges, but this did not lend itself to neat categorisation.

12.4.6 Around half of funds surveyed did not impose explicit caps on guarantee charges. For funds which did impose annual caps, the distribution was:



Source: Working Party survey

12.4.7 The level of the maximum annual cap on guarantee charges, which was the most common method, ranged from 0.8% p.a. to 2% p.a. Of the three funds that impose a lifetime cap on the amount of charges deducted, one fund imposes a cap of 5% of asset share, and two have a cap of 25%.

12.5 Conclusions and recommended good practice

12.5.1 Guarantee charging is relatively widespread across the industry, although it is by no means a unanimous practice amongst funds. The survey revealed the following broad themes:

- There did appear to be a difference in philosophy between mutual and proprietary funds for guarantee charging, particularly for funds which are closed.
- Closed funds in mutual firms were less likely to impose charges than proprietary firms.
- The size of the fund did seem to be correlated to the likelihood of charging for guarantees.
- The full amount of expected guarantee costs is not recovered via charges for any of the closed funds surveyed.

12.5.2 The existence of charge caps, most frequently in closed funds, can be interpreted as a step to limit costs borne by policyholders. The circumstances in which these have been imposed will vary across funds, and depend on whether it is only those policies which give rise to the costs which are contributing.

12.5.3 The nature of guarantee charging is likely to require close attention to ensure fair treatment of policyholders as the fund runs off.

13 Charges for risk benefits

13.1 Introduction

13.1.1 Funds typically deduct charges from asset shares to cover the expected cost of providing life cover and any other contractual benefits or options. The changing nature of a fund in run-off may lead funds towards reconsidering their charging strategy.

13.2 Volatility of experience as the volume of business declines

13.2.1 Risk pooling is a fundamental part of the operation of with-profits fund. However, for a fund in run-off the experience is pooled amongst a declining policy base, leading to statistical volatility. A fund should be aware of where the experience is expected to become more volatile over time, and manage the volatility or allow for the implications when exercising discretion. Charges to asset shares from insurance risks (e.g. mortality charges) may diverge from actual experience as the fund runs off therefore creating volatile miscellaneous surpluses which will need to be fairly distributed.

13.2.2 This could be smoothed by the fund, but the capacity to do so may reduce over time. Reinsurance of risk benefits would be one possible course of action for funds facing this situation, particularly those without the ability to absorb adverse experience via the estate.

13.3 Quality of data on an aging book

13.3.1 The natural course for a fund in run-off is for the average age of policyholders to increase over time. An extension of this is that risk charges will also trend upwards. Risk charges as a proportion of asset share will increase meaning the consequences of mis-estimation are larger.

13.3.2 The existence of gone-away policies exacerbates this impact. A proportion of the book may have reached advanced ages where it is increasingly unlikely that the policyholder is alive. It is possible the cost of life cover may have substantially eroded the value of the policy.

13.3.3 Funds may write off the liabilities for these policies over time but the risk of mis-estimation remains, and the capacity of the fund to absorb any strain without any impact on policyholder payouts diminishes over time.

13.4 Insights from the survey

13.4.1 The survey highlighted a range of approaches in a qualitative manner. The general theme running through the responses was that charges were set with reference to experience. There was some divergence in practice, such as maintaining fixed deductions over the lifetime of the contract (and hence not updated with emerging experience), or using pricing assumptions.

13.4.2 The survey asked whether the approach to determining asset share charges for risk benefits would change over time. The responses indicated there were no changes envisaged across the industry.

13.5 Conclusions and recommended good practice

13.5.1 The survey results did not point to any imminent change in the management of risk charges in response to run-off. One possible explanation could be that the tail end of run-off has generally not been reached, and so funds are currently sizeable enough for the existing approaches to fairly charge for the risks.

