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Conversions from With-Profits to Non-Profit: Two Case Studies from Sun Life Financial of Canada

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19 November 2015

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Introduction

John Jenkins, KPMG

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Overview

- Many companies have smaller closed with-profits funds and some have larger funds
- Desire to convert to Non-Profit:
  - Simplification
  - Gives policyholders advantage of fixed benefits
  - Often limited upside due to fixed interest investment strategies
  - Unit-linked alternatives may be relevant
- Solvency II

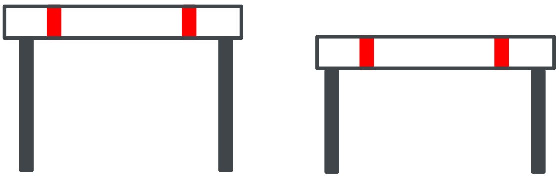
Methods of conversion

- Policyholders have a legal right to participate in profits
- Cannot convert without policyholder consent or court approval – methods are:

1. Already have powers
   - Previous Scheme
2. Scheme of Arrangement (Companies Act)
   - Requires policyholder vote and Court hearings

WPA perspective

- Must be justifiable for policyholders, but what does this mean – how high is the hurdle?



- What actually is the impact on policyholder benefits?
- How strong an opinion should the WPA give?

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Aspects to consider

- Investment strategy pre and post conversion
- Cost of capital post conversion
  - Sometimes confusing, old Schemes can be silent or vague
- What risks are changing?
  - Some funds already have expense deals
- Treatment of guarantees and options, particularly GAOs
- Surrender values post conversion as not typically guaranteed
- Tax implications for policyholder and company

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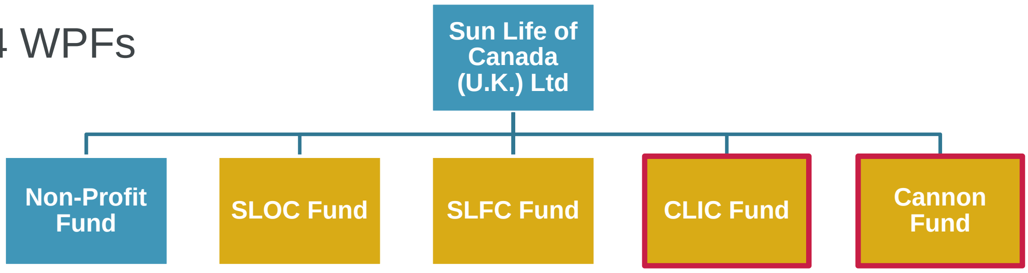
SLOC's With-Profits Funds

- 4 WPFs



- Conversion case studies:
  - Confederation Life Insurance Company
  - Cannon Pension Fund Deposit Account

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Cannon Conversion

Rosalind Rossouw, SLOC

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Overview of the Cannon Fund (pre- Conversion)

- Individual and Group Pension policies
- Small (<50 policyholders)
- PPFM allowed for conversion

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Overview of the Cannon Fund (pre- Conversion)

- Individual and Group Pension policies
- Small (<50 policyholders)
- PPFM allowed for conversion

"As the account reduces in size, the Company will consider the time when it may no longer be viable to continue it as a separate entity. The Company may then seek a scheme of arrangement to convert the Account into a non-profit type investment vehicle (with appropriate benefits) and merge the Account with another fund or to take some other course of action."

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Overview of the Cannon Fund (pre- Conversion)

		Pre-Conversion Characteristics
Assets		
Assets		25% cash, 60% fixed interest,15% equity
Costs		AMC, o/s claims, % conversion cost
Net Assets	(A)	
Liabilities		With-profits
Basic Account Value		Guaranteed (cannot decrease)
Guarantee Reserve		Cost met by Fund
Total Liabilities	(B)	
Terminal bonus rate	(A – B) / (B)	Discretionary

