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**TRADED ENDOWMENTS**

**by**

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## Executive Summary

*The following is a summary of the key points.*

1. Comparison of early surrender values with maturity payouts on policies taken out concurrently suggests there is a valid arbitrage reason for a TEP market to exist in the policies of many life offices (Chapter 1).
2. The TEP market is expected to trade more than £200m of policies in 1996. This is estimated to be only a quarter of the potential market.
3. The key to the further development of the market is the information given by life offices to policyholders when they enquire about surrendering their policy. Offices should consider this and other issues arising from the TEP market (Chapter 14).
4. The TEP pricing method involves discounting a projected maturity value based on current bonus rates. Market discount rates at any one time often vary little by any factor other than outstanding term to maturity. This leads, in my opinion, to significant variations between policies in their true value relative to price paid (Chapters 4, 10 & 11).
5. The quoting of the discount rate to investors may be interpreted as a projected return. This may lead to unrealistic expectations on the part of investors. Rates are typically 10-12% at present but have been higher in the past. The industry and its regulator should consider whether the figures and associated statements given to investors are satisfactory. In particular, they should consider the apparent inconsistency between the information disclosed on TEPs and the information disclosed by life offices on their own products (Chapter 12).
6. I believe that many policies in the current TEP market are overpriced relative to underlying asset share. This may be in part due to expectations of windfall gains from demutualisations and other restructuring within the life industry. In these cases investors may be better off with a single premium with-profits product direct from a life office (Chapter 11).
7. Policies have, however, been generally more attractive in the recent past and many investors will have purchased a low risk investment offering good value relative to other products. Even so, they may not receive the returns they expect on the basis of the figures quoted.
8. The TEP market seems doomed to eventual decline as endowments have lost much of their popularity and conventional products are being replaced by unitised products which are not currently traded.
9. The viatical market is small but has significant potential for growth and deserves to be taken seriously (Chapter 15).

# 1. Introduction

## 1.1 *What is a Traded Endowment Policy (TEP)?*

A traded or “second-hand” endowment is a conventional with-profits endowment contract that, having run for part of its term, is then sold by the original policyholder and the benefits assigned absolutely to a new owner. On all such policies the benefits on death or maturity are made up of the original or “basic” sum assured plus reversionary bonuses, added annually, and a terminal bonus added on death or maturity. Unitised with-profits contracts are not currently traded in the market.

## 1.2 *Who are the key players?*

There are a number of different players in the market but at its heart are two types of institution:

- *Market makers*

These act as principals by buying policies onto their own books for subsequent re-sale at a profit. The bulk of the market is now in the hands of market makers.

- *Auctioneers*

These act as agents of the vendor by arranging the sale of the policy to the highest bidder in exchange for a commission.

## 1.3 *Why does the market exist?*

With apologies for stating the obvious, the market exists because investors are willing to pay more for the future benefits payable under a continuing policy than a life office is willing to pay to the policyholder to surrender it. In fact, they must be willing to pay substantially more since, taking the market maker route as an example, the difference must cover some or all of the following:

- premium over surrender value payable to vendor
- commissions to IFAs for introducing vendor and/or purchaser
- administrative costs and residual profit of the market maker

The scope for the market to exist is evidenced by the figures in Table 1. These were derived from a survey of with-profits business in the July 1996 edition of *Planned Savings*. The table looks at the surrender values of 25 year term endowments surrendered on 1 April 1996 after running for 10, 15 and 20 years. They are compared with the maturity values of policies with equivalent full terms. All cases are for £30 per month premiums effected

on a male aged 30 at outset. The table shows surrender value “discounts” calculated as follows:

$$\text{SV Discount} = 1 - \frac{\text{Surrender value of 25 year policy after } t \text{ years}}{\text{Maturity value of } t \text{ year policy}}$$

**Table 1 - Comparison of maturity values and early surrender values at 1 April 1996**

|                    | <i>t = 10 years</i> |                    | <i>t = 15 years</i> |                    | <i>t = 20 years</i> |                    |
|--------------------|---------------------|--------------------|---------------------|--------------------|---------------------|--------------------|
|                    | <i>MV</i>           | <i>SV Discount</i> | <i>MV</i>           | <i>SV Discount</i> | <i>MV</i>           | <i>SV Discount</i> |
| Axa Equity and Law | 5,867               | 24%                | 14,077              | 40%                | 31,063              | 18%                |
| Clerical Medical   | 5,962               | 24%                | 14,156              | 32%                | 31,103              | 18%                |
| Commercial Union   | 6,054               | 29%                | 13,676              | 21%                | 30,190              | 14%                |
| Equitable Life     | 6,153               | 10%                | 14,986              | 8%                 | 29,961              | 6%                 |
| Friends Provident  | 6,065               | 26%                | 14,763              | 22%                | 32,325              | 22%                |
| General Accident   | 6,147               | 20%                | 14,295              | 21%                | 34,605              | 20%                |
| Legal and General  | 5,947               | 18%                | 13,439              | 19%                | 29,769              | 17%                |
| Prudential         | 5,622               | 17%                | 13,064              | 13%                | 30,083              | 11%                |
| Royal Insurance    | 5,440               | 26%                | 12,570              | 22%                | 30,405              | 22%                |
| Scottish Amicable  | 5,667               | 32%                | 14,267              | 35%                | 30,433              | 32%                |
| Scottish Life      | 5,501               | 24%                | 12,492              | 22%                | 30,828              | 21%                |
| Scottish Mutual    | 6,464               | 31%                | 15,338              | 40%                | 33,433              | 51%                |
| Scottish Provident | 5,657               | 11%                | 14,367              | 18%                | 30,816              | 21%                |
| Scottish Widows    | 5,946               | 22%                | 14,511              | 14%                | 32,392              | 13%                |
| Standard Life      | 6,014               | 15%                | 14,304              | 19%                | 31,079              | 13%                |
| Sun Life of Canada | 6,111               | 31%                | 13,817              | 29%                | 31,527              | 29%                |
| Tunbridge Wells    | 6,424               | 27%                | 14,532              | 23%                | 32,418              | 19%                |
| Wesleyan           | 6,252               | 20%                | 15,279              | 22%                | 35,582              | 21%                |
| Average            | 5,961               | 23%                | 14,107              | 23%                | 31,556              | 21%                |