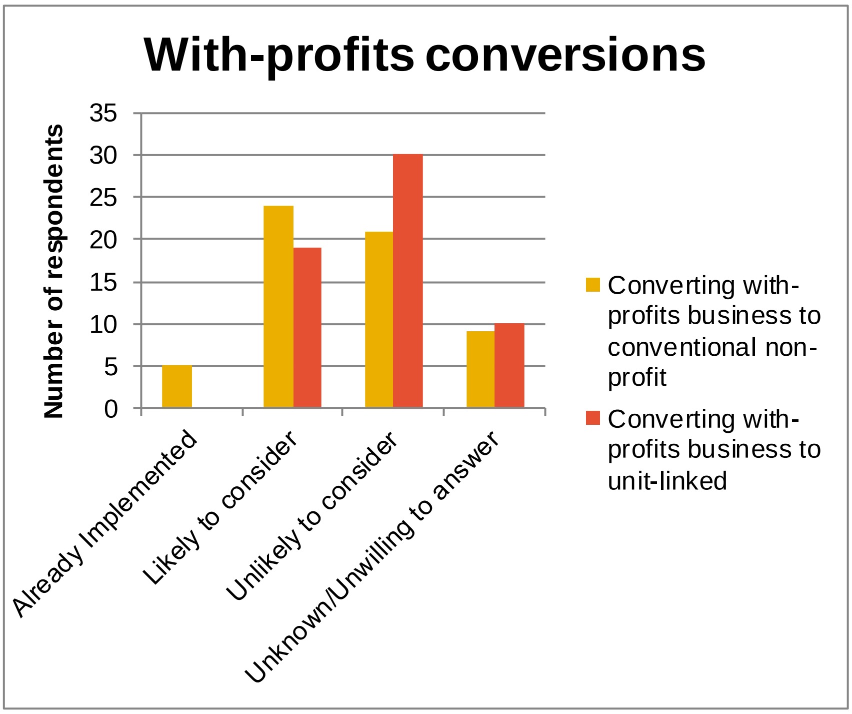
13.5.2 It is expected that management of these charges will warrant increased attention and focus in the medium term.

14 Converting a with-profits fund

14.1 Introduction

14.1.1 At some point, it becomes appropriate to consider winding up a with-profits fund. This section covers conversion of a with-profits fund into a non-profit structure, which may be to either a conventional non-profit or a unit-linked format.

14.1.2 While relatively few funds have converted to date, conversions will become more prevalent as with-profits business in the United Kingdom continues to mature. In the survey, firms were asked whether they had converted one or more with-profits funds already, or whether they planned to do so within the next ten years. The responses are shown below.



14.1.3 Descriptions in this section relate to conversion carried out within a proprietary life insurance company containing a single with-profits fund and a single non-profit fund, with all the policies and assets within the with-profits fund transferred to the non-profit fund and the with-profits fund being subsequently dissolved.

14.2 Rationale for converting of a with-profits fund

14.2.1 In some circumstances a company may be required to convert a with-profits fund under certain conditions, such as where a pre-existing court scheme requires a with-profits fund to convert once its size falls to a defined level.

14.2.2 More generally, as a closed with-profits fund declines in size, various issues can emerge that may be best addressed through dissolving the fund and replacing its policies with either conventional non-profit or unit-linked policies.

14.2.3 Some examples of the issues that may emerge are as follows:

14.2.4 Investment management expenses and concentration risk

14.2.5 As a fund decreases in size, it can become increasingly expensive to maintain its investment strategy.

14.2.6 For funds using direct asset holdings, maintaining an acceptable level of concentration risk within the same overall asset strategy will typically involve ever smaller individual asset holdings and proportional increases in investment management costs. This may be addressed by holding larger proportions of assets for which concentration risk is viewed as less important, such as gilts. However, while such a change may permit larger holdings of assets and lower ongoing asset management costs, the investment potential of the fund would be reduced.

