

EXAMINATIONS

September 2004

Subject 402 — UK Fellowship Life Insurance

Paper Two

EXAMINERS' REPORT

Introduction

The attached subject report has been written by the Principal Examiner with the aim of helping candidates. The questions and comments are based around Core Reading as the interpretation of the syllabus to which the examiners are working. They have however given credit for any alternative approach or interpretation which they consider to be reasonable.

M Flaherty
Chairman of the Board of Examiners

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- 1** Company XYZ will want to take the course of action where it earns the highest rate of return on capital employed, for a given acceptable level of risk. However, XYZ will also take into account a large number of other factors, such as strategic considerations.

It should also consider potential future changes in the regulatory environment.

Marks were awarded for these points irrespective of which section of the solution they appeared in.

- (i) **Closing to new business and allowing the existing book to run off over time**

The company will consider the following factors:

The length of time that it will take for the existing book to run off.

During this time period, the company is going to have to employ at least a minimal infrastructure (systems, customer services, actuarial support etc.) to manage that book of business. Alternatively it could employ an outsourcing company.

The company will have to decide whether to allow renewals and/or increments.

The costs involved in managing the book during the run-off period. This will include taking into consideration the dis-economies of scale that will arise over time, particularly if kept in-house. For example, management and premises overheads will far outweigh the incremental per policy servicing costs. In addition, in-force business will have to take the full burden of overheads normally attributed to new business. Hence, the unit cost per policy will increase over time as the book runs off. Outsourcing the administration may mitigate this.

Increased lapses and surrenders following closure to new business will exacerbate this problem. These may occur for example as a result of policyholder concerns regarding the security of the company.

The one-off costs associated with closing the company to new business. For example: redundancy costs associated with making the sales force redundant, plus the staff involved in the production of quotes and administering new business.

The practical issues that the subsidiary might face as a result of making a large proportion of its staff redundant. For example the ability to retain the remaining staff needed to service the in-force book as it runs-off, and the need to move to smaller premises (or sub-let part of the existing premises) as its need for office space diminishes.

The effect that closing the company to new business will have on the statutory solvency position of the company. For example, the company will have to recognise all of the costs associated with the closure. However, it will be able to release any expense provision held to cover the cost of closure to new business.

It will also have to allow in the valuation basis for the increase in unit costs over time due to the diseconomies of scale mentioned above, which is likely to worsen its solvency position. The company may be able to pass on some of these costs to the unit linked policyholders, but only if expense charges are not guaranteed. In practice, the extent of the increases may be limited by policyholders' reasonable expectations.

In addition, charge increases may lead to a significant increase in the lapse and surrender rates for the unit-linked business. This may not be in the subsidiary's best interests.

Claims volatility is likely to increase as the business runs off, which could increase the margins required in reserves. Alternatively reinsurance could be increased, but at a cost.

Depending on the free asset ratio prior to the closure, the subsidiary may require an injection of capital from its parent company to ensure that the subsidiary remains solvent. However, it can take into account the fact that it will no longer require free assets to support new business strain.

The impact on the investment policy of the company. This could be minimal, because it would be usual for the company to match its term assurance and keyman insurance liabilities through investment in fixed interest assets.

Any non-unit reserves (e.g. required to match guarantees on the unit linked business) are also likely to be invested in fixed interest securities.

The unit fund liabilities would be exactly matched through investment in the chosen unit linked funds.

The level of free assets is likely to be low, since the company has only written without profits business in the past, and the subsidiary is 100% owned by XYZ.

XYZ is likely to have withdrawn the profits from this business and invested these profits elsewhere, unless they were needed to support a desired free asset ratio, or leaving them in the subsidiary's insurance fund was chosen as the shareholders believed this would maximise the return on their capital. This means that the free assets are likely to have

been invested fairly cautiously, e.g. maybe in corporate bonds and a small proportion in equities.

If the free assets are substantial then a more aggressive stance may have been taken, and a larger proportion of the assets will be invested in equities, therefore will have to review this strategy going forwards.