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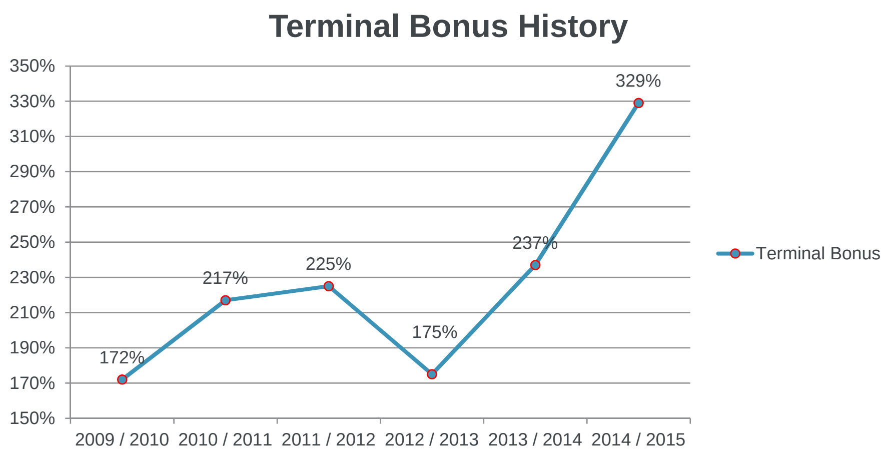
Overview of the Cannon Fund (pre- Conversion)



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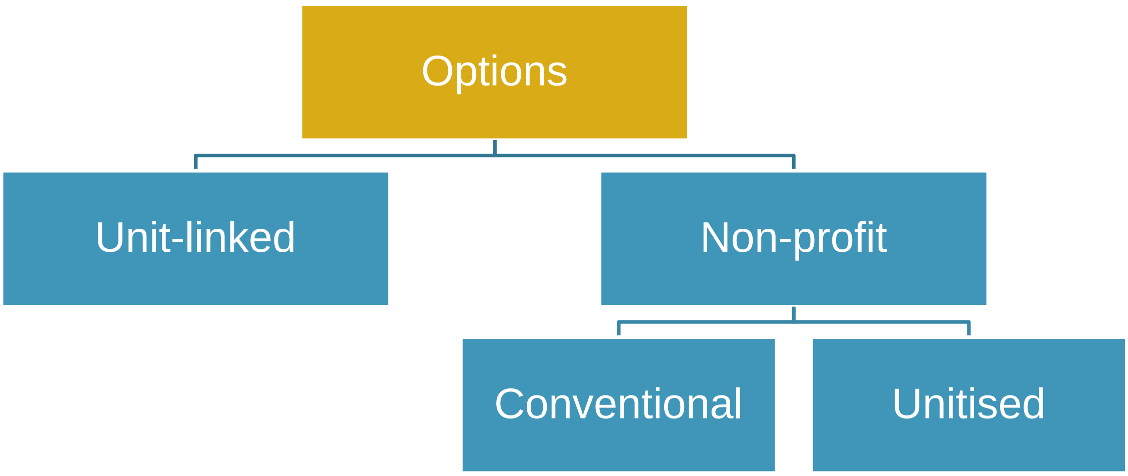
Why convert to non-profit benefits?

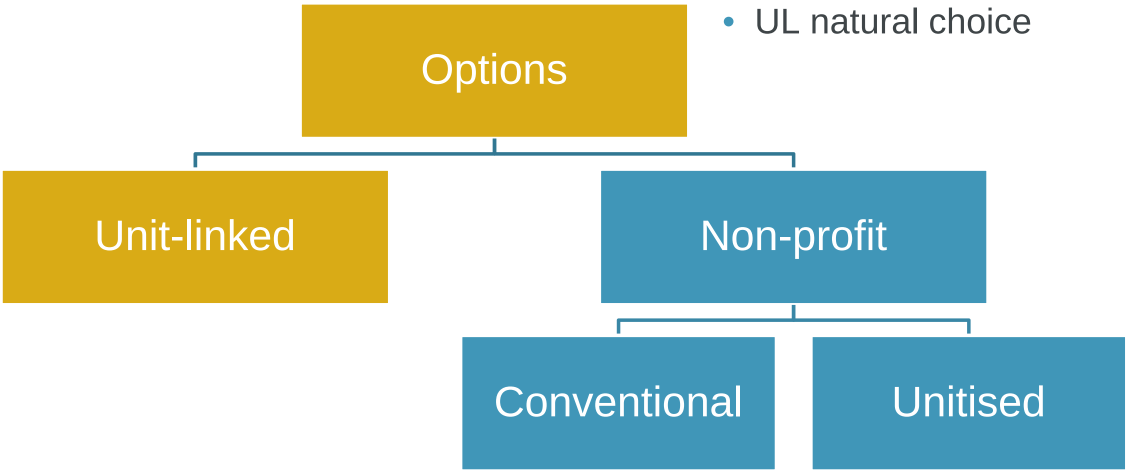
- Difficult to set appropriate assumptions
- Fluctuations in final bonus rates
- Difficult to manage efficiently
- Smoothing
- Fairness

