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Realistic Balance Sheet Management Actions

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What we intend to cover

Focus solely on management actions assumed under Peak 2, covering

- Key findings of our review of the 2004 Annual Returns
- Challenges facing firms, FSA and the profession
- Open discussion

What we don't intend to cover

- Other aspects of our review of the Realistic Balance Sheet submissions and Annual Returns

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RBS Management Actions

- Traditional, more 'vanilla' actions
  - dynamic EBR
  - dynamic bonus rates
  - smoothing policy and
  - charges against asset shares (or reducing target payouts)
- More complex evolving actions
  - Differential investment policy for assets
    - not backing asset shares
    - backing asset shares

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RBS Management Actions

Let's start with some audience participation (did you knows)

The most common management action was …..

… ***dynamic bonus rates, followed by dynamic EBR***

The average number of actions assumed by a firm in total was … ***2***

The highest number of actions assumed by a firm in total was … ***5***

Of these, the split of those in RBS vs RCM was… ***2 to 3***

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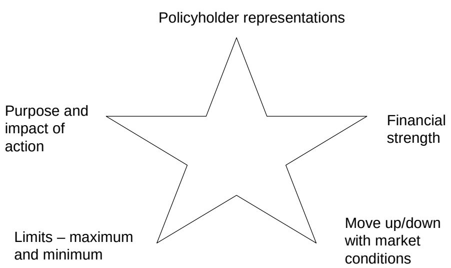
RBS Management Actions - Considerations



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Traditional Management Actions

(a) Dynamic investment strategy

- Very common management action
- Varying EBR in line with economic outlook/financial strength
- EBR should go up as well as down – policyholders expectations
- General minimum and maximum EBR levels; there will always be some exceptions
- Relative EBRs for closed and open funds – closed fund not necessarily a reason for lower EBR

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Traditional Management Actions

(b) Smoothing policy

- 2000-03 saw intense pressure on smoothing limits
- More recently, reversion to more normal levels
- Impact of year on year changes in asset shares
- General benchmarks, varying by financial strength
  - Under normal conditions
  - Under stressed conditions

Traditional Management Actions

(c) Prospective charges against asset shares

- Rarely referred to in firms' literature, so not so easy to introduce
- Some firms increase this charge under stress
- Acceptable provided
  - appropriate warnings in literature
  - consistent with PPFM/approved plan (CoB 6.12.30)
  - Proportionate to and consistent with cost (CoB 6.12.30)
  - Balanced approach – charge should go up/down as appropriate

Question: What order should such a charge take – e.g. should it only be applied after other actions have been exhausted first?

Traditional Management Actions

(d) Retrospective charges against asset share

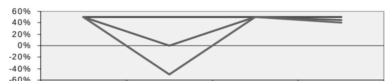
- Only 2 firms have assumed such a charge in stressed conditions
- CoB 6.12.33G
  - Changes in the charge should reflect changed business/economic conditions – not be arbitrary
  - An immediate reduction in asset shares (or target payout) not consistent with a well-developed plan

More complex Management Actions

Differential investment policy for assets not backing asset shares

An illustrative example

Equity backing ratios of components of RBS



	Asset share	Cost of guarantees/RCM	Estate	Total Assets
Traditional approach	50%	50%	50%	50%
"Cash" approach	50%	0%	50%	45%
"Put option" approach	50%	-50%	50%	40%

Traditional approach "Cash" approach "Put option" approach

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More complex Management Actions

Differential investment policy for assets not backing asset shares

- Now quite common – even for stronger firms
- Purpose of transaction
  - Hedge against changes in guarantee costs caused by fluctuating equity values
  - A hedge for controlling other charges e.g. prospective charge on asset shares

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More complex Management Actions

Differential investment policy for assets backing asset shares

- Currently, less common (though a few firms have operated one for some time)
- Based upon likelihood of guarantees biting; why have a relatively high EBR for policies which are heavily in-the-money?

Question: Should such a transaction serve to reduce the EBR or merely redistribute it?

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More complex Management Actions

Differential investment policy for assets backing asset shares

- Do policyholders need compensation for lack of equity exposure?
- Fair value paid on surrender
- Status and rights of policies with zero EBR

RBS Management Actions in stress

- Management actions are permitted in both the RBS and the RCM calculations
- Most firms assumed additional management actions in their RCM calculation
- Management actions assumed only under stressed conditions do not have to be disclosed
- RBS should cover the RCM scenario and so prefer all management actions to be assumed under RBS

Some food for thought ….

- How acceptable are management actions in circumstances where without such actions the WP fund would have sufficient assets to meet its realistic liabilities – but not its RCM?

Some food for thought ….

How should a closed fund disclose its working capital in its RBS? Possibilities:

	Option 1	Option 2	Option 3
Planned enhancements	0	70	100
Working capital	100	30	0
RCM	30	30	0
Excess working capital	70	0	0

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