The impact of closure to new business on the unit-linked funds in which its policyholders invest.

We are told that the conglomerate has an asset management company and hence it is likely that the unit funds offered to the policyholders are managed by that company. It is also likely that these funds are offered to more clients than just this subsidiary, i.e. the asset management company has other insurance companies as clients. If that is the case, and the policyholders of the subsidiary company only hold a small proportion of the units in the unit linked funds, then the impact on the funds will be minimal. If, however, the subsidiary's policyholders are the only holders of units in the unit-linked funds, then the costs of selling assets to meet withdrawals from the fund may get disproportionately large as the fund decreases in size.

In addition, it may be difficult to manage certain funds once they fall below a certain size (e.g. a property fund), since the assets are illiquid and a single property may be large in value. The withdrawal of units from such a fund over time would force the sale of assets, possibly when the asset class is depressed in value.

Some unit-linked funds might need to be combined as they decrease in size.

Unit pricing will move to a bid basis.

The company will take all of the above factors into account and will project the cash flows of the business during run-off.

This will allow XYZ to calculate the capital support that may be required at each future point in time, the expected transfers each year to the shareholders, and hence the value of the company to the shareholders if the business is allowed to run-off. This will be compared to the financial projections carried out for the other options that the chief executive is considering.

The company would need to consider the tax position of the company, which could change over time — it could be XSE currently, then move to XSI in the absence of further new business expenses, but eventually return to XSE as the funds under management reduce.

Other (less quantitative and more qualitative) factors will be taken into account.

For example:

- How is the stock market expected to react to the closure of the life insurance subsidiary? Is the share price likely to go up or down?
- Is there likely to be any knock-on impact on the amount of business sold by the other businesses within the group?
- For example, will customers who have taken loans from the loan and credit subsidiary choose to place their loan business with another provider, who can also provide the term assurance required to repay the loan in the event of the customer's death? (i.e. the customer may like the one-stop-shop option of being able to get the loan and term assurance cover from one organisation).
- Is there likely to be any other impact on the other businesses in the group? E.g. is staff retention in the other businesses likely to be a problem as a result of the closure and redundancies?

This question was generally well answered, but relatively few candidates discussed the impact on investment policy and the unit-linked funds. A number made the generic comment that the company would suffer more restricted investment freedom as a result of closure, without appearing to consider whether or not this statement is actually relevant for this particular company given the products it has sold.

Some candidates went into a lengthy discussion of why the company might have come to this decision and suggested how to avoid closure by increasing new business levels. These points are clearly relevant to part (iii), so additional marks were not given for repeating them in part (i).

(ii) Selling the life insurance subsidiary

The factors XYZ will take into account are:

The availability of a buyer who is willing to purchase the life insurance subsidiary at an acceptable price.

The current market place for sales of life insurance companies is very depressed in the UK. This is the result of low free asset ratios and poor investment returns over the last few years, meaning that companies have very little spare capital to consider purchasing a business.

XYZ is unlikely to get any goodwill value for the brand name, since the volumes of business it has sold are low and it has sold to customers within the group. This means that the brand may not be particularly well known in the life insurance market and therefore not worth anything in terms of attracting

future volumes of new business. However, it may be that if the potential for selling products to the client base is there, this may have value to another company e.g. to sell non-life products or even non-financial service products.

The costs associated with selling the subsidiary would be taken into account, including the costs of hiring external consultants to broker the deal and provide legal and actuarial advice.

The sale would have to comply with regulations regarding the transfer of business and be approved by the courts.

The shareholders will want to satisfy themselves that the price negotiated for the company is comparable with the net asset value plus what they believe to be the present value of future profits (PVFP) from the existing (and expected future) book of business. The shareholders would naturally be looking to maximise this value.

They would also place value on the brand, even though a purchaser may not.

If there is any outstanding litigation, this could significantly reduce the attractiveness of the subsidiary and the price.