14.2.7 Some funds may be able to use collective investment arrangements rather than direct asset holdings and incur lower costs due to spreading of investment costs across all the holders of the collective investment arrangement. Collective investment arrangements may not be suitable for all funds. In particular, an existing collective investment arrangement is unlikely to be suitable for a fund that closely aims to duration match its assets and liabilities. Establishing a new dedicated collective investment arrangement for such a fund would leave that arrangement and hence the fund exposed to the same expense and concentration risk issues faced by a fund that uses direct asset holdings.

14.2.8 Overhead expenses

14.2.9 Appropriate governance and management of a with-profits fund, including maintaining a segregated asset pool for the fund, involves some costs that are not fully variable with fund size. These costs can become disproportionate for small funds.

14.2.10 Uncertainty of smoothing and guarantee costs and tontine risks

14.2.11 Smoothing is a particularly attractive feature of with-profits business, which shields policyholders from short-term market fluctuations and reduces the volatility of policyholder payouts.

14.2.12 However, when a fund becomes very small, its persistency experience becomes more volatile. Maintaining the historic smoothing approach in such a situation can result in smoothing costs becoming increasingly unpredictable. In extremis, considering a simple 100:0 fund that has only two policyholders, smoothing costs of the penultimate exit would be entirely borne by the final policyholder; the final policyholder sees increased benefit volatility but receives no compensation for this.

14.2.13 Smoothing costs may be reduced by more closely aligning payouts and investment returns, for example by reducing the level of smoothing offered or by moving to more stable investments. The former may be seen as reducing a key with-profits benefit, and making payouts closer to those that would result from a unit-linked policy, which may run contrary to policyholders' reasonable expectations. The latter may materially reduce the investment potential of the fund.

14.2.14 Prudent smoothing reserves may be established to shield longer-staying policyholders from increased volatility of smoothing costs. Prudent reserves, however, are likely to result in the redistribution of wealth away from near-term exits and towards longer-staying policyholders and thus create a tontine effect.

14.2.15 Where material guarantee risks exist, guarantee reserves may need to be increased to reflect the greater uncertainty of future experience associated with a small population. Similarly to the provision of increased smoothing reserves above, this is likely to create a tontine effect.

14.3 Mechanisms for converting with-profits policies

14.3.1 With-profits features are described in policyholders' terms and conditions, which form the contractual relationship between policyholders and the insurance company.

14.3.2 When seeking to convert with-profits contracts, three methods are generally available for implementing the necessary changes to these contractual terms.

14.3.3 Conversion through a Scheme of Arrangement

14.3.4 A Scheme of Arrangement is a court-sanctioned voluntary agreement between a company and its creditors, governed by part 26 of the Companies Act 2006. In the case of a conversion, the creditors are the relevant with-profits policyholders.

14.3.5 The key aspect of a Scheme of Arrangement is that policyholders vote en masse on a conversion proposal and, if sufficient votes are received in favour, the proposal is effected for the fund as a whole. All its policies are converted, whether owned by policyholders who voted in favour, policyholders who voted against or policyholders who did not vote.

14.3.6 The threshold for voting approval is more than 50% of respondents by number and 75% or more of respondents by value. Non-respondents are ignored when determining whether these thresholds are satisfied.

14.3.7 Where a proposed Scheme of Arrangement affects all policies in the fund in similar ways, all the fund's policyholders belong to a single voting class and the proposal can be implemented based on the fund's population as a whole.

14.3.8 Where different groups of policyholders would be affected in different ways by a proposed Scheme of Arrangement, distinct voting class are established and the proposed Scheme can only be implemented for the fund as a whole if each voting class satisfies the 50% / 75% thresholds described above. Schemes can be designed so that each voting class converts or not depending on its own votes; however, conversion of some voting classes will leave a smaller residual fund for which the small fund issues described in the section above may be exacerbated.

