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Managing With Profits in Run-off: Changes to Day-to-day Management and Actions Specific to Closure and Run-off

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Introduction

With Profits Funds in Run-off

- Volumes of new with profits business in the UK have fallen to very low levels, and this, coupled with high levels of with profits maturities, means that most UK with profits funds are either closed or in run-off.
- The run-off of with profits funds presents new challenges for with profits firms, and steps may need to be taken to ensure that the funds run off in an orderly manner and that policyholders are treated fairly.
- A working party was established to consider these challenges and how firms might meet them.

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Managing With Profits in Run-off Working Party

- The working party has c25 members and its work has been undertaken through 4 working groups covering the following topics:
- Managing risk in the estate, capital thresholds for distributions and the form of estate distributions
- Fairness and policyholder communications
- Day-to-day management of with profits funds in run-off
- Potential actions in run-off (closure, conversion etc)
- The working party conducted an extensive survey on how firms manage with profits funds in run-off. This has provided valuable insights on industry practice

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Managing With Profits in Run-off Working Party

- The working party has prepared a paper setting out its views on managing with profits funds in run-off and the insights from the industry survey.
- This is available on the Institute and Faculty of Actuaries website at :
- http://www.actuaries.org.uk/life-insurance/pages/management-and-run-profits-funds

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Scope of this Workshop

This workshop focuses on the subjects considered by working groups 3 and 4:

- Determining Pay-outs and Bonus Strategy – Sharon Houghton
- Charges for Benefits, Expenses and Guarantees – Keith Jennings
- Investment Strategy – Dick Rae
- With-Profits Conversion – Steve Jones

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Determining Pay-outs and Bonus Strategy

Determining Payouts and Bonus Strategy

- Shift in policy type
- Lumpy maturity profile
- Lack of asset shares or policy data

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Annual Bonus Strategy

- Supportable annual bonus
- Exercise of discretion
- Earlier distribution of surplus
- Customer perspective
- Fairness across policy types

Survey Insights

- Around 50% have changed
- Most moving to more final bonus
- Initiated by poor solvency
- Practice continuing

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Distribution of Business

- Shift in policy type
  - WOL and pension
  - Paid up policies
- Lumpy maturity profile
  - Changes in profile
  - Peaks of risk exposure
- No asset shares/sparse data
  - Increasing frequency
  - Balance of stability and 100% payout ratios

Survey Insights

- Few companies have changed or expect to change approach to WOL or paid up
- A minority have taken account of changes in maturity profile
- Large number expect to review granularity of final bonus

Smoothing Cost

- Target is a cost neutral position at the end of the fund
- Regular review eg impact of payout profile
- A shorter cycle will increase payout volatility
- Interaction of smoothing cycle and level of investment risk
- Monitor and deal with any build up

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Charges for Benefits, Expenses and Guarantees

Expense Charges

Declining in force portfolio reduces capacity to spread overheads

Implementing a sustainable solution to control unit costs

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Charges for Guarantees, Capital and Smoothing

Loss of Inter generational subsidies in guarantee charging

Guarantee charging restricted by regulation, historic practice or fairness

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Charges for Risk Benefits

Increasingly volatile experience as business volumes decline

Poor data quality on aging book

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Investment Strategy

Investment issues : Issues that are more acute for a with-profits fund in run-off

- Measuring solvency
- Lumpy assets
- Credit risk
- Hypothecation
- Replication of guarantees
- Liquidity