XYZ might have to give warranties or indemnities to the purchaser, which it might not want to do as it will still have contingent liabilities. This balance of interests between the two parties (buyer and seller) would lead to the final negotiated price for the company. XYZ would have to consider whether the negotiated price is sufficient.

In deciding this it would take into account not only the PVFP of the existing and future expected business, but also the costs avoided under option (i) (e.g. the redundancy costs, the costs of managing a business that is reducing in size year on year).

XYZ might decide that in order to achieve the optimal sale value, it should split the company and sell each element separately, rather than as whole.

Some of the factors mentioned in (i) are also applicable here. E.g. XYZ would consider the impact that the sale of the life insurance subsidiary might have on the share price. Would selling this subsidiary lead to the expectation of the sale of other subsidiaries in the group? Would retention of staff in the other businesses become an issue if other subsidiaries felt at risk from being sold?

The company may want to sell it as a going concern from the point of view of its staff maintaining their jobs. However, it may be attractive to a “vulture fund” which may well close the company to new business and manage the portfolio to maximise emerging profits. In this scenario, expense levels are important and it is likely that many staff would be made redundant in the process.

Some staff may not be wholly employed in the insurance subsidiary but instead in group support functions, and their future would need to be considered.

XYZ should take into account policyholder reactions to the proposal, since they are mainly clients of XYZ's other businesses.

The risk appetite of XYZ shareholder should be taken into account.

If they are unwilling to continue to underwrite insurance business risk, then this would be the best option.

The better answers to this part of the question took into account the specific circumstances of this company, particularly the likelihood of a limited goodwill value plus the implications of a sale for the rest of the conglomerate.

A number of candidates wasted time describing the mechanics of an embedded/appraisal value calculation, which was not required. The question asked for the factors to be taken into account in assessing whether or not to sell the company (e.g. the embedded/appraisal value, the price etc), not how any quantitative assessments would be carried out.

(iii) **Investing in the insurance company to achieve growth from £20m new business premium income to £160m new business premium income in three years**

Firstly, XYZ would have to decide how best to focus the investment in order to meet the proposed targets, and should develop a plan. XYZ should also consider the feasibility of the target, i.e. whether it is realistic.

It should investigate market capacity, and take into account the potential actions of competitors.

XYZ would have to determine the products that the subsidiary should sell in order to achieve the growth target. It would also have to determine the distribution strategy for the sales of these products.

The subsidiary could consider building on the back of its previous distribution channel, i.e. through direct marketing and a direct salesforce to clients within the XYZ group. This could be done by launching new products that might be attractive to the clients of XYZ's other businesses, or by offering products that are complementary to XYZ's other businesses. For example, the subsidiary could consider offering individual income protection and critical illness products. It could use the services offered by the private healthcare subsidiary to manage the income protection and critical illness claims.

Similarly, the life insurance subsidiary could consider introduction a range of single premium bond products for investment in funds offered by the asset management company in the group.

Alternative distribution channels to be used by the subsidiary should also be considered, for example, selling through the insurance intermediary channel. This is likely to require changes to be made to the products to make them attractive, for example increased commission. It may be that the existing products need to be repriced to make them more attractive, or additional features included.

Term assurance is a very price sensitive product and to achieve high volume sales in the insurance intermediary market a very keenly priced product is required.

Keyman insurance is a specialist product and is usually placed through the insurance intermediary market — hence a review of the subsidiary's keyman product to make it suitable for the insurance intermediary market may have a significant impact on the volumes sold. However, this is a fairly small specialised market and the company may want to consider whether it would be better investing its time and effort into products that are likely to lead to high volume sales.

XYZ would have to consider the capital that would have to be employed to support the new business growth. In particular to meet:

- the costs of investment in the company's infrastructure (IT systems etc.) to support the rapid expansion plans
- the costs of meeting the development costs associated with launching new products (staff costs, marketing materials etc.)
- the new business strain created as a result of writing large volumes of new business, to meet the acquisition costs and to set up the required reserves

XYZ will need to consider the extent to which it would need to purchase reinsurance in order to mitigate the risks inherent within the new business. XYZ may also feel that it has to reinsure some business due to the lack of expertise within the subsidiary in writing the new lines of business.

