**The Actuarial Profession**
making financial sense of the future

Running a Closed Business - Run-Off Solutions

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## Agenda

- Background
- What are the risks and how can you deal with them?
- How can you manage the balance sheet?
- Discussion

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## How do closed funds arise?

- Falling stock market
- Increasing life expectancy
- Cost of guarantees
- New business strain, especially with stakeholder pensions
- Falling margins
- Increasing regulation
- Company restructure

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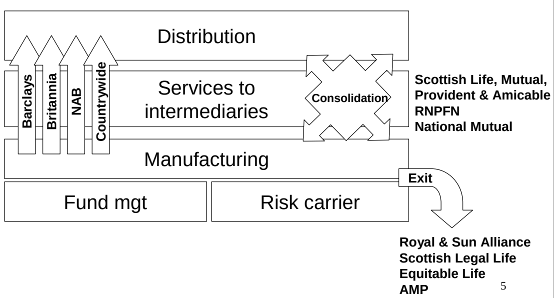
## How do closed funds arise? (continued)

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## Criticisms of closed funds

- "Closed funds can spell performance misery, with providers experiencing serious financial difficulties and providing woeful communication to policyholders." – AKG report

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## Criticisms of closed funds

- “Closed funds can spell performance misery, with providers experiencing serious financial difficulties and providing woeful communication to policyholders.” – AKG report
  - Little commercial pressure to offer good value, service or communication
  - Weak financial position
  - Customers locked into cautious investment strategy

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## Criticisms of closed funds

- “However, there are also cases of the reverse, with a positive outlook for performance and secure companies run in an increasingly open fashion.”
  – AKG report

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## What are the risks and how can you deal with them?

- Expenses
- Investments
- Guarantees
- Persistency
- Service levels
- Staff
- PRE/TCF
- Run off risks
- Legacy issues
- Solvency

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## Expenses - a risk or an opportunity?

- A real area of concern
- Closure can bring focus
- Possibility of transferring expense risk to shareholder or outsourcer
- Look for fixed per policy costs - without tramlines
- Consider additional costs
- Need service level protections
- Similar issues for investment expenses

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## Investments - guaranteed poor performance?

- Investment performance another area of real concern
- Can outsource if necessary to keep competitive
- Are investment mix changes because of financial weakness or closure?

May need to:

  - move to lower volatility, lower return assets
  - cut out high risk or speculative projects and investments
  - pay closer attention to matching and liquidity

- Marketing considerations diminish
- Consider separate EBRs/other assets by block of business
- Stochastic modelling essential in determining investment strategy

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## Guarantees - who pays?

- Can destabilise a declining fund
- Can impact EBR and estate distribution
- May want to buy out guarantees - en mass or case by case
- Need stochastic modelling to understand, provide for and manage
- Charge particular policyholders, all policyholders, the estate or shareholders?
- Consider reinsurance or other forms of protection

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## Persistency - is it good or bad?

- Closing can significantly affect persistency
- Ensure pay outs set accordingly
- Can worsen realistic position, improve statutory
- Best business tends to go
- Some management of persistency is possible
- Achieve a balance with other actions eg changes to EBR or bonuses

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## Service levels - what level is appropriate?

- Balance of standards and cost
- Agree levels and monitor
- PRE issues - communication is vital
- Distributors and analysts likely to be suspicious

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## Staff - why should they stay?

- Need to reduce staff numbers - but keep control
- Danger of particular skills or knowledge being lost
- Possible low morale and sense of failure
- Outsourcing can bring benefits

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## PRE/TCF - do these change?

- Do policyholders have different expectations of a closed fund?
- Policyholders will have concerns
- Position of each closed fund will be different
- Expectations need to be managed
- Communication is vital

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## Run off risks - how do you avoid a tontine?

- Tontine most a problem where there are large guarantees or future profits.
- Over-distribution must be avoided
- Look to reduce volatility
- Financing, EBR, RB/TB, PRE, smoothing all need to be reviewed
- Combining with another fund
- Stochastic modelling is vital

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**Legacy issues - are these different in a closed fund?**

- Important knowledge can be lost as staff leave
- Legacy issues become more difficult to deal with
- More issues arise as policyholders explore every avenue to leave the fund on the best possible terms
- Systems and processes less likely to be replaced or updated
- No distraction from new products or changes to sales practices

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**Solvency - does it matter?**

- Different view - less worry about published position
- What do policyholders expect?
- Careful balance of financing costs, investment policy and insolvency.
- Greater emphasis on realistic than statutory position
- Again stochastic modelling vital
- More emphasis on long term and stability

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## Using what measure of solvency?