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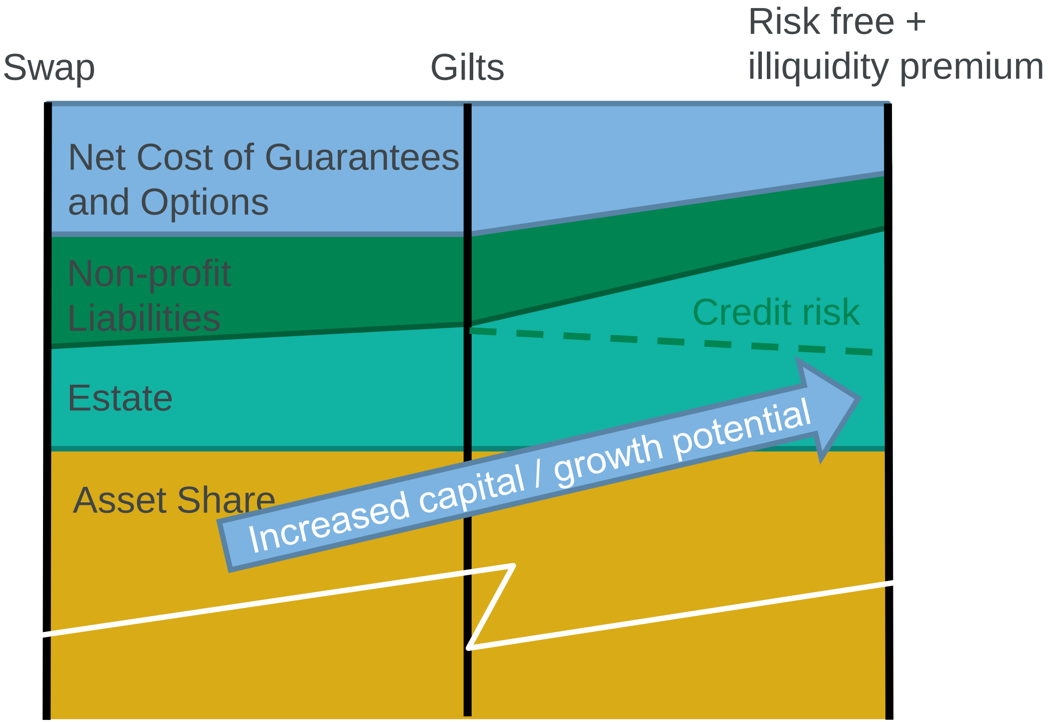
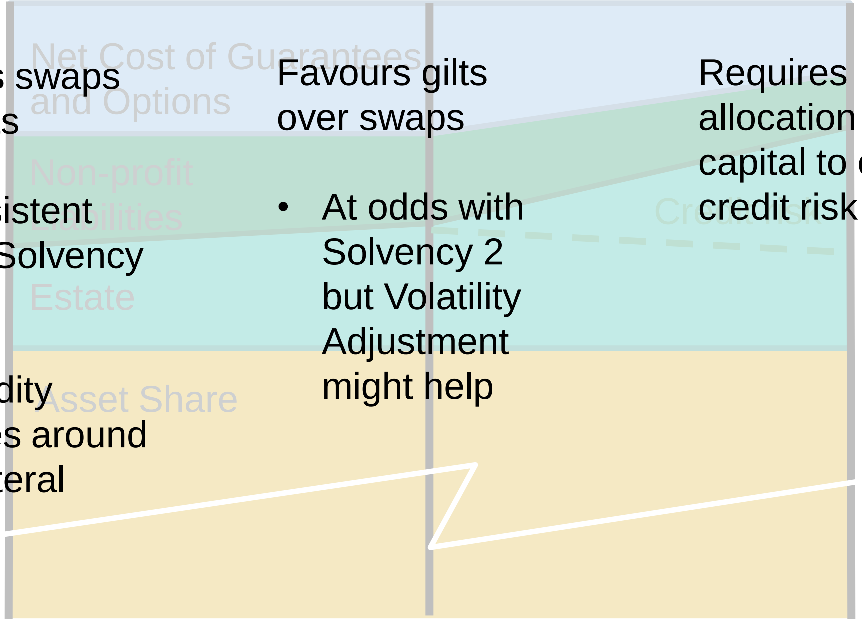
Measuring the Solvency of a Fund
Impact of discount rate on risk capacity