The subsidiary is likely to need external help in pricing the products, putting in place improved underwriting procedures and in designing and implementing adequate systems. It could also use reinsurance to alleviate the capital strain.

XYZ will need to consider the staff required to develop, market, sell and administer the new products. It needs to be sure that it can recruit the necessary staff at a reasonable cost in its chosen location.

The company will to some extent want to minimise the amount of capital it needs to invest in the company, and this will influence the products that the

company chooses to launch. For example, in order to minimise the new business strain it may need to sell a significant volume of unit linked products that are designed to be capital efficient.

The company will need to consider its investment policy and asset allocation/switching strategy as a result of the new business. In particular, it will need to consider whether it will use the expertise of the asset management company within the group to manage assets on its behalf (and negotiate a deal for this) or whether to have its own investment team and manage its own assets.

The company should note that there is little point in increasing the volume of new business premiums written if the overall profit contribution is reduced due to a significant decrease in margins in order to secure the additional sales. Detailed financial projections, showing all of the expected policy cashflows at each future point in time will be required. These projections should take into account the benefits obtained from spreading overheads over a larger number of in-force policies., and any development and investment costs. They should also take into account any impact on the life office's tax position.

The projections will also determine the statutory liabilities and the free assets at each future point in time and the timing and size of capital injections required from XYZ.

To determine whether this option is to be favoured, the return on capital employed will be considered. But the company also must assess the risks inherent in investing further in the life insurance subsidiary. The risks may be assessed by carrying out sensitivity and scenario testing to look at the impact of assumptions varying from the central rate. In particular the impact on the solvency position of the company and the need (and likelihood) of further injections of capital at future points in time should be investigated. The risk of new business falling well short of the projected figures should certainly be analysed.

XYZ should assess whether there are other areas within the conglomerate that would generate higher returns from this level of investment, at an appropriate level of risk.

It needs to consider where it might obtain the capital from in order to support the life insurance company in this way.

Successful growth might have a positive impact on other parts of the group.

This part was generally well answered, with most candidates discussing a wide range of possible approaches to achieving the required new business growth, and the implications of each. A few candidates assumed that the only possible approach was to purchase another company and did not consider other options.

- 2 (i) Asset shares are the starting point for determining the benefit payout on death, surrender or maturity, allowing for an appropriate level of smoothing. This is consistent with policyholders' reasonable expectations, as established in marketing literature, with profits guide / PPFM etc.

Asset shares might be specifically used in financial management as follows:

Determination of reversionary bonus rates

Supportable future reversionary bonus rates are determined by equating the asset share to a realistic prospective gross premium valuation, and then solving for the bonus rate. The calculation should allow for an appropriate level of terminal bonus.

It is normally done for a tranche of business or specimen policies.

Determination of terminal bonus rates

The terminal bonus rate is set in order to bring the sum assured plus declared bonuses up to the level of asset share at the date of claim. This is normally done for a set of specimen policies.

Similarly, market value adjustments for with profits bonds are set by reference to the asset share.

It is likely that the company will offer unit-linked investment options for the pension policies, and hence will determine market value adjustments to apply to switches from accumulating with profits to unit-linked funds.

The asset shares used to determine market value adjustments may be less smoothed than those used to determine terminal bonus rates for, say, pension policy maturities. However, other factors must also be taken into account when determining the extent to which an MVA can be applied, such as past practice and communications to policyholders.

Determination of free estate

The free estate is a realistic assessment of spare capital in a with profits company.

It is calculated as the excess of assets over the sum of:

- asset shares
- additional with profits liabilities in excess of asset share (e.g. payout glidepath, guarantees)
- without profits and unit-linked liabilities determined on a realistic basis.

If the company has a significant portfolio of with profits business, then these realistic liability calculations also form part of the new regulatory reporting requirement.