14.3.9 A Scheme of Arrangement involves a first court hearing at which the proposed conversion is considered. Typical inputs to this court hearing are a description of the proposed Scheme, reports from an independent expert (usually an actuary), the relevant actuarial function holder(s) and with-profits actuary(actuaries) as well as non-objection from the Prudential Regulation Authority and Financial Conduct Authority.

14.3.10 Advice from the independent expert and the with-profits actuary usually falls under the scope of the transformations technical actuarial standard, which requires consideration of: any material changes to policyholder cashflows; the extent of any potential reduction in policyholder benefits; the potential for any change in the likelihood of receipt of payments; the circumstances in which the benefits of groups of policyholders would be adversely affected; and the quantifiable advantages which might be gained by any groups of beneficiaries.

14.3.11 Assuming the first court hearing is successful, a policyholder mailing is carried out explaining the proposed conversion and asking policyholders to vote on the proposal. A policyholder meeting is also held; any policyholders attending this meeting are able to change their vote from that (if any) they submitted previously.

14.3.12 If the voting thresholds are met, then a second court hearing can be held to approve the Scheme.

14.3.13 Conversion as part of a Part VII transfer

14.3.14 A Part VII transfer is a court-sanctioned legal transfer of some or all of the policies of one company to another, governed by Part VII of the Financial Services and Markets Act 2000.

14.3.15 A Part VII transfer can incorporate a conversion of one or more of the transferring with-profits funds, or it can set size thresholds at which one or more of the transferring with-profits funds may be subsequently converted without the need for further court approval. These thresholds may comprise both an optional conversion threshold and a (smaller) mandatory conversion threshold.

14.3.16 No voting process is required; if the court approves a Part VII transfer that incorporates a conversion of a with-profits fund, the entire fund is converted according to the provisions of the Part VII transfer.

14.3.17 As there is no voting process, the court needs expert advice to ensure that the terms of the proposed conversion are appropriate for policyholders. In practice, this is usually supplied through the same reports as would be appropriate for a Scheme of Arrangement as well as non-objection from the Prudential Regulation Authority and Financial Conduct Authority.

14.3.18 Conversion with Individual consent from policyholders

14.3.19 Either of the above mechanisms may include an opt-out arrangement where each policyholder is given the choice to remain in the with-profits fund rather than convert.

14.3.20 Conversions without a Scheme or a Part VII transfer are possible. For example, an insurance company may write to each of the policyholders within a with-profits fund offering them the choice of keeping their existing contract or converting it to an alternative such as a conventional non-profit contract. Only those contracts where policyholders agreed to the conversion would convert; contracts would remain unchanged in respect of those policyholders declining the offer or any non-respondents.

14.3.21 Voluntary arrangements such as these can be a useful mechanism for some issues that may face a with-profits fund. One such example may be offering enhanced transfer values for policies with guaranteed annuity options where the with-profits fund can only afford to maintain a defensive investment strategy. Such an enhancement may be affordable due to the release of onerous reserves and / or capital requirements faced by the with-profits fund, and the replacement policy may offer the policyholder more investment potential.

14.3.22 However, voluntary arrangements are often unsuitable for resolving issues faced by a small with-profits fund. Not all policyholders will respond in favour (or some policyholders will opt out), leaving a (possibly much) smaller with-profits fund. The small fund issues discussed in the preceding section may well have been exacerbated by the reduction in the fund's population, and thus conversions with individual consent may often be unsuitable mechanisms for resolving small fund issues.

14.4 Post-conversion structure

14.4.1 Conversions may be to a conventional non-profit or a unit-linked structure and the remainder of this section outlines some factors that should be considered when deciding which structure is more suitable.

14.4.2 A key aim in most circumstances should be that any change in the balance of risks versus reward for policyholders should be acceptable. Conversions that maintain the mean level of reward while reducing risk, or that increase the mean level of reward for little additional risk, are likely to satisfy this criterion. A conversion with a reduction in the mean level of reward may also be acceptable as long as there is a commensurate reduction in risk. In particular, converting to conventional non-profit policies will normally eliminate risk in respect of maturity and death benefits, and may justify some reduction in expected returns.

