The Actuarial Profession
making financial sense of the future

With Profits Business – Coping with Change
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Managing with-profits business through uncertainty

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REGULATION

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Regulatory Change

Sources of Regulatory Change

- Recent regulatory changes and current “in train” regulatory changes
- Future regulatory agendas
- Creation of the PRA and FCA

What’s been going on?

- PS 12/04 - Protecting with-profits policyholders
- CP 12/13 - Transposition of Solvency II – Part 2
- CP 12/38 – Mutuality and with-profits funds: A Way Forward
- Creation of Prudential and Customer Regulators – The Draft Memorandum of Understanding
- Other: Gender neutral pricing and RDR

PS 12/04 – Protecting with-profits policyholders

- Fully implemented now
- What difference has it made?
  - PPFM changes
  - Premium rate changes
  - Closure to new business
  - Other impacts
- Changes in behaviours

CP 12/13 – Transposition of Solvency II – Part 2

- Primarily about SII but…
- Consultation ended in October
- FSA response to the consultation. Q3-Q4 2013?
- Given SII delays will this be parked?

CP 12/38 – Mutuality and with-profits funds: A Way Forward

- Proposal to end the current difficulties over mutual capital and the identification of members and policyholders interests in the with-profits fund

The New World - PRA and FCA

- Subject to the necessary parliamentary approval the FSA will hand on its responsibilities to the two FCA and PRA on 1 April
- Draft “With- Profits” Memorandum of understanding published in November recognising additional requirements for with-profits funds
- With-Profits will primarily be dealt with by the FCA who have responsibility for “fairness”
- The PRA will have responsibility for matters of affordability and capital implications
- PRA holds trump card in the event of differences of opinion

Life after the FSA?

- Direction and objectives of the PRA and FCA
- Matters the FSA had deferred:
  - Shareholder charges to WP funds
  - Review of Customer Friendly PPFMs
  - etc.
- Where do they sit on the PRA/FCA agenda?
- New areas of interest? The Irish experience

Implications and Outlook

- Period of heightened regulator uncertainty for insurers
- The regulators “shopping list”. Will clarify in coming months?
- Potentially greater pace of change?

What can you do?

- Recognise that despite the run-off of the business that with-profits business is a matter of concern for the regulators - change is here to stay
- Engage in the change process!

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ECONOMIC ENVIRONMENT

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The economic environment

- Low yields
- Liquidity
- Globalisation
- Volatility
- Solvency 2

Low yields – Annual Bonus Rates

10 year risk free yield	1.9%
EBR	50%
Equity risk premium	4%
Expected return	3.90%
Expenses	-0.75%
Net return	3.15%
Policyholder share (90%)	2.84%
Expected inflation	2.9%
10% chance of getting better than	6.8%
“Safe” annual bonus rate	-1.5%

Low yields – Annual Bonus Rates (continued)

- Message to policyholders is not compelling
- We expect to be able to generate a modest return for you, that hopefully keeps up with inflation, but we might do better or worse
- We cannot give you any of the return as annual bonus – you will just have to wait until the end and see what happens
- This is the reality for many policyholders with annual bonus rates set at nil or very low levels, and any returns being very dependent on the amount of final bonus

Low yields – impact on projection rates

- Projection rates significantly lowered in many funds in recent years
- Funds with low EBRs now using very low projection rates
- New FSA policy statement (PS12/17) comes into effect on 1 April 2014
- A projection must be calculated using rates that accurately reflect the investment potential of the product and do not exceed the following maximum rates of return:

	Low	Intermediate	High
Life	1.5%	4.5%	7.5%
Pensions	2.0%	5.0%	8.0%

Low yields – impact on projection rates (continued)

- Reduced projections (combined with low annual bonus rates) make it difficult to find compelling good news to tell with-profits policyholders
- Some funds are distributing estate, which does give a good news story to focus on

Low yields – hypothecation of fixed interest returns

- Fixed interest returns have been very strong in recent years
- Policyholders close to maturity may wish to lock into these gains
- There do not appear to be any strong reasons for exposing short dated policyholders to medium or long dated yield movements if it can be avoided
- Hypothecating fixed interest returns by outstanding duration can improve stability of expected returns to maturity for all policyholders

Low yields – the search for returns

- Review of investment strategies to optimise returns
- Diversifying investment exposures to get the highest expected returns for a given level of volatility
- Conclusions very dependent on assumptions
- Funds may feel constrained to not put too much into new asset types meaning that the overall impact may not be large
- Small incremental improvements more likely than any step change in expected returns
- Trade off against liquidity when assets with higher expected returns are less liquid

Low yields – more radical options

- Research suggests that many customers do not understand their with-profits products
- Low annual bonus rates lead to difficult communications with customers
- Could with-profits funds be wound up and customers given simpler products instead – such as unitised or non-profit?
- The capital released could be paid out now, as could any free surplus
- Would be very difficult to achieve but could transform the industry and the way in which our customers look at us
- This seems to be quite a topical area with feedback suggesting that a number of firms are looking into these types of ideas

Liquidity

- With-profits funds have flexibility about which assets to sell to meet claims
- However must guard against selling more liquid assets today if that would leave remaining policyholders unduly exposed to illiquid assets
- Even mainstream with-profits asset types are now less liquid than they have been in the past, e.g. property and corporate bonds
- No-one really knows when, or even if, past levels of liquidity will returns to these markets. There must therefore be material risks in any strategy that loads more illiquid assets onto remaining policyholders
- Realistic disposal plans based on projected run-offs are now more important than ever

Liquidity (continued)

- Some with-profits funds may require support from shareholders in stressed conditions
- It therefore makes sense to do a liquidity test to see if the shareholder would have suitably liquid assets that could be transferred into the with-profits fund if needed

Globalisation

- Wider range of asset types now available such as private equity, hedge funds, emerging market debt, emerging market equity
- Opportunities for wider diversification with beneficial risk/return outcomes
- A global approach will give an increased exposure to the parts of the world that are expected to grow fastest in future
- UK share indices increasingly generate skewed exposures to particular industry types (mining, oil, banks)
- Policyholder literature in many with-profits funds do not unduly restrict investment freedom. However past court schemes may do so
- Policyholders would reasonably expect their providers to keep up to date and make use of the expanding range of investment opportunities in a balanced way

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Market Volatility – Possible responses

- More hedging (e.g. extending hedging to cover more risks such as credit risk)
- But is hedging, using short positions, a zero sum game in a closed fund that is distributing estate
- More frequent reviews of bonus rates and surrender values
- More frequent rebalancing of investments and hedges

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Market Volatility – Possible responses (continued)

- Higher frequency of rebalancing and rolling hedges can be expensive
- Might set trigger points for extra reviews rather than having more frequent reviews
- Trigger points mean that you just do the work when it is needed, rather than just doing the work more frequently whether it is needed or not
- More frequent reviews of bonus rates and surrender values may undermine the smoothing concept that is an inherent part of the with-profits offering

Solvency 2

- How to cope with delays
- Investment hedging - what to hedge?
- Estate distributions - what to distribute?
- Expenses - how much to spend?
- What will ICA+ mean?

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.