Other uses

The company can also monitor additional costs incurred by its with profits fund by comparing actual payouts with asset share. These costs include:

- cost of guaranteed benefits (e.g. ten year anniversary guarantee on bonds)
- cost of smoothing (by comparison with an unsmoothed asset share)
- cost of any additional uplift of benefits in excess of asset share (e.g. for marketing purposes).

This will enable the company to assess the extent to which it can continue to support these costs using its free estate.

Asset shares are also used in the calculation of the embedded value of with profits business in order to calculate projected bonuses.

They are also likely to be used in other model office projections or asset liability modelling of with profits business.

Comparison of overall asset shares with guaranteed benefits might be used to determine or influence investment strategy.

Asset shares might form a minimum statutory reserve for the unitised with profits business.

This was generally not well answered. Most candidates only mentioned the more obvious points such as for setting terminal bonus. Few candidates linked their answer directly to the with profits products being sold by this

company. There was limited discussion of the use of asset shares in a balance sheet context, or in assessing the cost to the company of certain features such as guarantees and smoothing.

A number of candidates wasted time by describing how asset shares are calculated, which was not required. Generally, answers did not include enough examples and detail to support the ten marks allocated.

- (ii) As annuity rates are linked to fixed interest yields, moving into fixed interest investments prior to maturity will ensure that the purchased annuity should not fluctuate significantly during that period. This is because an increase in yields will correspond to a decrease in the value of the fixed interest assets and hence the total fund available at retirement, but will also increase the amount of annuity that can be purchased per unit of fund. Similarly a fall in yields will increase the cost of an annuity but will also increase the value of the fund at maturity. Annuity rates are thus “hedged”.

Exposure to the volatility of equity and property markets will also have been removed before the maturity date.

This annuity rate hedging can be useful to the policyholder as it aids retirement planning. Whilst the amount of the retirement fund cannot be predicted, the policyholder can achieve a broad idea of the level of per annum annuity payment. However, it should be noted that for practical reasons annuity rates do not move exactly in line with fixed interest yields; there is normally a lag.

The hedging also depends upon being able to invest in the fixed interest assets on which the annuity rates will be based. Ten years from retirement, this may not be feasible.

The proposed automatic investment switching feature is often included as an option in unit-linked pension policies. However, with profits benefits are smoothed which removes some of the market exposure.

Reversionary bonus rates and terminal bonus scales are changed relatively infrequently and so, unlike for unit-linked policies, the expected size of the maturity fund will normally be known prior to the retirement date. This does however leave the policyholder exposed to changes in annuity rates.

As policies become more mature, they normally develop a greater terminal bonus cushion in excess of the guaranteed benefits. If the company were to adopt optimal asset/liability matching techniques, then policies closer to maturity would be expected to have a greater rather than lesser investment in equity type assets.

The company currently uses the same investment return in its asset share calculation for all policies. This suggestion would mean having to have different investment returns for policies within ten years of maturity.

This will therefore also require a set of new terminal bonus scales that takes into account term to maturity as well as duration in-force. This will mean extra work for the company.

It may choose to calculate individual policy asset shares, e.g. using shadow fund techniques.

There will be systems issues, but these should not be too onerous.

There still could be data issues, including obtaining accurate and timely investment return information.

In order to minimise the mismatch at maturity, the fixed interest investments selected should be those which are used to set annuity prices, by type and term. In order to do this, different term fixed interest investment returns should be used for different outstanding terms to maturity.

If the suggestion were implemented then it would be difficult to reconcile the theoretical asset mix with the actual asset mix. It is also more practical for the Appointed Actuary to advise on broad asset allocation, rather than building up an asset mix from an individual policy level.

It is likely that it cannot be implemented for existing policies, since it does not correspond with the investment information that was described to the policyholders when the policies were taken out, i.e. it goes against their reasonable expectations.