Design and options



Design and options

- UL natural choice



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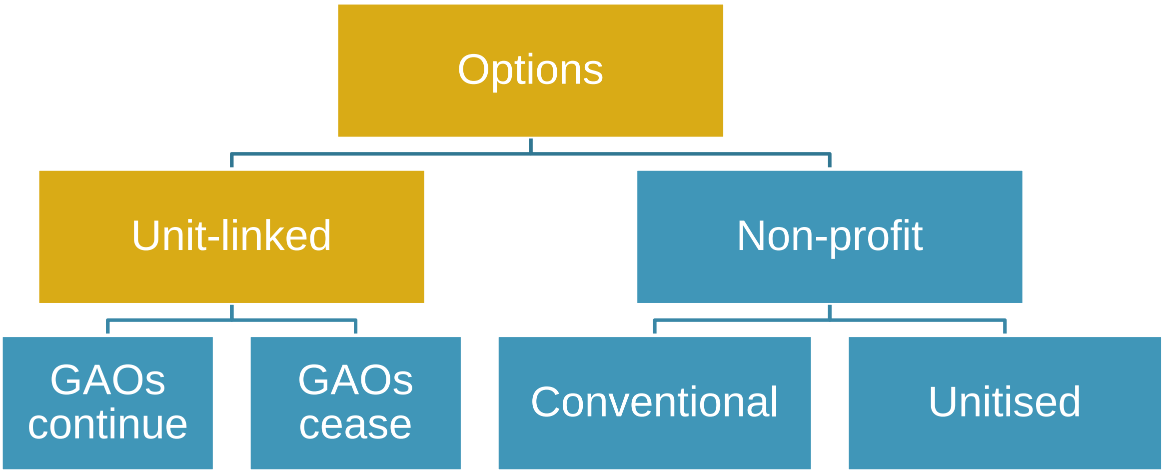
Design and options



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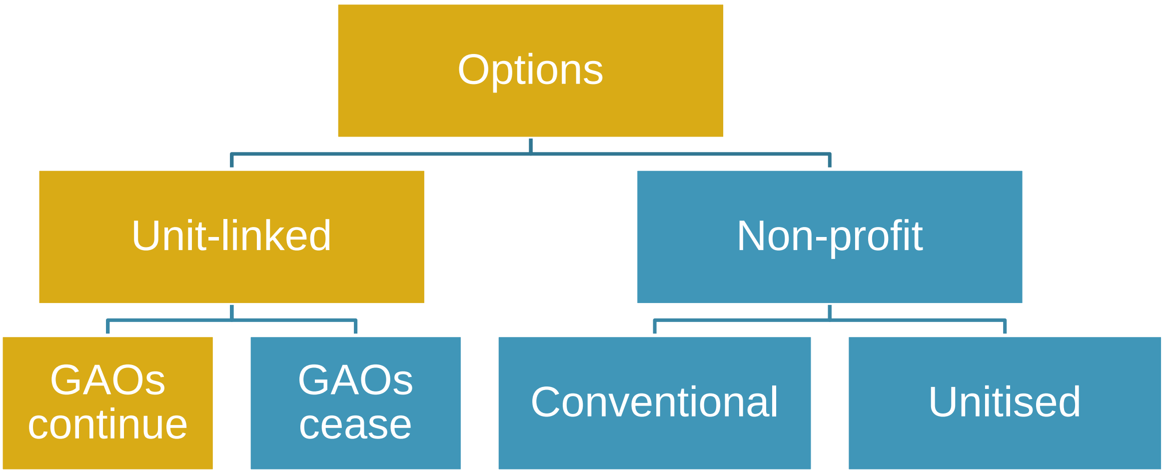
Design and options