14.4.3 Policyholders need to be able to understand the implications of a conversion and it may be easier to explain these implications where benefits post-conversion follow a similar structure to those pre-conversion. As such, there may be a natural preference for converting a conventional with-profits fund to a conventional non-profit structure and a unitised with-profits fund to a unit-linked structure. A possible simplistic explanation of the former may be that the variable bonus levels currently received will be replaced by a fixed level of "bonuses", and of the latter that the unit price will no longer be the smoothed price determined by the company based on the performance of the with-profits fund, but instead by the market value of the unit funds in which the policy is invested.

14.4.4 Unless all of the converting with-profits policies have guarantee levels relating to basic with-profits benefits that are well out-of-the-money, it may be judged necessary to include a similar level of guarantees on the converted policies. While this will normally occur naturally if converting to conventional non-profit policies, including a guaranteed underpin on unit-linked policies may be complex to manage and capital-intensive. Such guaranteed underpins may be more efficiently managed within a with-profits format than within a unit-linked format.

14.4.5 Other policy features transferred intact as part of the conversion may be easier to manage within one format rather than another. For example, the cost of guaranteed annuity options may be more predictable, and those options easier to hedge in an acceptable manner, within a conventional non-profit format rather than a unit-linked format.

14.4.6 Any additional administrative complexity resulting from the conversion is likely to worsen the conversion terms, either for policyholders if the cost is fully allowed for in the conversion basis, or for shareholders. Cost disadvantages may be reduced or avoided by converting to products that already exist within the company, or using existing unit-linked funds if converting to a unit-linked structure.

14.5 Determining the level of post-conversion benefits

14.5.1 As part of the conversion, all the assets in the fund will normally be put towards purchasing post-conversion benefits on an agreed pricing basis.

14.5.2 Asset adjustments

14.5.3 A deduction from the fund's assets would normally be appropriate for the costs of conversion. Where a conversion occurs when a fund is very small, the costs may appear disproportionate when spread across the very low numbers of policies remaining. Establishing conversion cost provisions well before this point is reached may be viewed as spreading the cost of conversion more equitably across the fund's policyholders. If no such provisions have been established, the company may feel it necessary to cover some of the costs of conversion.

14.5.4 A deduction from the fund's assets would normally be appropriate in respect of any share of future bonuses that the shareholder may be entitled to. Where the conversion reduces mean returns received by policyholders, this deduction should be reduced commensurately.

14.5.5 The value placed on the fund's assets should include the value of future profits in respect of any non-profit business currently residing in the with-profits fund.

14.5.6 An appropriate valuation basis will need to be set in relation to any taxable losses existing within the with-profits fund at the point of conversion.

14.5.7 Pricing basis

14.5.8 A valuable starting point for the pricing basis is one set using the company's normal pricing approach, if one exists for the post-conversion benefits being established. However, various adjustments should be considered.

14.5.9 The premium basis should normally provide shareholders with appropriate compensation for the risk they are taking on, but it may be inappropriate to include additional profit margins over and above that amount.

14.5.10 A company would normally expect to make some expense savings as a result of a conversion and a decision needs to be made as to whether these are retained by shareholders, passed on to policyholders or shared. Where a with-profits fund is currently being charged less than the normal incurred level of expenses such that the shareholder is making expense losses, it may be judged appropriate for the shareholder to retain the expense benefits.

14.5.11 Costs of capital may be viewed as largely invisible within a strong with-profits fund, where the inherited estate is adequate to cover an appropriate level of capital requirements. As a conversion distributes the fund's inherited estate, this loss absorbency is no longer available after conversion with the implication that the conversion reduces the company's excess capital. A charge for this additional frictional cost of capital would normally be appropriate.