Typically the percentage of the fund in each of the major asset categories is stated in marketing literature and the with profits guide / PPFM. Policyholders will therefore expect that they will be invested in a mixed fund throughout the duration of their policy. This also ties in with the “pooled fund” concept of a with profits fund, i.e. all policyholder funds are invested together for the benefit of all.

Ten years is a long time over which to make the switch, particularly as the move to fixed interest limits the opportunity to participate in higher equity and property returns. This is exacerbated if retirement is delayed beyond the selected retirement age.

The company should perhaps reduce the time period, say to three to five years. It also needs to decide how to phase the switch in during this period.

It may decide to offer this as an optional feature, and switch policyholders into a fixed interest unit-linked fund instead of changing the with profits asset mix (although this will give less perfect hedging).

If the feature is offered to new policyholders, it will have to be explained carefully in the PPFM and other literature.

Most candidates mentioned PRE implications and some practical issues, but few seemed to appreciate that the point of moving to fixed interest investments is to achieve a (partial) hedge against annuity rate movements, not just a switch into a less volatile asset type.

Many candidates assumed that the practice of allocating the same investment return to all policies would continue, rather than pointing out that this would have to change. If the same investment return continued to be allocated across all policies, then the switching would be irrelevant and the proposal would not make sense.

Some candidates stated that the inherent level of guarantees increases as policies mature, and hence it is appropriate to move into fixed interest. However, on average one would expect the earned rate of return to exceed the annual credited bonus rate, and the relative guarantee burden should therefore decrease with time (subject to investment conditions).

- (iii) If the proposal is not implemented, then the actual costs incurred as a result of this guarantee would continue to fall to the free estate. The sustainability of this approach depends on the relative size of the free estate.

It should also be borne in mind that the free estate is there to support all with profits business, not just the bonds. Also, the free estate could be being used up for other purposes.

There are more likely to be other calls on the free estate when markets fall (e.g. smoothing costs), which is also when the actual cost of the guarantee will be higher. It therefore seems appropriate to make a charge to policyholders for the guarantee. The company needs to determine the way in which it makes this charge, and which policyholders should bear the cost.

PRE (or treating customers fairly) considerations mean that it is unlikely that the company can make charges to existing policyholders. Therefore it will only be able to introduce a charge for new policyholders.

The company should take into account potential litigation arising if it proposes different treatment of different policyholder groups, and legal advice may be required.

It should check past marketing literature and with profits guides / PPFM to determine whether there is sufficient flexibility to introduce charges to existing policyholders. It is likely that it will have to amend this literature for new policyholders in order to establish the practice of taking guarantee charges going forwards.

The company must determine which specific group of new policyholders should be charged. For example, it should consider whether to charge just the

bond policyholders for this guarantee, or whether to spread the cost over all with profits policyholders. The latter could be deemed to be inequitable.

An alternative might be for costs to be borne by other than with profits policyholders, e.g. through increased unit-linked charges. However, this is unlikely to be consistent with the PRE of unit-linked policyholders.

The company must then decide whether to charge policyholders with the cost of the guarantee retrospectively, i.e. when it has bitten, or whether a regular prospective charge is made to the with profits bond policyholders during the first ten years to cover the expected cost of the guarantee.

If the charge is taken retrospectively, then a policyholder getting the benefit of the guarantee might not have had his asset share reduced by any guarantee charges.

New policyholders are unlikely to be happy to pay for guarantees on policies sold before they bought their policy. The same is true for bond policyholders that have already passed their ten year policy anniversary.

The amounts involved would potentially be lumpy: no cost for several years whilst markets are performing well and the guarantee has no value, then a big cost if markets fall, the guarantee bites and policyholders take advantage of the guarantee and either cash in or switch into unit-linked investments. This exacerbates the communication issue.

The company would have to decide how these costs would actually be charged to with profits policyholders. For example, spreading in proportion to asset share is an option, but might not be deemed to be equitable.

The prospective approach seems more equitable than the retrospective approach, because each bond policyholder contributes towards the cost of his own policy benefit.

