The Actuarial Profession
making financial sense of the future

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The Changing Landscape of With-Profits Business

Session A10

21 November 2011

Agenda

Change in regulatory landscape
- Gender directive
- RDR
- CP11/05

Implications of Solvency II
- What is changing?
- What does that mean?

Impact on customers
- Benefit expectations
- Service levels

Future of with-profits
- From firms' perspective
- From market perspective

Change in regulatory landscape

Test Achats gender directive

Key change is:

- No discrimination permitted in benefits and premiums charged to retail customers

Implications on WP funds are:

- Big issue is whether the terms attaching to options and guarantees in existing WP products might need to be amended post-2012 when they might otherwise lead to new policies (e.g., a new annuity in payment) on gender-specific terms
- Firms will need to reprice new business so that a common set of rates are used for both genders
- Probably little else specifically — but waiting for Commission guidance that is expected by end of year, as well as consultation from HMT on transposing judgment into UK legislation — we expect this to define what constitutes a ‘new contract’

Retail distribution review

Key changes are:

- Providers may not pay commission for advised sales; advises determine their own adviser/consultancy charges, which are payable through product or direct. Initial and ongoing services. Pure protection excluded
- All non-independent distribution will be labelled ‘Restricted.’ Panels?
- Intermediaries are adaptable, but likely to squeeze remuneration

Implications on with-profits funds are:

- Moving to Restricted advice may become attractive/compelling
- Products targeted at specific customer segments attractive
- More competition from advised and non-advised collectives
- For new contracts, firms need to reprice product lines without commission allowances for advised business — might lead to closure of legacy products?
- For existing business, advice given post-RDR to top up the contract would be subject to adviser charging (=> new contract with different charging structure to the original?)

CP11/05 — Background

- With-profits regime review of COBS 20 rules in H1 2010. Key concerns:
  - Effectiveness of governance
  - Policyholder communications
- Reattributions
  - Review of reattribution process — where it worked well and where there were concerns
- Subjects covered within CP11/5
  - The rights of with-profits policyholders
  - Charges to the fund
  - Management and run-off plans
  - Writing new business
  - With-profits committees and governance
  - Strategic investments
  - Fund closure and run-off plans
  - Other topics

CP11/05 — The rights of with-profits policyholders

Key issue here:

- To restate FSA view of with-profits policyholders' interests

Feedback:

- Narrow v. broad view
- Mutuals v. proprietary funds
- Variety of flavours of mutuality
- Types of conflicts of interest

Comment:

- Continue to take the view with individual firms that policyholders' interests are more extensive than an expectation of pure asset share and will continue to discuss how this might impact on individual firms

CP11/05 — Charges to the fund

Key changes proposed:

- Firms must only charge costs incurred to with-profits business
- Includes look-through of any intra-group service company costs
- Policy intent here was to stop firms distorting the 90:10 gateway by charging excess profits through in-house service charges

Feedback:

- Unfair if transferring risk
- Could be a disincentive to maintain with-profits funds
- Establishing fairness via 'benchmarking' may be more appropriate

Comment:

- Recognise the long-term nature of costs recovery
- The usefulness of formula-based charging structures
- The problems with benchmarking
- Want to avoid unintended consequences for in-house asset managers and for mutuals

CP11/05 — Management and run-off plans

Key changes proposed:

- Distribution plan: Demonstrate how the firm will ensure a fair distribution to with-profits policyholders
- Management plan: Demonstrate how the firm intends to deal with risks associated with a significant and sustained fall in new business volumes
- Early discussion with FSA on updated plans when volumes drop substantially

Feedback:

- Largely reasonable development, but an extra burden?

Comment:

- Policy intention is to formalise current business planning, not to create new burdens
- Interaction with SII and ORSA requirements under review

CP11/05 — Writing new business

Key changes proposed:

- Policy intent here was to have a subtle shift away from small losses being acceptable, so as not to disadvantage the prospective entitlements of current with-profits policyholders

Feedback:

- New business strain unavoidable, but will the new business deliver a profit?
- Or is it a slow drain on the estate?