*Source: Planned Savings July 1996*

The figures in Table 1 need to be interpreted with some caution since commissions and sums assured are higher on a 25 year policy than on the lower terms. Also other initial expenses may be apportioned in proportion to commission. The surrendered policies will have therefore suffered higher expense and mortality costs than the maturing policies with which they are being compared.

However, it is difficult to see how these factors in isolation can explain many of the figures shown in the table, particularly for the 20 year comparison. The conclusion must be that there is some scope for a market to exist in second-hand policies to provide arbitrage between surrender values and maturity values. This scope differs significantly from office to office and from policy to policy within the same office.

It is worth noting that Equitable Life have the lowest surrender value discounts. Their policies are rarely, if ever, traded on the second-hand market.

#### **1.4 *Too large to ignore?***

An auction market in traded endowments has existed for over 150 years. Volumes traded remained small until the late 1980s when new players entered the market in the form of market makers. In a few years the volumes traded have expanded dramatically and the turnover for 1996 is expected to exceed £200m.

When the market was a small backwater there was little cause for life offices, regulators and actuaries to pay too much attention to it. This is no longer the case. The market may be small in terms of the overall investment market but it is by no means insignificant. Some 20,000 policies will be traded through the market in 1996 and a far greater number of policyholders may be missing out on a better deal. Should life offices and the regulators now be paying closer attention to this market to protect the interests of investors and original policyholders who sell into this market and those who could but do not?

Although actuarial involvement in the market-place is small, it is certainly growing. A small number of actuaries work in the market-making field but a number of funds have been established to invest in traded policies which require actuarial input in the fields of policy selection and valuation. It is likely that more such funds will be launched. Clearly there are also issues for life office actuaries to address in connection with the market.

#### **1.5 *This paper***

There have been many articles on the traded endowment market in the financial pages of newspapers and the financial trade press. There has been, to my knowledge, no significant literature or discussion of the area within the actuarial profession. This paper aims to provide background information on the market with particular emphasis on technical areas of interest to actuaries. It also discusses wider issues such as regulation and the attitude of life offices to the market.

I have endeavoured to check the factual material presented but apologise for any errors that may remain. Any views expressed are entirely personal and do not purport to represent those of my firm, or any body within the life industry, traded endowment market or actuarial profession.

#### **1.6 *Acknowledgements***

I would like to thank some of the small actuarial contingent active in the field for their assistance in the production of this paper, in particular Graham Cottingham, David Beale, Roger Lawrence and Nick Taylor. My own knowledge of the subject is based on my involvement as adviser to a single fund. My thanks also go to those who helped to fill in the gaps in my knowledge of other aspects, in particular Ned Cazalet, Morris Bisdee,

Stephen Westwood, Dan Nathanson and Sue Goodall. There are many others involved in the market whose views I would like to have canvassed but didn't due to limited time.

I thank my office colleagues for their helpful comments and patient proof-reading, in particular Cathey Hickton for decoding my notoriously scruffy writing. Finally I thank my ever-supportive wife Carole for her patience through the "lost weekends".

## **2. A Brief History**

### **2.1 *Insurable interest***

The Life Assurance Act of 1774 prohibited the issue of policies effected on lives in which the policyholder had no interest to prevent the then widespread practice of gambling on human life. The legal interpretation of “insurable interest” and when it should exist was developed by subsequent case law. In particular, the case of *Dalby vs. India & London Life (1854)* established that insurable interest need only exist at the time the policy was effected - no insurable interest is required of any subsequent assignee.

### **2.2 *A quiet backwater***

Sales of policies for assignment have been taking place since the latter part of the 18th century and are evidenced by advertisements placed in newspapers of the day. The first public auctions of policies commenced in 1843 under the name of a Mr Marsh. The business went into liquidation in the 1880s and was purchased from the liquidator by Messrs Foster & Cranfield. The firm of Foster & Cranfield continued the business and still operate policy auctions to this day.

The policy auction business remained a quiet backwater until the late 1980s. Typically there would have been one sale per month with some 10-20 lots per sale, made up of both policies and reversionary interests.