The approach will be communicated at the time of sale, which enables the policyholder to decide whether or not the benefit of the guarantee outweighs the potential cost and is hence a desirable product feature. It might also increase awareness of the guarantee and therefore increase take-up rates.

In order to set the appropriate level of charges, the company must estimate the expected cost of the guarantee. This should be done using option pricing techniques or stochastic modelling in order to obtain a best estimate value (to which an appropriate margin might be added).

It is likely that a level charge would be applied to all policies, say as an annual % of asset share in each of the first ten years. This could perhaps be implemented through a reduction in the credited investment return. The company will have to decide whether the charge should be reviewable or fixed

at outset. Ideally, it should be reviewed regularly in order to avoid a tontine effect.

It should be noted that reducing the asset share by an annual charge will actually increase the cost of the guarantee unless the annual bonus is reduced by the same amount, so the calculation may have to be iterative. The accumulated amount of charges taken plus expected future charges on existing business, should be compared with the actual cost of guarantees paid plus the outstanding expected future costs.

The accumulated amount of charges already taken could also be ring-fenced within the with profits fund until it is needed to contributed towards actual costs when the guarantee bites, in order to avoid it being absorbed by other costs.

The company will have to decide how best to investment the accumulated charges. One option to consider is the purchase of appropriate derivatives.

Whichever method of charging is adopted, systems changes are likely.

The company should also take into account the impact on policy projections and marketability. Do competitors apply equivalent charges?

The charge could reduce reserves (e.g. realistic balance sheet).

Finally, the pension policies have an equivalent guarantee at the maturity date, so in order to be equitable to all policyholder groups, similar charges should be made for this guarantee. Considerations would be as above.

Most candidates mentioned equitable treatment of policyholders, PRE considerations, calculation of the cost and some practical implications. However, many made assumptions about who would be charged and how, without discussing the alternatives.

A lot of candidates also seemed to be confused between pricing for and reserving for a guarantee. Many suggested charging for the 99th percentile guarantee cost, which would probably be prohibitive in practice!

A few candidates discussed the pros and cons of having the ten year guarantee in the first place, which was not required.

- (iv) This proposal might help to increase policyholders' understanding of their with profits policies. However, PRE must be managed very carefully. Ideally smoothed asset shares would be shown, rather than raw unsmoothed asset shares.

The company should consider how close actual payouts are to smoothed asset shares. Terminal bonus scales are normally broadbrush, e.g. based on specimen model points, so the two would equate only by chance. An extreme

consequence might be that payouts would have to be based on individual asset share calculations.

Clear explanation would have to be provided regarding how benefits will relate to the asset share.

There is a danger that policyholders will only take any notice when benefits are less than asset share and not when vice versa. This could generate complaint cases and potential compensation.

Early on, the asset share might look small compared with the premium paid, which might generate further complaints and queries.

There are practical issues regarding the calculation of individual asset shares. It is possible that the company is able to do these calculations, particularly given that the business is all accumulating with profits. It may already calculate a shadow fund for each policy. If not, additional systems costs will be incurred.

This is particularly an issue if the communication encourages policyholders to request their asset share more frequently. Data such as investment returns might not be available on a daily basis. The bonus statement will also have to be redesigned, resulting in additional costs.

Depending on how well the information is explained, the proposal might generate additional queries and hence further costs.

If the surrender value is shown as being in excess of the asset share, then there is the potential for anti-selection. This is especially the case for with profit bonds, particularly at the ten year guarantee date.

Anti-selection is more likely if the policy was sold by an insurance intermediary. The company should investigate the practice of competitors.

This question was reasonably well answered. However, the better answers were those that related to the specifics of this company, particularly the fact that all of the business is accumulating with profits business and the potential for anti-selection at the ten year bond guarantee date. Some candidates mentioned problems arising from the disclosure of negative asset shares at early durations, but the fact that the business is all either single premium or recurrent single premium means that this is unlikely.

END OF EXAMINERS' REPORT