The Actuarial Profession
making financial sense of the future

Realistic Balance Sheets and Implications for the Future of With Profits

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Agenda

1. What is the Realistic Balance Sheet?
2. Is it a good thing?
3. Case Studies - typical funds
4. How are companies responding?
5. What about the customers?
6. Conclusions

1. What is the Realistic Balance Sheet?

- Sets a level of required capital based upon:

  - “market driven” discipline for the valuation of assets and liabilities
  - stress test to reflect impact of financial risk

- Basis for future management of assets and liabilities?
- Basis for determining future investment policy and treating customers fairly??

2. Is it a good thing?

- Yes, a significant improvement over the previous approach

  - Explicit and consistent assessment of liabilities - no implicit margins
  - Reflects the way the business is run - allows for management action
  - Distinguishes between final bonus margin and free assets
  - More transparent
  - More protection for policyholders
  - More comfort for FSA

2. Is it a good thing?

But there are problem areas

- Economic scenario generators and calibrations
  - different answers with different models
- Need for consistency and actuarial standards
- What is the risk free rate?
- Determining volatilities
- Allowing for correlations
- Value of non profit business

2. Is it a good thing?

But there are problem areas

- Risk Capital Margin uncertain
  - level of solvency expected - BBB?
  - nature and size of tests
- Other ICA stress tests
  - mortality (particularly annuitant)
  - value of non profit business
  - operational, credit, liquidity and group risks
- More importantly is it too prudent?

  Does it overstate the cost of long term guarantees and options?

3. Case studies - typical funds

Case study - different with profit funds
Fund 1

- The fund appears fine on a statutory basis. However, it has a lot of “free assets” backing terminal bonus
- The fund is weak on a realistic basis
- The liabilities of the fund are mature, with a significant proportion of Conventional With Profits business
- The relative weakness of the fund has led to it having a low proportion of its assets in equities (about 30%)
- The fund only uses equity assets to back the assets supporting asset shares, ie excess assets are backed by fixed interest.

3. Case Study - Fund 1

STATUTORY BASIS	Central	Following 30% Equity Fall
With Profits Assets	**10,000**	**9,141**
Mathematical reserves	8,722	8,604
RMM	388	388
Other liabs	219	166
With Profit Liabilities	**9,330**	**9,158**
Resilience Capital	0	0
Assets above liabilities and capital	**670**	**-17**
Free asset ratio	**7.2%**	**-0.2%**

3. Case Study - Fund 1

REALISTIC BASIS	Central	Following 30% Equity Fall	+10% increase equity/property volatility
With Profits Assets	**10,000**	**9,169**	**10,000**
Asset shares	8,385	7,648	8,385
Gte Costs	855	973	1,046
Other liabs	219	152	219
With Profit Liabilities	**9,459**	**8,773**	**9,650**
RCM	337	240	245
Assets above liabilities and capital	**204**	**156**	**105**
Free asset ratio	**2.2%**	**1.8%**	**1.1%**

3. Case studies - typical funds

Case study - different with profit funds
Fund 2

- The fund is strong on a realistic basis and on a statutory basis

  …however, there is much less margin for terminal bonus
- The fund is younger, with the majority of its liabilities being Unitised With Profits
- The fund's strength has led to a high equity proportion (about 50%)
- The fund invests the assets backing guarantees / estate in equities as well as fixed interest.

3. Case Study - Fund 2

STATUTORY BASIS	Central	Following 30% Equity Fall
With Profits Assets	**10,000**	**8,532**
Mathematical reserves	8,377	8,089
RMM	340	328
Other liabs	281	241
With Profit Liabilities	**8,997**	**8,658**
Resilience Capital	74	0
Assets above liabilities and capital	**929**	**-126**
Free asset ratio	**10.3%**	**-1.5%**

3. Case Study - Fund 2

REALISTIC BASIS	Central	Following 30% Equity Fall	+10% increase equity/property volatility
With Profits Assets	**10,000**	**8,599**	**10,000**
Asset shares	7,507	6,527	7,507
Gte Costs	980	1,034	1,165
Other liabs	270	119	270
With Profit Liabilities	**8,757**	**7,680**	**8,942**
RCM	264	341	211
Assets above liabilities and capital	**979**	**579**	**847**
Free asset ratio	**11.2%**	**7.5%**	**9.5%**

4. How are companies responding?

Investment policy

- Asset Liability Management and managing the probability of ruin
- Lower Equity Backing Ratios
- Different Equity Backing Ratios for different blocks of business
- Matching of guarantees
- Hedging instruments
  eg. GAOs. Great business for Investment Bankers!
- Credit switching? (depends on CP195)

4. How are companies responding?

Management discretion

- Much lower regular bonuses
- More active bonus cuts to reduce smoothing reserves
  i.e. less smoothing
- Charges for guarantees at fund or policy group level
- New bonus series

4. How are companies responding?

- All actions designed to reduce the capital required
- All actions in line with/driven by PPFM
- Are actions consistent with “Treating Customers Fairly”
- Many funds closing to new business
- Few strong funds survive but with lower bonuses and fewer guarantees
- New versions of with profits emerge as simple smoothed managed funds

5. What about the customers?

- Is this the with profit business the customer was sold?
  - Many end up in closely matched funds
    - i.e. these are non profit contracts now
  - No risks mean no rewards
  - Returns stable but unexciting, based mainly on bonds
- Lack of transparency over investment performance in closed funds
- Customers feel trapped and vote with their feet
  - dangers of mass surrender
- Advisers not sure what to do
  - dangers of another misselling scandal

6. Conclusions

- A structural approach to risk reflecting how the business is run
- Better recognition of expected cost and risk of guarantees
- Need to manage to the level of capital available. New regime introduced when funds are at their weakest and shareholder capital is scarce
- Lack of transition from FSA is causing undue haste and could lead to decisions which seriously impact interests of customers. Dangers of panic reactions heightened by media and Equitable overeaction from government and regulators
- Very few players writing new business. New variations required
- Lack of new business leads to the closure of mutuals
- Major decline in Industry accelerated

6. Conclusions

- Another Equitable has been avoided but at what cost?