Comment:

- Consideration being given to what clarification can be provided in this area and the period over which profitability should be considered

CP11/05 — With-profits committees and governance

Key changes proposed:

- Policy intent is to ensure that boards and governing bodies in firms receive good advice
- With-profits committees provide focus and give appropriate level of challenge, but broader interests can influence final decisions, outcomes. Reasons need proper recording

Feedback:

- Concerns expressed about WPA proposals because of position within firms
- Variety of view on threshold requirement for a with-profits committee

Comment:

- Guidance on conflicts of interest could be reviewed to see if it can be made less prescriptive
- Continue to look at the issue of when a WPC instead of an independent person is more appropriate

CP11/05 — Strategic investments

Key changes proposed:

- Management must satisfy itself that a strategic investment is likely to have no adverse effect on with-profits policyholders

Feedback:

- Wide variety of views expressed, particularly by mutuals
- Firms argued that these were in the interests of their membership

Comment:

- Strategic assets deserve special focus and need justification
- Likely to review the definition and some of the proposed guidance

CP11/5 — Other issues

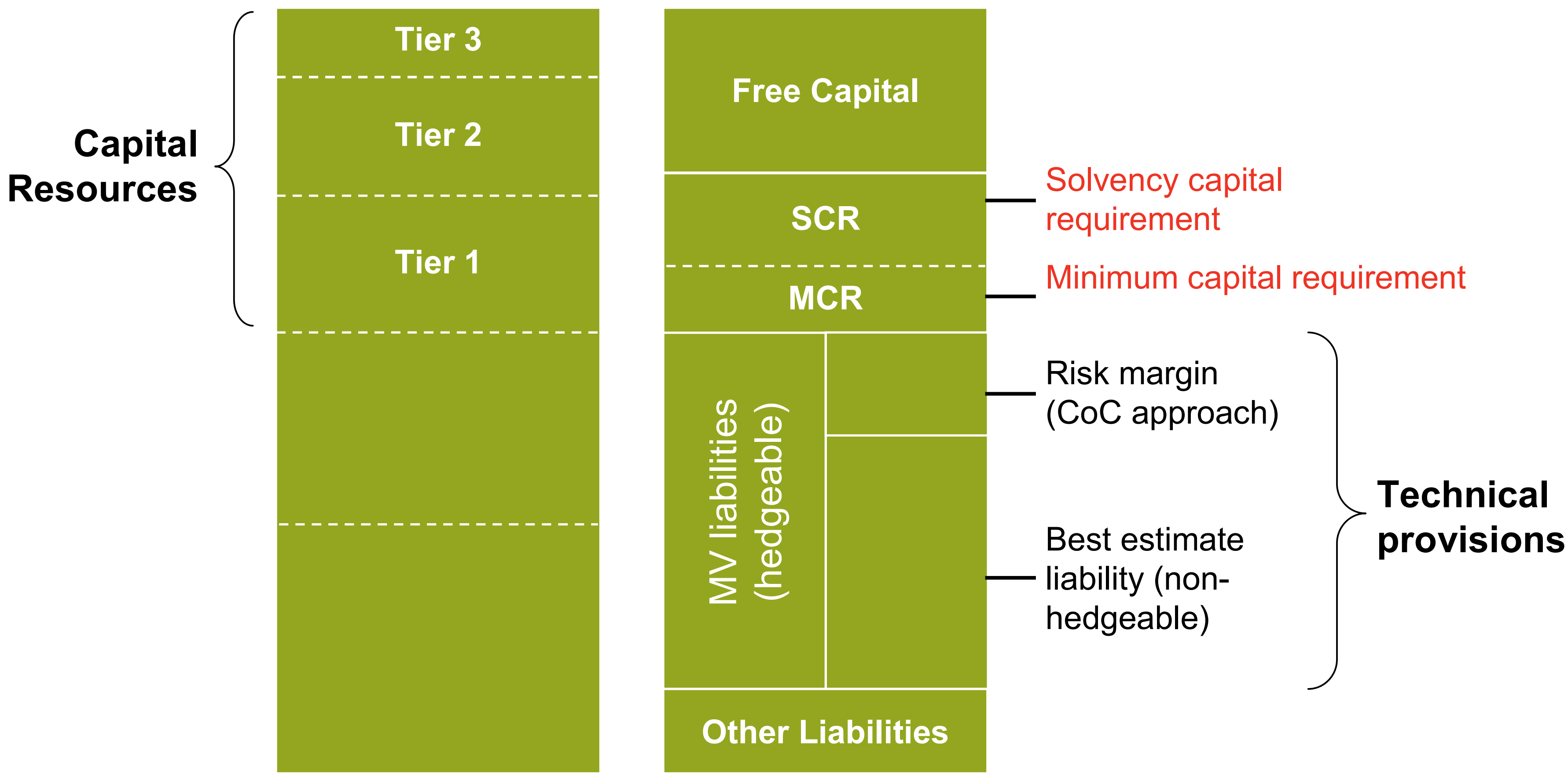
- Fund closure and run-off plans
  - General support that it would be sensible to extend to pre-2005 closures
  - But will look at what parts of these are appropriate to already closed funds and over what timescale they should be produced
- Market value reductions
  - General recognition that firms should be able to manage their liquidity risk