Overview of the Cannon Fund (post- Conversion)

		Pre-Conversion Characteristics	Post-Conversion Characteristics
Assets			
Assets		25% cash, 60% fixed interest,15% equity	Policyholder's choice
Costs		AMC, o/s claims, % conversion cost	Maintained, incl s/h GAO prem
Net Assets	(A)		
Liabilities		With-profits	Unit-linked
Basic Account Value		Guaranteed (cannot decrease)	Not guaranteed (can inc / dec)
Guarantee Reserve		Cost met by Fund	Cost met by Shareholder
Total Liabilities	(B)		
Terminal bonus rate	(A – B) / (B)	Discretionary	Surplus fully distributed

Financial evaluation

- Conversion approach: MV Assets – GAO premium – amount towards Cost of Conversion – current liabilities
- Remaining amount divided between remaining policyholders in proportion to their basic account value
- Amount used to purchase a unit-linked pension policy of an equivalent value, invested in chosen proportions

Policyholder impact

- Reduced volatility but fluctuating unit prices going forward
- No immediate policy value difference but no future bonuses
- Increased investment flexibility
- AMC unchanged
- GAO entitlement retained
- Benefit security - UL policy value would need to reduce by +/- 80% before guarantee would become effective
- No tax implications

Policyholder communications

Jun 2013
- Warm-up letter

Sep 2013
- Follow-up letter

Nov 2013
- Holding letter explaining delay

Jan 2014
- Letter incl Q&A and Explanatory Statement

Jun 2014
- Voting pack
- Place adverts

Aug 2014
- Policyholder meeting

Oct 2014
- Wrote to confirm meeting supported Proposal & Court Approval
- Fund selection request

Nov 2014
- Wrote to policyholders to provide details of new policy

- Single point of contact: Customer Advocate

Policyholder voting and Court Arrangements

July 2014
- First Court hearing

Aug 2014
- Policyholder meeting
- Votes counted

Oct 2014
- Second Court hearing

- Single voting class
- “Policy value” value as at 30 Nov 2013 of basic account plus the realistic value of a Policyholder’s GAO entitlement where applicable
- For Scheme approval: More than 50% of votes in favour with >75% of voting class policy value

Policyholder voting and Court Arrangements

July 2014
- First Court hearing

Aug 2014
- Policyholder meeting
- Votes counted

Oct 2014
- Second Court hearing

31 Oct 2014
- Conversion to Unit-linked

- Single voting class
- "Policy value" value as at 30 Nov 2013 of basic account plus the realistic value of a Policyholder's GAO entitlement where applicable
- For Scheme approval: More than 50% of votes in favour with >75% of voting class policy value

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CLIC Conversion

Jonathan Martin, KPMG

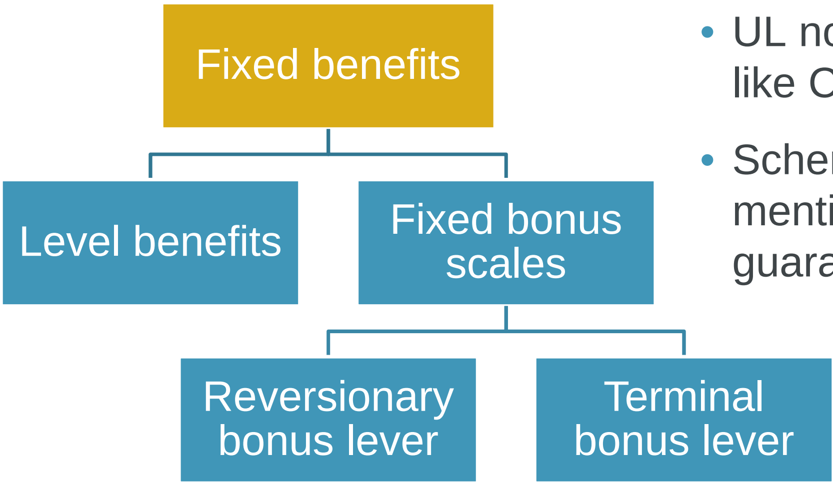
Overview of the CLIC Fund

- Confederation Life Insurance Company
- Closed to new business 1990, acquired by SLOC in 1994
- At end 2013:
  - 2,667 policies (84% whole life / 16% endowment)
  - Assets of £55m
  - No pensions and immaterial amount of non-profit business

Why convert to non-profit benefits?

