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An ALM "Win-Win" for With Profits Customers and Shareholders

Douglas Morrison, Standard Life
Nick Sinclair, Standard Life

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The transaction – what and why

Under an existing longevity swap i.r.o. a £3.5bn annuity portfolio, Standard Life's WP fund makes fixed monthly payments to the Proprietary fund in return for the actual annuity outgo.

This transaction commutes those monthly payments from the WP fund.

Win/Win:

- The WP fund pays a single premium that is less than the assets it holds to meet the schedule of payments. This **crystallises value for the WP fund** above the current value of this business to the fund while **not increasing its risk profile**.
- Shareholder capital is available in the Proprietary fund to seek **higher risk-adjusted returns** on the assets required to meet these liabilities.

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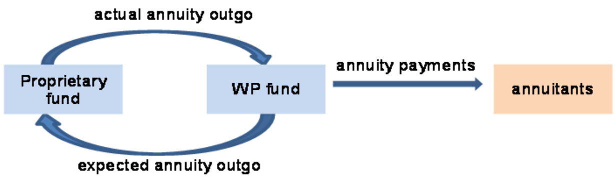
- Background
- WP fund considerations
- Commercial considerations
- Governance and Regulators

Background – the annuities

- At demutualisation in 2006 Standard Life's WP fund included a £12bn portfolio of Immediate Annuities in payment.
- Longevity risk was transferred to shareholders; investment risk was retained by the WP fund.



- In 2008 £6.7bn of the portfolio was reinsured to Canada Life in a single premium transaction, crystallising value for both the WP fund and shareholders.
- As at 31/12/2013 the remaining liability was c£3.5bn.

Background – the WP fund

- Investment profit/loss on annuities falls to WP policyholders via estate.
- The demutualisation scheme requires WP fund investment strategy to be set by reference to a notional mutual company with a defined amount of capital.
- So more investment risk in annuities ➔ less risk in WP asset shares
- We fully use the fund's capacity for investment risk for the direct benefit of policyholders through WP asset shares.
- Annuity longevity swap outgo backed by 100% gilts.

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How could the WP fund extract value from the annuities?

- More efficient risk-free strategy
- Another reinsurance deal
- Transaction with Proprietary fund
- Other ?

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Transactions in the WP fund

SL may enter into any Related Transaction provided that it is on terms which …. are unlikely to have a material adverse effect on the interests of the holders of WP Fund With Profits Policies.

If a Related Transaction includes the making of a loan to a connected person using assets in the WP Fund ….it may be effected if the loan:

- *will be on commercial terms;*
- *will be, in the reasonable opinion of the Board, beneficial to the holders of WP Fund With Profits Policies; and*
- *will not, in the reasonable opinion of the Board, expose such Policyholders to undue credit or group risk.*

***Related Transaction**: a material transaction or arrangement entered into by SL (on behalf of and to the account of the WP Fund) with any other SL Fund, with any other person, or which otherwise affects the property or liabilities of the WP Fund.*

Demutualisation Scheme para. 35

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Commercial Considerations

- Transaction with the Proprietary fund provides an opportunity to add value to both with profits customers and shareholders, subject to:
  - Suitable terms being agreed, including what constitutes a ‘fair value’.
  - Shareholders are able to invest assets to generate risk-adjusted returns that provide sufficient reward for the additional credit risk exposure
  - The company has sufficient capital to support the transaction and continue to provide security to policyholders.

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Determining the 'Fair Value'

- Developed an approach to determine a fair value for the transaction
- This assesses the potential investment return that compensates the with profits fund for:
  - The illiquidity it could tolerate
  - Without materially increasing the level of investment risk
- Transparent pricing framework, which is dependent on market conditions
- Benchmarked against bulk annuity transactions

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Delivering Value for Shareholders

- Shareholder value is dependent on:
  - The premium received (and therefore the value retained in the WP Fund)
  - Risk-adjusted yield once the premium received has been fully reinvested
- To achieve this, we had to determine:
  - What yield was needed to deliver the required value
  - What investments were going to deliver this yield whilst managing the credit risk
  - How we were going to source the volume of assets required
- The search for yield became the biggest challenge given the economic backdrop

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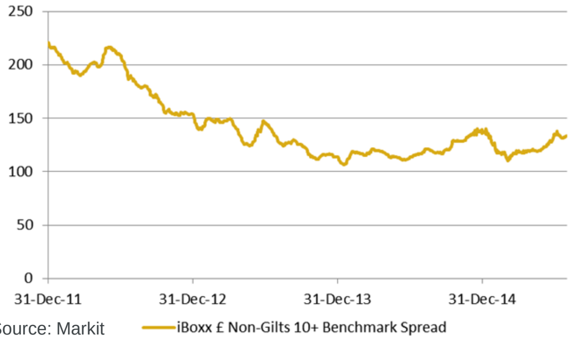
Developing the Investment Strategy

- Existing annuities in Proprietary fund backed mainly by corporate bonds
- In the current low interest rate environment and the tightening of spreads we needed a strategy that delivered a higher risk-adjusted return



Source: Markit

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Delivering the Yield

- Investment strategy developed to meet the yield hurdles developed for project
- Strategy primarily involved:
  - Focusing on a shift from 'liquid' unsecured → 'illiquid' secured
  - Extending our investment capabilities to new assets
  - Careful management of investment pipeline for managing the capital position and the emergence of profit
  - Solvency 2 considerations

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Governance

- Single project team responsible for formulating terms that:
  - met all WP fund requirements and protected WP policyholders' interests, and
  - met commercial objectives.
- Reviewed by WP Actuary, WP Committee, regulators
- **Not** by negotiation between 'policyholders' and 'shareholders'

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Engaging with the regulators

- Non-objection sought from FCA and PRA before implementing
- Fair terms for WP fund
- Resolvability

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Questions

Comments

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

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

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