The Actuarial Profession
making financial sense of the future

With-Profits Business – the Next Step
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Prospects for the future of with-profits

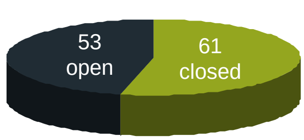
Agenda

State of the nation	• Funds are running off • With-profits is difficult to understand
Managing run-off	• Capital management • Strategic actions • Tactical actions
Implications of CP11/5	• Distributions • Charges to with-profits funds • Mutuals
Products and distribution	• Recent issues and reactions • Regulatory changes • Implications for products

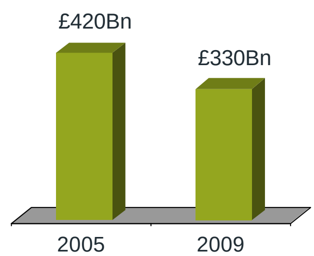
State of the nation

Funds are running off

Funds



Assets Under Management



Source: CP11/5

With-profits is difficult to understand

"With-profits returns are generally on a downward spiral and it is not surprising that some providers are still cutting bonus rates and payouts even after a strong year for investment markets. However, ***the difference between the best and worst providers is huge*** *in terms of where they can invest, the bonuses they pay and the likely future returns for policyholders."*

Patrick Connolly, AWD Chase de Vere, March 2011

*"****With-profits bonds are a huge future mis-selling possibility****. We hear from hundreds of people each year who hold these bonds, and few have realised that there are market value reductions. If things turn sour this will be a big issue."*

The Sunday Times, 15 May 2011

"In most cases with-profits is not offering value for money. *It's all opaque. A fund may grow by ten per cent in a year but the company pays out only two per cent and the saver is left wondering where the other eight per cent has gone."*

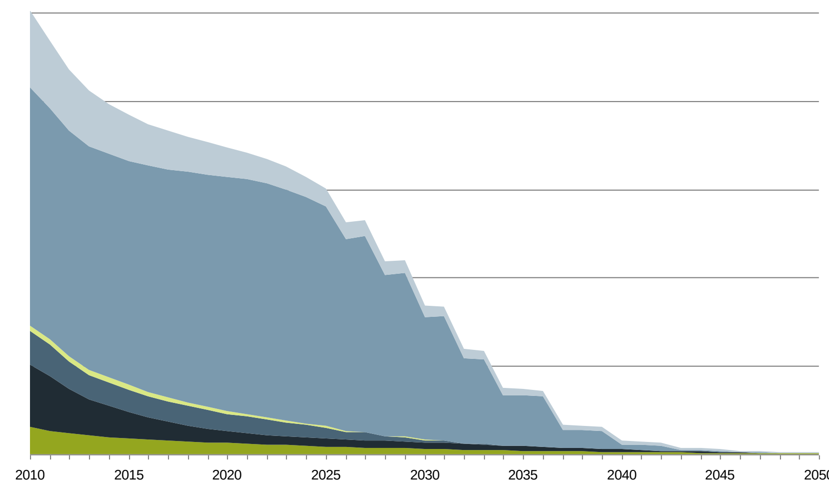
The Mail on Sunday, 13 February 2011

"With falling new business figures and a very mixed bag of performance, ***it would seem that the only thing that is likely to drive a move to with-profits in a big way is the introduction of more guarantees****…people are willing to put their money and faith in with profits bonds as long as they have assurances that they will not lose out in a big way, as has happened in the past."*

Money Marketing, January 2011

Managing run-off

Typical with-profits fund profile



Capital management

Risk Management Cycle

Asset Management

- Increased asset hypothecation
- EBR and credit risk reductions
- Implement lifestyling
- Reduce 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 build up of guarantees
- Pace of estate distribution
- Changes to smoothing policy
- Remove past discretionary enhancements/profits
- Use of guarantee charges
- Increased use of reinsurance
- Longevity swaps

Cost Management

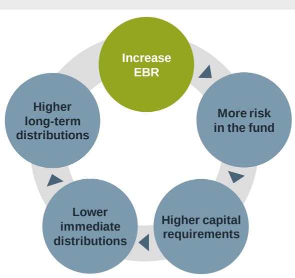
- Outsourcing
- Process improvements
- Alignment of systems and methods across funds

Implications of CP11/5

Distributions

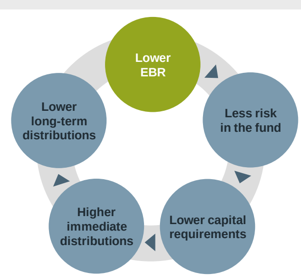
- Address fast run-off
- Avoid a 'tontine'

- 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

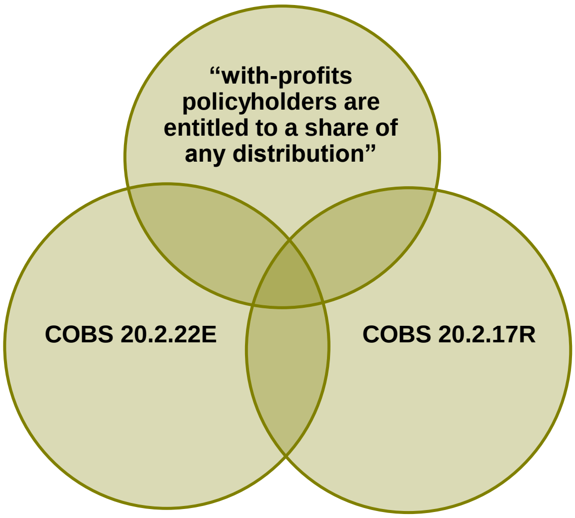
Distribution plans and management plans

- 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 around updated plans when volumes drop substantially
  - Could trigger a run-off plan even if not formally closed
- Largely reasonable development, but an extra burden?