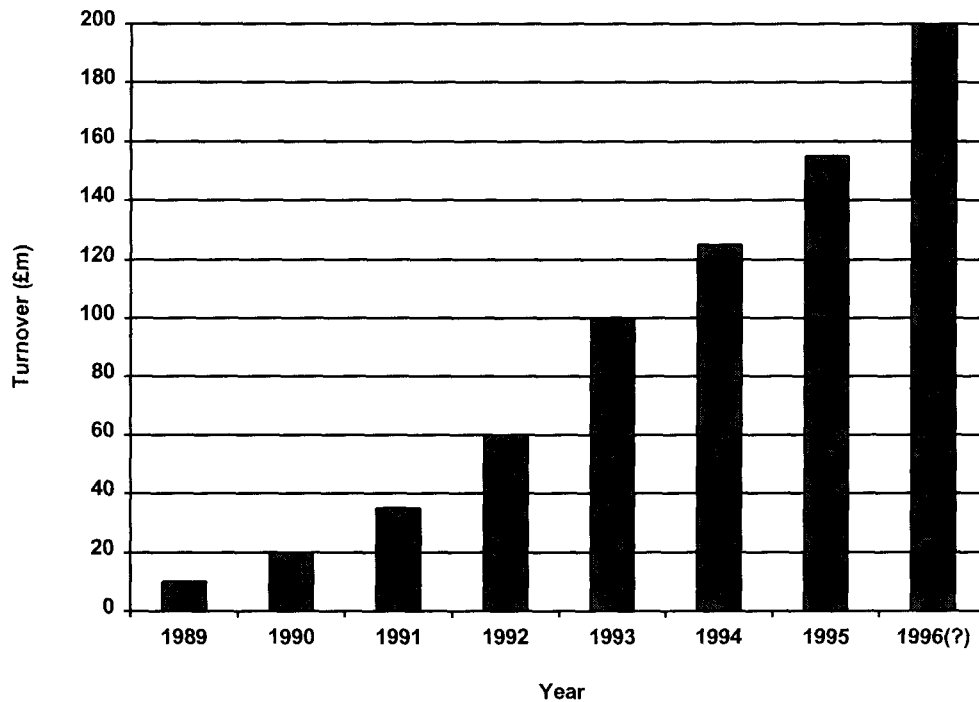
In 1988 a firm called Policy Network entered the market. They acted in a similar role to an estate agent by valuing policies and circulating details in order to match buyers with sellers. The process could, however, take a considerable amount of time to find a buyer and complete the sale - a source of frustration to vendors who may require the cash urgently.

### **2.3 *The key development***

Other people were now becoming aware of the potential of the market and in 1989 the first market maker, Policy Portfolio, appeared to be followed shortly by others. Such market makers bought policies as principals and kept policies on their books until a buyer was found. The policies purchased could be financed until resale largely by borrowing using the policies themselves as security.

Other market makers were formed in the early 1990s and the market developed rapidly using successful marketing to develop the awareness of both vendors, investors and advisers. The rapid development is illustrated in Figure 1 which shows the turnover of the market since 1989.

**Figure 1 - Development of Traded Endowment market turnover**



*Source: Association of Policy Market Makers*

## **2.4 Further evolution**

The rapid increase in market players and volumes traded in the early 1990s brought with it a need to establish a forum to pursue the common interests of those players, to avoid duplication of some necessary functions and to provide for an orderly and consistent market in traded endowments. The Association of Policy Market Makers (APMM) was founded in 1992 and now has 8 members including the largest auction house. The APMM has a Code of Practice governing the conduct of its members to which they are expected to adhere.

Another aspect of the attempts of the market to improve its image has been the encouragement given to the press etc. to refer to it as the “traded endowment policy” market rather than the “second-hand endowment policy” market. SHEPs have become TEPs.

Regulation of the market has developed rather haphazardly. Market makers who deal directly with the public are required to be regulated under the Financial Services Act. The first reference to the market in a regulator’s rules appeared in February 1992. All the members of the APMM are required, as a condition of membership, to be regulated by the PIA. Other market makers who deal only via other regulated firms (principally IFAs) are under no requirement to be regulated.

A key milestone in the industry was the launch in July 1992 of the Kleinwort Endowment Policy Trust plc (KEPT), an investment trust established to invest in traded endowments. There are now four publicly quoted funds available to UK investors. Three are UK based investment trusts and one is an offshore fund based in Jersey. All are closed-end funds but, at the time of writing, an open-ended fund based in the Isle of Man is about to be launched.

The prospect of “windfall” gains from demutualisations, take-overs and distributions of “orphan” assets have increased the appetites of investors for traded endowments in recent months. The flow of funds from maturing TESSAs has also boosted demand for relatively stable investments offering the prospects of better returns than those available from bank and building society accounts.

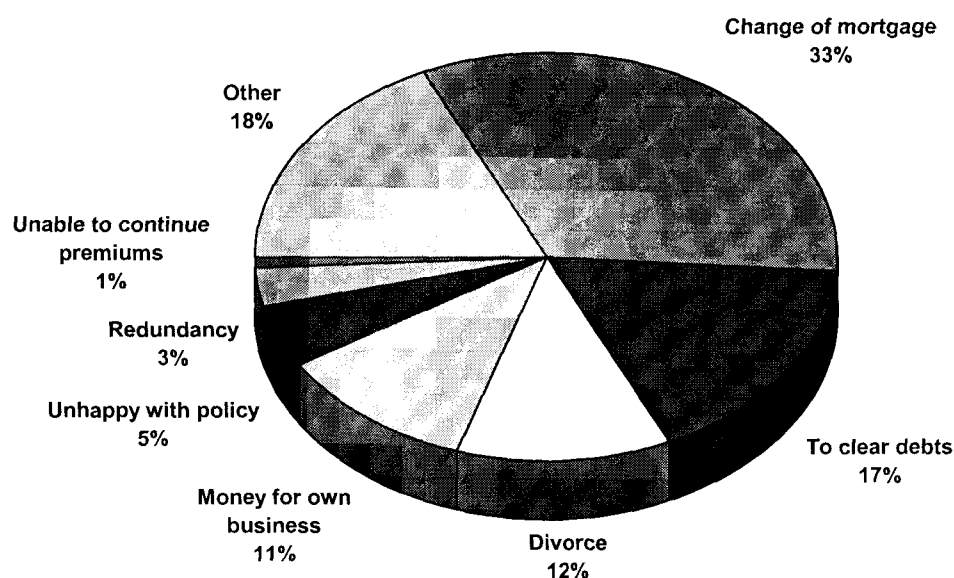
This has further highlighted the main problem of the market - supply. Any glance at the substantial volume of advertising carried out by the traded endowment industry will confirm that this is directed mainly towards acquiring policies from people considering surrendering their policies. The future success of the industry will depend on the degree to which potential surrenders can be directed towards the market.