- Statutory solvency – ensuring assets exceed liabilities by at least the regulatory minimum margin
- Realistic solvency – ensuring assets exceed liabilities on a realistic basis
- Using solvency as defined by the Insolvency Act 1986:
  - Ensuring that the company can meet its short-term liabilities as they fall due
  - Ensuring that the company can meet its long-term liabilities

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## The definition matters, for example

- To ensure that surrenders do not adversely impact solvency what should we pay?

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## The definition matters, for example

- To ensure that surrenders do not adversely impact solvency what should we pay?
  - Statutory solvency – up to the statutory reserve
  - Realistic solvency – up to the asset share (plus glidepath plus value of guarantees?)
  - Solvency as defined by the Insolvency Act 1986 – up to the value of the guaranteed benefits

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## Options for managing the balance sheet

- Insolvency
- Use of reinsurance
- Restructuring the balance sheet
  - Assets
  - Liabilities
  - Lessons from non-life insurance
  - Example of a radical restructure

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## Administration or other insolvency procedures

- Administration order (made by the Court)
- Winding up order made by the Court for reasons other than insolvency
- Voluntary liquidation (following shareholder resolution)

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## What happens in administration?

- Policyholders (and other creditors arising from insurance contracts but not reinsurance contracts) have statutory priority over other creditors
- Other creditors also have priority under the Insolvency Act 1986, such as employee liabilities
- Assets and liabilities relating to the long term business must be segregated from assets and liabilities relating to other business

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## What happens in administration (continued)?

- Value of policies is value of future benefits less value of future premiums
- No allowance made for discretionary benefits unless the fund is in surplus
- All policyholders could be impacted
- Administrator would try to ensure continuity of cover
- Financial Services Compensation Scheme protects 90% of value of policies

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## Use of reinsurance and securitisation

- Securitisation
- Reinsurance
  - Longevity risk
  - Take-up of guaranteed annuity options
  - Financial

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## Restructuring the balance sheet

- Assets
  - Derivatives
  - Close matching
- Liabilities
  - Exchanging guarantees for benefit enhancement
  - “Unitising” the with-profits fund

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## Lessons from non-life insurance – Schemes of arrangement

- A deal between the insurer and its creditor policyholders
- In exchange for an agreed payment, policyholders give up any outstanding and future claims against the insurer
- If the requisite majority of creditors back a scheme, it binds the insurer and all creditors
- All schemes must be approved by the courts and the Financial Services Authority

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EXAMPLE OF A RADICAL RESTRUCTURE

## Unitising the with-profits fund

- Life insurer converts a book of with-profits contracts into unit-linked contracts
- Policyholders are offered the opportunity to exchange their existing contracts for unit-linked contracts (either voluntarily or compulsorily)
- The scheme changes the way in which policy values are determined
  - Before: reference to a guaranteed benefit augmented by discretionary bonuses
  - After: reference to the number of units held in an investment fund and the current unit price of that fund

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EXAMPLE OF A RADICAL RESTRUCTURE

## Unitising the with-profits fund – benefits to insurer

- Better matching of assets and liabilities
- Avoids having to shift from equities into bonds
- Removal of investment guarantees
- Company can operate with significantly less excess capital
- Possible future cost savings
  - On-going actuarial management and compliance
  - Operational synergies if the scheme allows old legacy business to be removed

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EXAMPLE OF A RADICAL RESTRUCTURE

## Unitising the with-profits fund – drawbacks for insurer

- May require significant compensation to policyholders
- Policyholders and FSA may not consent to change
- Profit profile will be altered – profits may not emerge as smoothly
- Shifts operational risks to shareholders from WP policyholders
- Change to unit-linked may require new administration systems
- High administrative costs associated with communicating the scheme to policyholders and implementing the change
- Move may generate bad publicity
- Possible future mis-selling claims if policyholders do not fully understand the pros and cons of the change
- May encourage surrenders

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EXAMPLE OF A RADICAL RESTRUCTURE

## Unitising the with-profits fund – pros and cons for policyholders

+ Policyholders are able to choose their own investment profile
+ Unit linked policies may be more flexible – premium payment, choosing risk benefits, switching between different funds
+ Unit linked policies are easier to understand
+ Charges are more transparent under unit linked policies
+ Policyholders may get compensation – crystallisation of their current asset share
+ Greater policyholder protection
– Removal of investment guarantees – policyholders are exposed to future investment risk
– Loss of future credit for miscellaneous surplus
– Policies may no longer be qualifying

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## Restructuring

| Statutory scheme of arrangement | Part VII transfer | Agreements with individual policyholders |
|---|---|---|
| • Requires majority approval (75% by value and 50% by number of voters)<br>• Legally binding on the rest<br>• Tried and tested legal process<br>• Process used by Equitable | • Can transfer all or some business to another company<br>• Can modify benefits in the process<br>• Requires court approval but not policyholder consent | • Agreement is voluntary<br>• Leaves rump of with-profit business<br>• May be quicker and cheaper<br>• May generate less bad PR |

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