Charges to with-profits funds

- Changed rule
  - Firms must only charge costs to a with-profits fund
  - Includes look through of any intra-group service company costs
- Issues:
  - Unfair if transferring risk
  - Could be a disincentive to maintain with-profits funds
- Establishing fairness via ‘benchmarking’ may be more appropriate

Mutuals



- Options:
  - Find alternative source of new with-profits business
  - Split the fund with the agreement of with-profits policyholders
  - Strategic investment

Products and distribution

Recent Issues and Reactions

- Regulatory, economic and consumer-driven.
- Increased hypothecation of assets, ALM complexity, partial hedging.
- Widened spread of risk asset exposure. Some re-risking since 2008YE.
- Greater transparency, less exercise of discretion in benefits compared to traditional with-profits model.
- Investment policy terms (or guarantee periods) reducing; focus on guarantees.
- Increased costs of guarantees (interest rates and asset prices).
- Arguably - emphasis on headline "EBR" rather than overall risk premia or investing for long-term value/outlook.

Which in Practice Means…

- YE10 Overall funds' EBR ranging from 4% to 75%, average 39%. [1]
- Asset share and capital reqt assets EBR increased from 38% for 2008YE to 42% at 2010YE. [2]
- Corporates YE10: from 12% to 97% of FI portfolios. [3]
- For HY 2011, WP comprised 23% of SP onshore life sales, 3% of SP pensions sales and 5% of retirement annuity sales. [4]

- 1 Source: Goldman Sachs Survey; YE10 FSA returns, from F48, Column 2
- 2 Source: Goldman Sachs Survey; FSA returns F48, Column 2, economic exposure, assets backing WPL and WPCR; total assets from F19, line 29
- 3 Source: From Goldman Sachs Survey; FSA returns F48, Column 2, economic exposure, assets backing WPL and WPCR
- 4 Source: Derived from ABI statistics

Advantages of With-Profits Designs

- Consumers desire guarantees and smoothing.
- Benefit discretion and investment flexibility enables:
  - Guarantees can be offered with relatively high exposure to risk assets in normal circumstances.
  - Smoothing relies on inter-policy subsidies, and flexibility to change/cut in extreme conditions. BSA.
- Discretion/management actions reduce capital requirements.
- New business strain and capital requirements can be (temporarily) covered by estate; with justification.

Retail Distribution Review

- No commission for advised sales; adviser charge through product or direct. Initial and on-going services. Pure protection and consultancy charging excluded.
- All non-independent distribution will be labelled “Restricted”. Panels?
- Intermediaries are adaptable, but likely to squeeze remuneration.
- Moving to Restricted advice may become attractive/compelling.
- Products targeted at specific customer segments attractive.
- More competition from advised and non-advised collectives.
- Closure of legacy products?

CP11/5

- New business only written if no adverse effect on WP policyholder interests (previously ‘material’).
- Inter-generational cross-subsidy.
- Claims targetting. Guarantee charges. Expenses.
- Complex:
  - Profitability analysis.
  - Expense synergies.
  - Bonus and investment policy.
  - Distributions.
- ‘Management’ and ‘Distribution’ plans.

Regulator Change, Product Intervention - DP11/1 and FS11/3

- Change to FCA and PRA.
- Financial Conduct Authority – “lower risk tolerance”.
- Product intervention approach, outcomes-focussed; on top of RDR changing point-of-sales standards.
- Key FSA concerns around consumer:
  - Information, or use of information to make appropriate purchases.
  - Being obstructed from making accurate judgements.
  - Recognising and acting on emerging problems.
  - Infrequent purchases – low consumer pressure.
  - Non-alignment of distribution incentives.
- TCF material updated or rules.
- ‘Problematic’ product features include non-standard assets. ‘Complexity’.

Product Implications - General

- No pricing cross-subsidies between existing and new business.
- Demonstrate ‘no impact’ on existing business, capital requirements vs expenses and investment policy.
- Greater transparency and tighter discretion.
- May constrain practice and increase capital requirements.
- Target specific customer needs for Restricted Advice channel.
- Outsource contracting books.
- Be mindful of DP11/01.

Product Implications - Investment

- Increased asset share hypothecation and hedging.
- Tighter discretion.
- Future of explicit EBR?
- Asset diversification beneficial for SII capital requirements.
- Backing assets may exploit Basel III/Solvency II differentials.
- Basis for guarantee charges.

Product Implications – Insurance Risk

- Protection spectrum. Annuities.

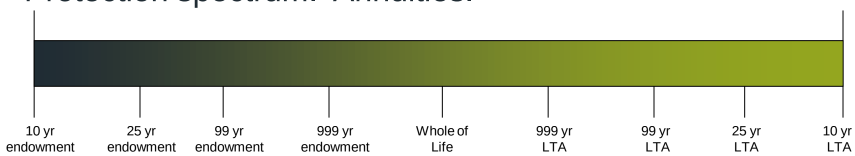


Illustration source: Towers Watson

- Share uncertain insurance risk – longevity, gender neutral rates, morbidity.
- Asset share credit/debit or premium adjustment.

Questions or comments?

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

The views expressed in this presentation might be those of the presenter.