### 3. The Players in the Market

#### 3.1 Original policyholders

It will come as no surprise to learn that the majority of policies reaching the market were originally taken out in connection with mortgage arrangements. Research by a leading market maker amongst policyholders selling their policies shows that some 80% of policies were taken out for this purpose, the remainder being taken out as a savings plan or, to a lesser extent, to provide life cover. Of more interest are the results of that research into why policyholders are disposing of their policies. These are summarised in Figure 2.

**Figure 2 - Reasons for selling policy**



*Source: Beale Dobie*

It is not difficult to infer from some of the above reasons that some policyholders will need their cash in a hurry. One of the drawbacks of the traded endowment market is the time taken in many cases between accepting an offer from a market maker (or selling at auction) and receiving the cash. This is largely the result of the time taken to complete the legal work involved in transferring title to the policy, in particular in establishing that the seller has title to the policy.

A policyholder considering surrendering a policy has other alternatives which he may not be aware of, these being:

- make the policy paid-up
- obtain a loan from the life office using the policy as security
- sell the policy through an auctioneer or market maker

It is clear that IFAs are under an obligation to advise policyholders of the possibility of obtaining a higher price in the TEP market. However, if no IFA is involved, which is the majority of cases, the policyholder may not be aware of the existence of the TEP market. The advertising aimed at such policyholders is extensive but the feeling within the market is that no more than 25% of policies which could be traded are currently being traded. This proportion has increased and will no doubt continue to increase. Nevertheless, some 60,000 policyholders may be surrendering this year for sums less than they could obtain by selling in the market. The question of the information given to surrendering policyholders by life offices and tied-agents is discussed in detail later in the paper.

If the policyholder or his adviser is aware of the market he should also be aware that there are many possible market maker buyers, not all of which deal directly with members of the public, in addition to the auction route. Getting the best deal involves some “shopping around”.

## **3.2 Investors**

Investors in TEPs tend to be generally more wealthy and sophisticated than the individuals who sell into the market. The auction market until the late 1980s was dominated by private investors and a number of family trusts. The rapid expansion of the market has seen a number of new types of investor. Investors can hold anything from a single policy to a large fund of thousands of policies requiring significant management and professional advice. The following are the main classes currently active:

### **3.2.1 UK private individuals**

The UK private investor would tend to be of high net worth and most would be over 45. The nature of the investment, producing a smoothed return on a known date, gives traded policies a role in retirement and school fees planning. They are also used to provide cash for family occasions such as weddings and anniversaries and have a role in inheritance tax planning.

### **3.2.2 Overseas private investors**

Traded policies are very popular with overseas investors, particularly in Germany, Scandinavia and the Far East. Their popularity is partly as a result of favourable tax treatment given to certain life assurance policies in the countries concerned which is deemed to include second-hand UK policies.

### **3.2.3 Trusts**

Trusts, especially family trusts, invest in the market.

### **3.2.4 SSASs and SIPPs**

Small Self-Administered Schemes (SSASs) and Self Invested Personal Pensions (SIPPs) are significant investors. The access to an underlying spread of assets with a low volatility and a fixed maturity date make them attractive. This attraction has been enhanced by the introduction of provisions for annuity deferral enabling a portfolio of policies to be constructed to provide a regular income drawdown and a final annuity purchase fund at age 75 or earlier. The investment of pension scheme assets in policies which are themselves invested in a taxed fund is a possible objection to the use of traded policies. It appears that such investors and their advisers have concluded that the expected returns and risk profile on such policies compare sufficiently favourably with gross returns on other assets to overcome the objection.

### **3.2.5 Group pension funds**

Some group pension funds invest in policies as part of their portfolio. These tend to be at the smaller end of the spectrum.

### **3.2.6 Collective investment vehicles**

It has been mentioned above that there are currently four publicly quoted funds available to UK investors. There are also a number of large funds managed on behalf of groups of private investors in the UK and overseas. These funds are discussed in some detail in Chapter 13.

## **3.3 Auctioneers**

Although auctioneers now account for less than 20% of the market, they have been around for 150 years and are dealt with first on grounds of seniority! There is only one firm, Foster & Cranfield, carrying out public auctions in a saleroom as we know them. There are other firms described as auctioneers which operate in a different manner.

Auctioneers act as agents of the seller and are remunerated by commission on a stated scale. A description of the auction process is given in Chapter 6 below.

### **3.4     *Market makers***

Market makers now account for over 80% of the total market. They operate by purchasing policies onto their own books for onward sale to investors. They are remunerated by the difference between sale and purchase prices less any commissions and disbursements involved. A more detailed description of market making is given in Chapter 7 below.