Measuring the Solvency of a Fund

Capital implications for managing rates risk

Swap	Gilts	Risk free + illiquidity premium



Favours swaps over gilts

- Consistent with Solvency 2
- Liquidity issues around collateral

Favours gilts over swaps

- At odds with Solvency 2 but Volatility Adjustment might help

Requires allocation of capital to cover credit risk

Matching market risk
Minimising hedgeable risk

Net Cost of GAOs	Forward swaps	Forward gilts	Payer swaptions
Net Cost of Mat Guars	Cash + short equities		Put options
Non-profit Liabilities	FI bonds		Gilts
Distributable Estate	As asset share		Cash
Capital requirements	Cash		Other
Asset Share	Balanced portfolio Hypothecation		Duration matched ZCB + call replication

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Lumpy assets : property

- Sale and lease back of own buildings
  - e.g Head office
- Easiest assets to divest are the most attractive/liquid assets
  - Cross generational issue
- Unitise
  - Segregated fund - need to find investors as fund divests
  - Pooled fund - fund may not accept all of property portfolio

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Lumpy assets : property

- Move into property investment trusts

Trade at a premium/discount to NAV
E.g.

Source: F&C Investments

Employ (modest) leverage
E.g.

Example of Gearing History	
2005	21.0%
2006	14.5%
2007	11.7%
2008	10.3%
2009	18.5%
2010	20.6%
2011	25.4%
2012	15.0%
2013	13.1%
2014	22.3%

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Issue : Liquidity requirements

- Reducing income
  - Premiums
  - Coupons/dividends
  - Maturities
- Liquidity needs
  - Collateral
  - Smooth out cash flow peaks/troughs
- Considerations
  - Gilts Repo
  - Divestment risk

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With Profits Conversion

With-profits conversions: the basics

- A conversion dissolves a with-profits fund and replaces all its policies with non-profit policies
  - Conventional non-profit or unit-linked policies?
- "All" of the assets in the WP fund at the time of conversion are used to buy non-profit benefits on an agreed pricing basis
  - Costs of conversion may be deducted
  - The capitalised value of shareholders' share of profits may be deducted
- Following this, the with-profits fund no longer exists

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Why a conversion may be appropriate

- A WP fund can become too small to operate efficiently
  - Diseconomies of scale
    - Maintenance and investment management expenses
    - Costs of managing concentration risk
    - May affect policyholder benefits and / or shareholder profits
  - Smoothing can break down
  - Costs of guarantees can become increasingly unpredictable
- Can be managed within a with-profits structure
  - Impact on investment potential or tontine risks
- A conversion may be required by an earlier court scheme

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How to implement a conversion

- WP features are part of contractual entitlements
- Changing contractual entitlements en masse:
  - A Scheme of Arrangement, subject to a policyholder vote
  - A Part VII transfer
- A Part VII transfer can “pre-approve” future conversions
  - No policyholder vote is subsequently required
- Independent expert (and other) reports
- Optional conversion mechanisms can be useful
  - But here, are likely to leave an even smaller with-profits fund

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Structure of post-conversion benefits

- Conventional non-profit or unit-linked?
  - Least change
  - Ease of communication
  - Policyholder understanding
  - Ease of operation
  - In-the-moneyness of guarantees
  - Best value
- Any other change to policy features?
  - Guaranteed Annuity Options

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Level of post-conversion benefits

- Start with company's normal pricing basis, and adjust?
  - Profit margins
  - Expense allowances
  - Investment returns
  - Cost of capital
  - Other margins / compensation for risk
  - Present value of shareholder transfers
  - Inherited estate ownership
- Impact on risk vs. return
  - Policyholders
  - Shareholders

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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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Questions? Comments?

Replication of guarantees

Measuring solvency

Intergeneration charging for guarantees

Credit risk

Liquidity

Hypothecation

Restrictions on guarantee charging

Sustaining cost control

Poor data quality on aging book

Increased volatility of risk charges

Lumpy assets

With-profits Conversion

Reduced ability to spread overheads

Annual bonus strategy

Distribution of business

Smoothing

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