- 1994 Transfer Scheme gives powers of conversion:
  - Optional threshold = 5000 policies (passed in 2009)
  - Mandatory conversion = 500 policies (expected by 2030)
- Low risk fixed interest investment strategy
  - Limited policyholder upside
- Credit spreads favourably low
- Simplification

Design and options



- UL not natural choice like Cannon
- Scheme wording mentions “scale of guaranteed bonuses”

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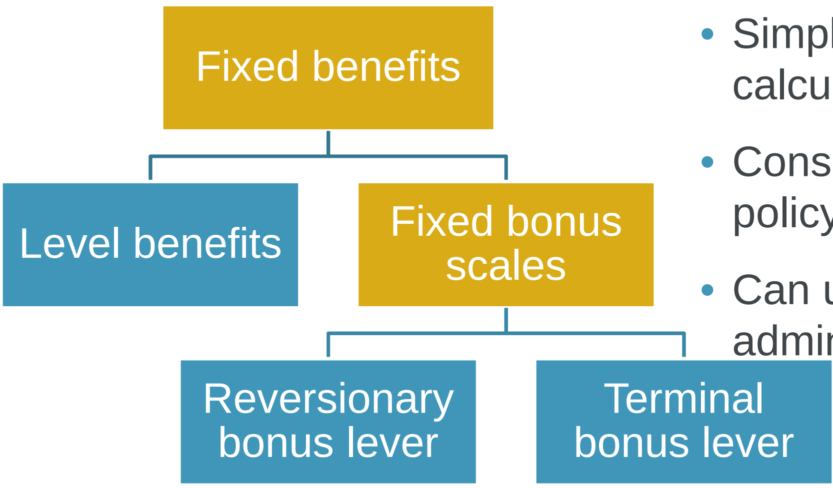
Design and options (cont.)



- Simplicity of calculation
- Consistency for policyholders
- Can use existing admin systems

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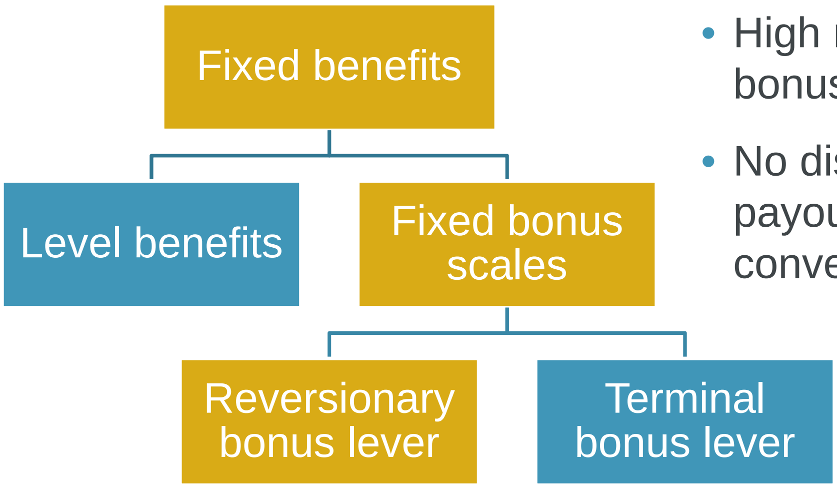
Design and options (cont.)



- High reversionary bonus rates
- No discontinuity in payouts at point of conversion

Financial evaluation

- Conversion approach:

  MV Assets = BRV + Other liabilities + Cost of conversion
  + Cost of capital + Cost of switching assets

- Key driver is investment strategy, which impacts BRV (through expected returns) and cost of capital
- Scheme does not prevent any costs of conversion or cost of capital being charged to the fund

Investment strategy options

- Key test is to weigh cost of capital against expected return
- Bonus setting assumption: **50%** of credit spread is liquidity
  – what assumptions for other strategies give same discount rate?