### **3.5     *Brokers***

This category includes IFAs in the UK and brokers overseas. The former are involved in advising both policy sellers and investors whereas the latter would deal principally with investors.

IFAs are generally paid a commission by market makers of 3% of the sale price on any policy purchased through them. IFAs may also be paid a commission by auctioneers in respect of sellers introduced by them - e.g. Foster & Cranfield would typically pay a commission of 1/9th of the difference between sale price and surrender value.

Market makers also pay commission on policies sold on to investors via intermediaries. Again this is typically 3% but some market makers pay higher amounts.

### **3.6     *Trawlers***

An IFA involved in the sale/surrender of a policy is under a duty to provide “best advice” to his client. If such advice involved the sale of the policy in the TEP market with the IFA arranging the sale then “best execution” would involve finding the highest price for that policy. At any one time there may be say 15-20 firms in the market to buy policies. Obtaining the best price may therefore be a time-consuming business for the non-specialist IFA.

To meet this problem, a few firms provide a specialist service to IFAs, being effectively “IFAs’ IFAs”. These firms will trawl the market for the best price and are geared up to circulate the market with the policy details required to enable a market maker to provide a quote. They are remunerated by a share of the lead IFA’s commission.

It should be noted however that some market makers do not deal with trawlers or only with selected trawlers. The reason for this is that they feel that the work involved in producing a quote is disproportionate to the chances of obtaining the business in such a wide market place.

### 3.7 Life offices

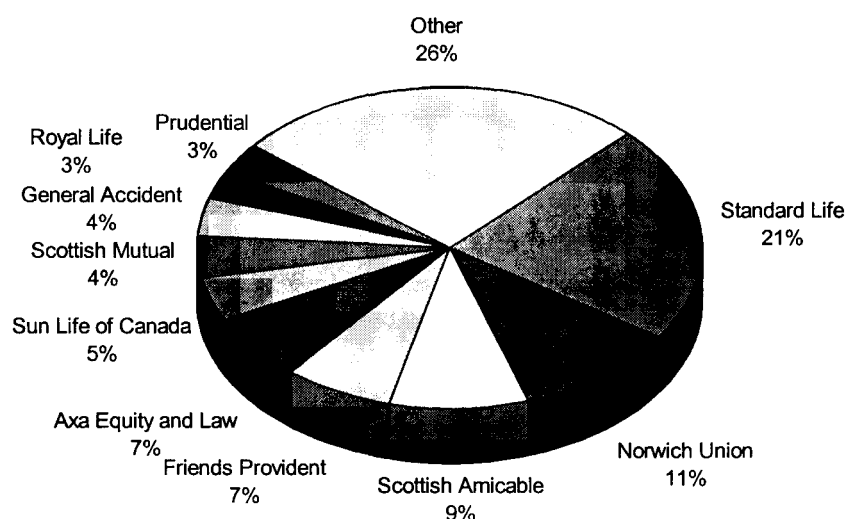
The life offices themselves hold a key influence on the market for four principal reasons:

- They provide the basic commodity traded.
- The market exists because investors value the policies significantly higher than the surrender values payable by offices. If offices increased their surrender values, the policies may no longer be tradable.
- Supply to the market is heavily influenced by the information given to policyholders who seek to surrender their policies. Most such people will remain ignorant of the possibility of obtaining a greater sum in the TEP market unless they are told by the life office.
- The life offices are required to provide administrative services involved in the transfer of title to the new owner. This aspect has improved considerably but can still take several months in extreme cases.

These and other issues concerning the offices are discussed in detail in Chapter 14.

An indication of the breakdown of the market by life office is shown in Figure 3. This was derived from an analysis of the stock lists of three leading market makers. Note that the proportions can change significantly from time to time, especially in response to changes in surrender value bases.

Figure 3 - Breakdown of market by life office



Source: Beale Dobie, *Policy Portfolio, Securitised Endowment Contracts Stock Lists, Sep 95- Jun 96*

## 4. Pricing

### 4.1 Introduction

The method of pricing TEPs is a legacy of the days when the market was much smaller and less sophisticated than it is today. It is also a legacy of a time when investment returns and bonus rates were more stable than today and projected returns were given on the basis of current bonus rates. I believe there are serious deficiencies in the method and the related disclosure which may result in some investors being given unrealistic expectations of the returns they will receive.

The method is, however, objective and relatively straightforward to explain.

This chapter deals purely with describing the pricing method itself and the factors influencing the pricing parameters. The assessment of a TEP for purchase is discussed in Chapter 10.

### 4.2 Basic method

The basic method of pricing second-hand contracts for sale is:

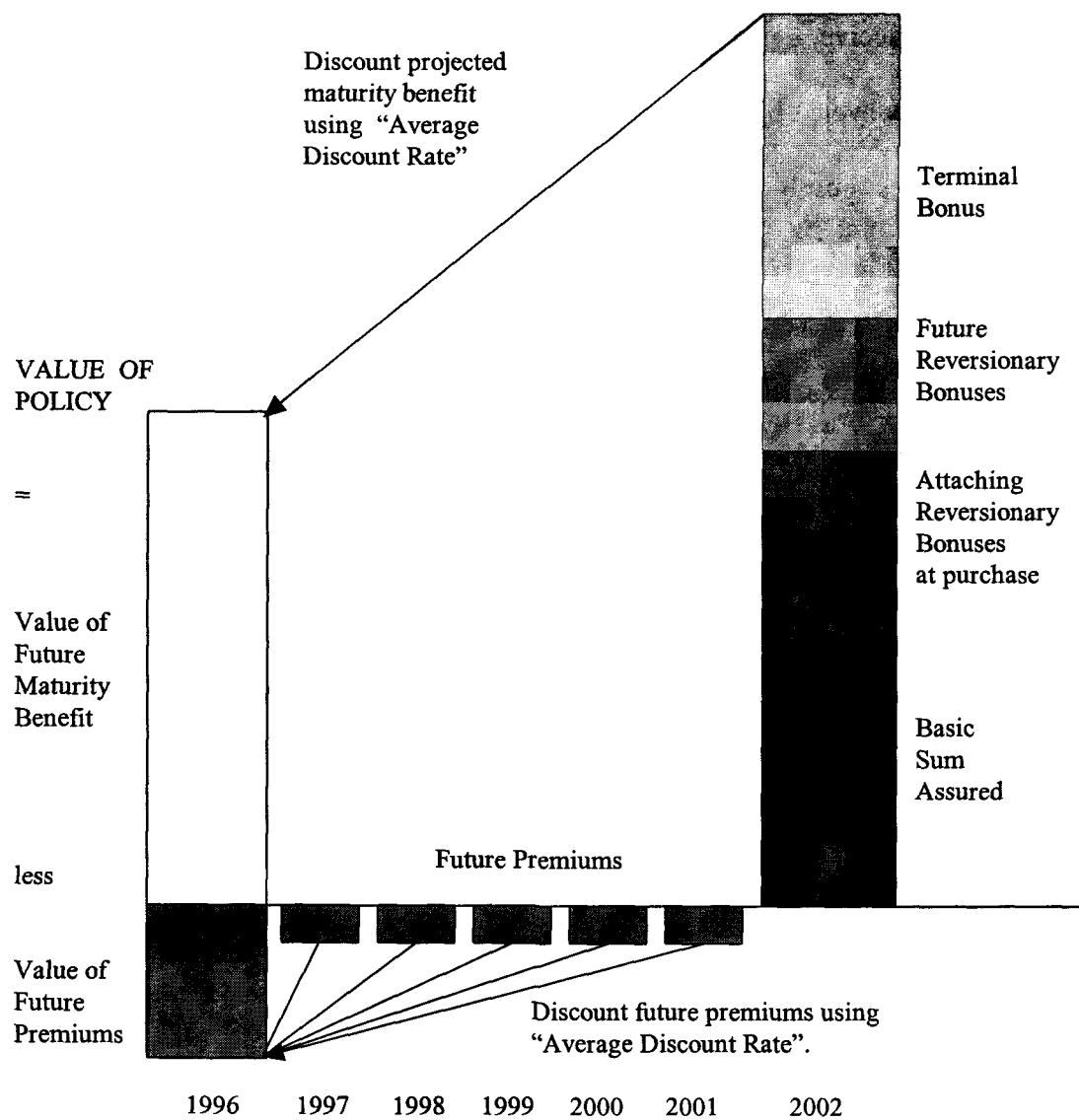
- (i) Project the maturity value on the basis that current rates of reversionary and terminal bonus are maintained to maturity. This is known as the “*Formula Maturity Value*” or “*FMV*”.
- (ii) Calculate the present value of the FMV using a specified rate of interest, known as the “*Average Discount Rate*” or “*ADR*”.
- (iii) Calculate the present value of the stream of future premiums payable by the investor using the same interest rate as in (ii) above.
- (iv) The price is the present value of the FMV less the present value of future premiums i.e. (ii) – (iii).

For any given price the ADR can be calculated. This is invariably quoted to potential investors by market makers on their stock lists. Although the ADR is the “headline” indicator of the pricing basis, it is not the case that all policies are priced by a market maker using the same ADR. There are a number of factors affecting ADR which are discussed below.

Note that there is no element of mortality in the basis. This reflects the fact that investors purchase with a view to holding to maturity and will not, in most cases, attempt to ascertain whether the life assured is still alive after purchase.

A schematic representation of the pricing method is set out in Figure 4.

**Figure 4 - The Pricing of a Traded Endowment Policy**



### **4.3      *Calculation of the Formula Maturity Value***

The calculation of the FMV is generally a straightforward process based on applying current rates of reversionary and terminal bonus to the basic sum assured and/or attaching bonuses to calculate future bonuses. The main complications are:

- whether bonus scales are compound or “super compound”.
- offices operating more than one bonus series.
- whether bonuses declared on non-annual premium policies are proportionate or not.
- unconventional bonus rate structures e.g. Sun Life of Canada operate a North American-style “contribution” system.
- special bonuses declared from time to time.

For unconventional bonus structures or where a bonus series has not been in force long enough to be declaring terminal bonus rates for a term equal to that of the policy being valued, a different method is used. In such cases the FMV is generally based on the maturity value of a currently maturing policy from an earlier bonus series having the same sum assured and term.

Clearly, it is vital to know when life offices change their bonus rates. The Association of Policy Market Makers delegates this task to their Technical Committee who establish contacts within the offices and systems for verifying any new rates communicated to them. The intention is that details of new declarations are obtained as reliably as possible and introduced into the pricing systems of member firms at the same time.

The Technical Committee would also deal with the treatment of special bonuses and policyholder benefits arising from mergers, demutualisations etc. to ensure an agreed and consistent approach between market makers.