14.5.12 The investment returns assumed in the pricing basis will normally reflect the choice of investments used to back the post-conversion liabilities. This choice is particularly material for conversions to conventional non-profit business. In the case of conversions to conventional non-profit, the lack of loss absorbency and capital requirement considerations may make maintenance of the same asset mix as used within the with-profits fund unviable. In particular, it may be difficult to maintain any equity backing ratio.

14.5.13 Having determined a theoretical pricing basis, adjustments may be required to ensure any change in the balance of risks versus reward for policyholders is acceptable.

14.6 Conclusions and recommendations

14.6.1 The conversion of the business of a small and declining with-profits fund to conventional non-profit or unit-linked policies could well prove beneficial for both the affected policyholders and the firm. The conversion would most likely serve to reduce the costs of maintaining the business and would reduce potentially volatility of policy benefits, providing greater certainty for policyholders.

14.6.2 However, unless conversion is permitted under an existing court scheme that applies to the fund, the conversion of the with-profits policies to conventional non-profit or unit-linked policies would require a court process to be followed, which, unless there were other issues that could be addressed via the same process, could prove to be both time consuming and costly. Such time and costs would most likely, by definition, seem excessive for a small fund.

14.6.3 Given this, it is recommended that the regulator give consideration to extending the regulatory framework so as to permit with profits firms to take steps to rationalise and simplify their with profits portfolios in a timely and fair manner but without requiring costly and time consuming legal processes.

15 Conclusions and recommendations

15.1.1 The management of with-profits funds in run off is a complex area and has implications for both policyholders and the firm. Actions previously taken and events of the past will influence how the fund is managed in run-off, in particular, past practice, communications to policyholders and any Scheme rules. With profits funds in run-off need to be carefully managed so that conflicts of interest are recognised and dealt with, and so that policyholders are treated fairly.

15.1.2 The authors hope this paper, as well as providing insights, can stimulate debate on the management of with-profits business in the future.

15.1.3 Areas identified within this report as important for good practice include:

(i) The alignment of the capital management and practice of with-profits funds with risk appetite and estate distribution strategy.

(ii) Clear communication of management actions to all stakeholders, including the Board and policyholders.

(iii) The avoidance of complex management actions within actuarial models which would not be applied in practice.

(iv) Consideration within the risk appetite framework of the fund of all different stakeholders.

(v) A clear analysis of different estate distribution options and their effect on the fund, different policyholders and shareholders.

(vi) Strong governance, including the With-Profits Actuary and With-Profits Committee, as well as the firm's governing body.

(vii) Appropriate management of conflicts of interest, which is likely to include open discussion of areas where conflicts of interest arise.

(viii) Improvements in customer communications, which should lead to better engagement between companies and their customers.

(ix) Improvements in regulations, to allow companies more freedom to communicate with their customers in a more engaging and creative way.

(x) Regular review of bonus strategy as the fund evolves, including ensuring the appropriate data and systems are in place to manage the fund in the long term.

(xi) Regular review of investment strategy, including consideration of hypothecation of assets, to ensure investment strategy remains appropriate.

(xii) Strategic and / or structural change to manage the cost base of funds.

(xiii) Management of guarantee and risk benefit charging to ensure fair treatment to policyholders as funds run-off

(xiv) More tools will be needed for firms to manage funds as they get small.

15.1.4 It is recommended that the regulator give consideration to extending the regulatory framework so as to permit with profits firms to take steps to rationalise and simplify their with profits portfolios in a timely and fair manner but without requiring costly and time consuming legal processes.

15.1.5 Developments which are likely to affect the management of with-profits funds discussed in this report include the implementation of Solvency II, particularly in whether it forces a more common definition of the estate, and the development of hedging strategies to manage risk in funds in run-off.

15.1.6 Behavioural Economics clearly has insights to offer in the management of with-profits funds, as well as in other areas. A working party has recently been established to look into behavioural economics as it impacts the actuarial sphere.

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17 References and Further Reading

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