Next steps

- Policy statement planned for Q1 2012, probably February — but may not resolve all issues
- Other COBS 20 changes in the Solvency II CP2 (COBS 21 changes and other issues with CP1 in Q4)
- CP on communications issues with with-profits customers at some stage. The FSA is not satisfied with policyholder communications — there are significant weaknesses in what firms are doing to ensure that policyholders receive sufficiently comprehensive, timely and clear information

Implications of Solvency II

Solvency II pillar 1 — Basic structure



How did your main with-profits fund solvency ratio compare to ICA results?

1. Much improved (>120%)
   6%
2. A little improved (105%< x <120%)
   6%
3. Broadly similar (95%< x <105%)
   31%
4. A little worse (80%< x <95%)
   31%
5. Much worse (<80%)
   13%
6. Do not know
   13%

Capital management

Asset Management

- Increased asset hypothecation
- EBR and credit risk reductions
- Implementing lifestyling
- Reducing holding in direct property
- Sophisticated ALM and dynamic hedging techniques
- Alternative assets (derivatives, increased o/s investment…)
- Managing liquidity in decline
- Asset share shorting
- Conversion to non-profit

Liability Management

- Restricting buildup of guarantees
- Pace of estate distribution
- Changes to smoothing policy
- Removal of past discretionary enhancements/profits
- Use of guarantee charges
- Increased use of reinsurance
- Longevity swaps

Cost Management

- Outsourcing
- Process improvements
- Alignment of systems and methods across funds

Management actions

- Changes may be enforced by removal of Peak 1
- More formal, documented and challenged
- Required to assess whether they are objective, realistic and verifiable

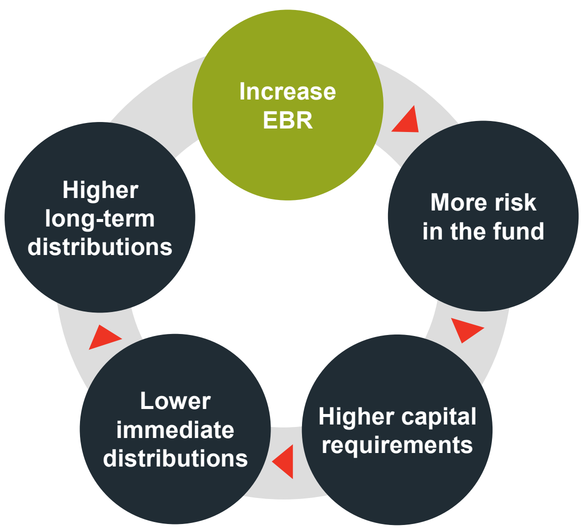
Objective	Realistic	Verifiable
• A clear plan of what, when, how and by whom • Board and WPC sign-off • Backtesting controls • Reporting procedures	• Reflect market conditions at that time • Reflect commitments to p/holders and supervisors • Be consistent with current principles and practices and SCR • Should not overstate their value	• Sufficient evidence that management actions are objective and realistic