### **4.4      *Factors influencing Average Discount Rates***

#### **4.4.1    *General investment conditions***

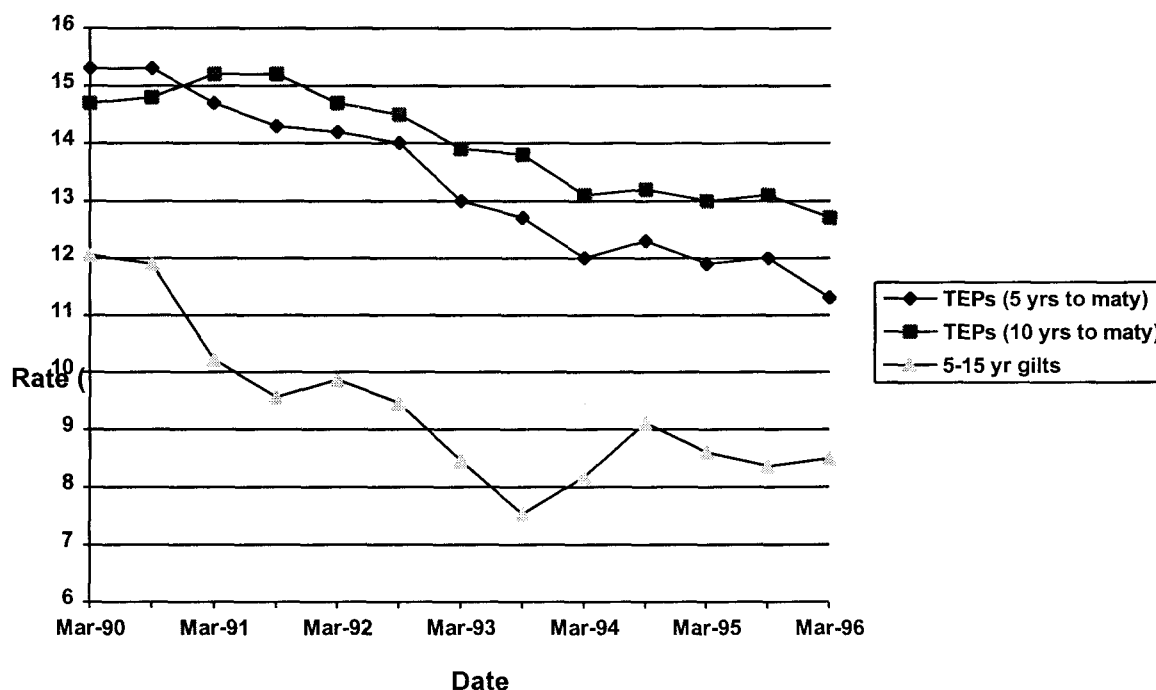
These will influence the TEP market as a whole. TEPs will be compared with other investments by potential investors. A TEP might be regarded by a potential investor as a form of single premium bond with a negative coupon (the premiums) and a variable maturity payment with a substantial guaranteed element (basic sum assured and attaching bonuses) and a non-guaranteed element protected, to some extent, from the fluctuations of the underlying investment markets. An investor might therefore compare the TEP with a low-coupon gilt of similar maturity date or zero-coupon preference shares. Unless the investor (or his adviser) were convinced that bonus rates were set to increase he would demand a premium over the fixed-interest rate to compensate for the risk of future bonus cuts.

The above analysis suggests that the general level of the TEP market is influenced by yields available in the fixed interest market and the expectation of future bonuses. The difference between ADRs and fixed interest yields has stayed high in the 1990s as the

general expectation through this period was for bonuses to be cut in response to the expectation of the continuation of a lower inflation environment.

A comparison between market ADRs on TEPs and gilt yields is shown in Figure 5 below for the period 1990-96.

**Figure 5 - Average Discount Rates on TEPs vs. gilt yields, 1990-96**



*Source: Policy Plus International*

The discounting of an estimated maturity value might be described as a prospective method of valuing a policy. This is the method chosen by the market as it is reasonably objective and easy to explain. Another approach, a retrospective method, might be to estimate the value of the underlying “pot” of assets backing the policy - the asset share - and base the valuation on this. The rationale for this is that the life office’s Appointed Actuary would recommend terminal bonus rates which related maturity values to a smoothed asset share. The higher the asset share at purchase, the more valuable the traded policy will be. Few private investors or their advisers would be in a position to attempt this calculation. The approach is used by the larger funds with access to actuarial advice and is discussed in more detail in Chapter 10.

The regarding of the policy as an underlying pot of assets might lead to the conclusion that values should fluctuate with the equity market to some extent. This is to some extent true but tends to come through as a reaction to expected changes in terminal bonus rates rather than in any way mirroring short-term stock-market fluctuations.