Investment strategy	Return over gilts	Cost of capital	Proportion of spread
Existing strategy (WP)	High	N/A	50%
Government bonds (NP)	Low	Low	N/A
A and above rated corporates (NP)	Medium	Medium	71%
Existing strategy (NP)	High	High	78%

- Assumption too aggressive for corporate bond strategies so chose government bonds (risk free under SII)

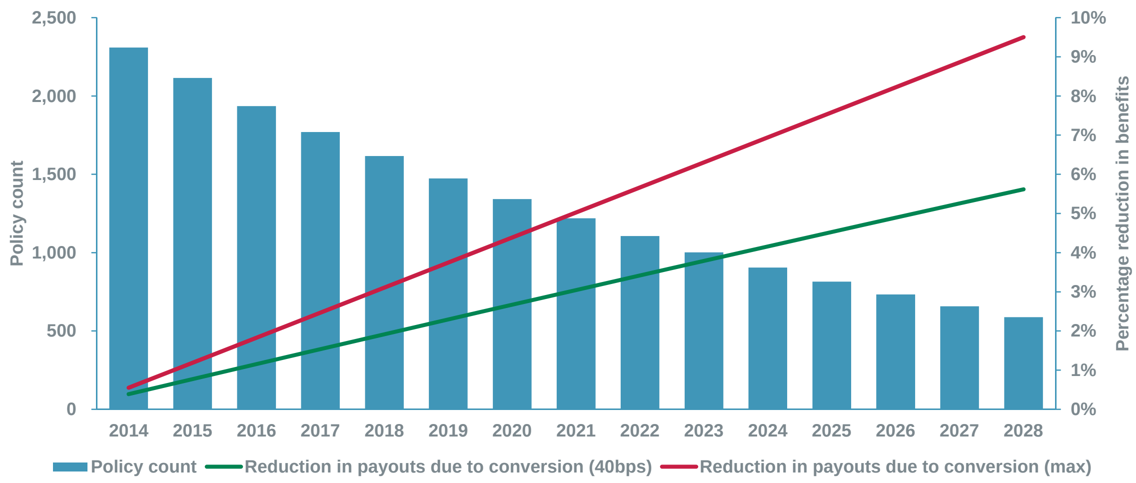
Investment strategy options (cont.)

- Need to consider potential shareholder actions post conversion that might invalidate the conversion basis
- If we went ahead with the government bonds strategy but corporates gave a better return vs cost of capital…
- Then shareholder could switch into corporate bonds post conversion and profit from the higher return…
- Which would be unfair to policyholders

Policyholder impact

- Assessed policyholder fairness by comparing expected payouts on the with-profits and non-profit bases
- Reduction in RB rate = lower expected returns + cost of capital + cost of asset switching – expense savings
- Expected 40bps reduction means <5% average payout reduction
- Maximum fair reduction of 55bps means <10% max payout reduction

Policyholder impact (cont.)



Timeline

Warm-up letter to policyholders

May 2014
- Detailed AFH proposal to Board
- Informed regulators

Oct 2014
- AFH and WPA reports to WPC and Board

Nov 2014
- AFH and WPA reports to regulators

Dec 2014
- AFH and WPA reports finalised

Jun 2015
- Final results to WPC and Board

Final policyholder communication
- Policy endorsements
- Personalised schedule of benefits

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Policyholder outcome

- TBs were frozen and RBs reduced by 20bps – a smaller than expected reduction in benefits due to good trading outcome
- Very few customer contacts – one request for reports and one minor complaint
- Good customer outcome due to open communication, sticking to timescales and access to call centre

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Closing remarks

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Wider perspective – Working with the regulators

- Regulators' views are important
- In our experience the regulators come back with sensible points
- Engage early as the level of detail can vary
- Fairness questions can come from PRA as well as FCA

Wider perspective – Lessons learned

- Plan properly – expect it to take longer than you are expecting it to take!
- Establish at outset whether an Independent Expert is required
- Do it carefully – things coming out at the end can cause big issues
- Get all stakeholders in agreement at an early stage
- Good idea to take powers for conversion if doing a Part VII transfer

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Questions **Comments**

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