There is an opportunity to review management actions in the light of revised solvency position and risk appetite arising from Solvency II

Distributions

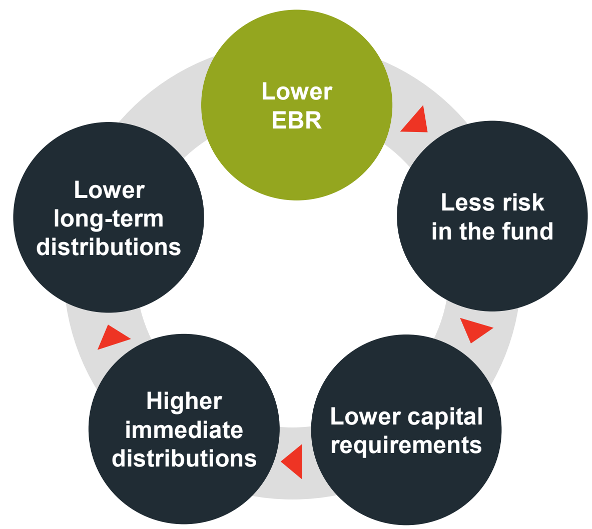
- Address fast run-off
- Avoid a 'tontine'

- Maintain sufficient capital
- Minimise risk



'Favours' Longer-Term Policies

Investment policy can create a real intergenerational tension…which cannot be reversed as fund runs off



'Favours' Shorter-Term Policies

Impact on customers

What do customers care about?

- What they get back
- Seeing their benefits grow
- How they are treated

Who pays?

What is TCF

?

Protect dividends against higher capital consumption

Avoid reduction in future benefits

Future of with-profits

Segregation of the FSA

The FSA is to be split into:

- The Prudential Regulatory Authority (the PRA) and the Financial Conduct Authority (FCA)
- First outlined in ministerial speech at Mansion House in June 2010
- More details provided in draft Bill, which laid out the proposed legislative framework published with HM Treasury's June 2011 White Paper: *A new approach to financial regulation: the blueprint for reform*
- Depending on legislation, expected to be effective by end 2012
- Sees the prudential regulation of life assurance firms under the control of the PRA
- Conduct regulation to be undertaken by the FCA

Segregation of the FSA

More details of how the Prudential Regulation Authority intends to carry out insurance supervision in future were published in June. See:

http://www.fsa.gov.uk/pubs/other/pra_insurance.pdf

Also published by the FCA in June was a similarly entitled document: *Approach to Regulation*

http://www.fsa.gov.uk/pubs/events/fca_approach.pdf

Firms' perspective

- Continued decline, greater consolidation
- Specialist knowledge and corporate history will become scarcer
- Little capacity to generate estate growth
- Stronger and more active risk management…
- … but maybe still separate regulatory and internal balance sheets

Market perspective

- Out of favour — customers, media, financial advisors (FSA)
- With-profits “brand” discredited — anyone for a mortgage endowment?
- Tax disadvantageous (personal taxation and now loss of I-E on protection business)
- Not transparent
- Attractive alternatives available
- RDR
- Limited new product innovation
- Little savings anyway

New business volumes have continuously fallen over the past decade

The changing landscape of with-profits business

For the avoidance of doubt, nothing that you have seen or heard in what Stuart said in this presentation constitutes guidance by the FSA.

Questions or comments?

Expressions of individual views by members of The Actuarial Profession and its staff are encouraged

The views expressed in this presentation are those of the presenter