#### 4.4.2 Life industry factors

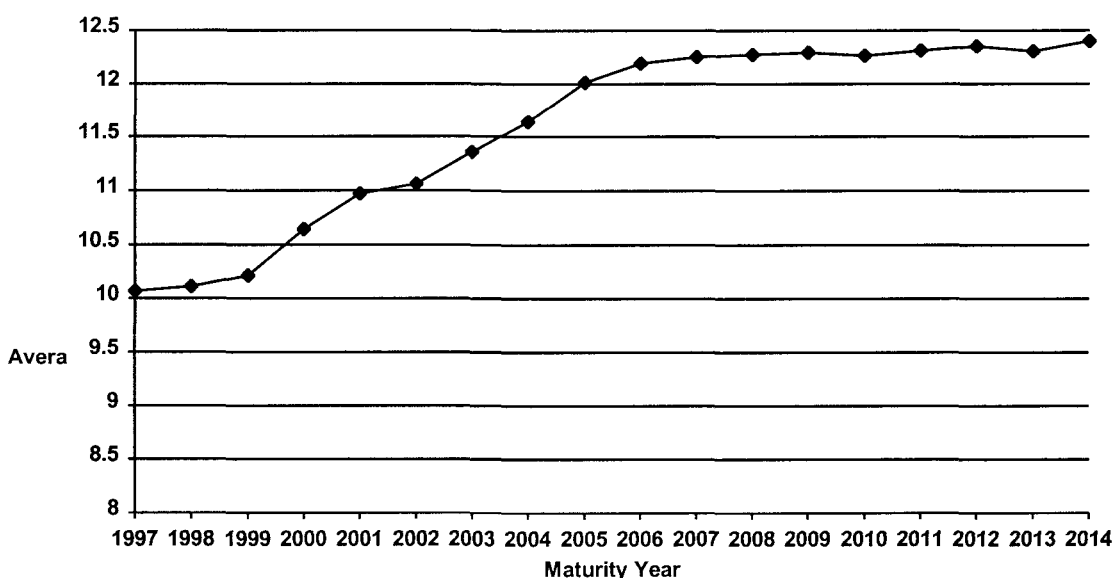
There are factors which affect the life industry as a whole and are expected to influence the prospective returns under TEPs and the demand for them. The most significant are the announced and prospective policyholder benefits accruing from the restructuring of the industry in the form of demutualisations, take-overs, distribution of “orphan assets” etc. This has undoubtedly fuelled interest for the TEP market in general.

#### 4.4.3 Outstanding term

Of the factors specific to individual policies, the most significant influence on ADRs has been and remains the outstanding term to maturity. The ADRs in the market increase with outstanding term. This reflects the demand from investors for policies closer to maturity, the greater uncertainty of more distant bonus declarations and the normal shape of the yield curve for fixed interest investments.

Figure 6 shows the average ADRs for each year of maturity for all policies appearing on the stock lists of three leading market makers at 30th June 1996. Use of the outstanding term to differentiate between ADRs on individual policies is universal in the market. Some market makers appear to use other criteria to a very limited extent to differentiate policies.

Figure 6 - Average ADR (%) by Maturity Year



Source: Beale Dobie, Policy Portfolio, Securitised Endowment Contracts Stock Lists

#### **4.4.4 Individual life office**

It might appear surprising that ADRs do not vary greatly between life offices for policies having the same outstanding term. When selecting an office with whom to take out a new policy, one might look first and foremost for a consistently good performance in the maturity value league tables. This approach does not necessarily work for a second-hand policy. The FMV will already allow for performance to date by including an element of attaching reversionary bonuses. It will also use current bonus rates to project the remainder of the FMV. Thus, other things being equal, you will have to pay more for a policy from a strong-performing office.

The decision for an investor is how the bonus rates for a particular office are likely to move in future. ADRs should be higher for the offices where prospects are worst. In practice the market shows little evidence of making such judgements. ADRs show little variation between offices and, where they do vary, tend to be down to factors such as how well-known the office is and prospects of windfall distributions.

#### **4.4.5 Composition of maturity value**

The FMV is made up of a number of elements giving each policy a different risk profile. These elements are:

- Sum assured and attaching reversionary bonuses.
- Future reversionary bonuses.
- Future terminal bonus.

Sums assured and attaching bonuses are guaranteed by the life offices. They represent the downside protection on the policy and on some policies may exceed the purchase price of the policy and offer a guaranteed positive return even when future premiums are taken into account.

Future reversionary and terminal bonuses are not guaranteed and depend on future investment conditions and life office policy. They are therefore considerably riskier. Some offices, such as Commercial Union, are weighted towards a high dependence on reversionary bonuses, whilst others, Standard Life for example, are weighted towards terminal bonuses. Conventional wisdom is that terminal bonuses are considered to be more risky than future reversionary bonuses as the latter would generally be set at a rate which the office expects to maintain. It should be noted, however, that some offices have made very deep cuts to their reversionary bonus rates over the past few years.

Market makers vary in how they build in the effect of the risk profile into their pricing. One approach taken is to project the various elements of the FMV and discount them at different rates to reflect the variation in risk. The basic sum assured and attaching bonuses, being guaranteed, are valued at the lowest discount rate. The future reversionary bonus element of the FMV is typically valued at a higher rate to reflect the increased risk attaching to future declarations. The terminal bonus, having the highest perceived risk is discounted at a higher rate still. A fourth rate might be chosen to value the future

premiums. This would generally be lower than the rate applied to the projected benefits. This approach would only be used for internal pricing. A single ADR would be quoted to potential investors which related the resulting price to the total FMV.

A more simplistic approach would be used by most market makers.

#### **4.4.6 Original policy term**

In recent years, terminal bonus rates on policies with shorter terms have been more volatile than policies with longer terms. Market makers might therefore use a higher discount rate for policies with shorter terms (e.g. 10 years) than policies with longer terms (e.g. 25 years).

#### **4.4.7 Tax treatment**

The tax treatment of a TEP in the hands of an investor depends on whether the policy is qualifying or non-qualifying. A qualifying policy will be subject to Capital Gains Tax in the hands of a UK private investor. A non-qualifying policy will be subject to income tax on a top-slicing basis. The latter may be less suited to higher-rate tax payers who make up the bulk of the private investors. Hence non-qualifying policies may sell on slightly higher discount rates.

#### **4.4.8 Premium level**

Policies which require a lower level of ongoing premium payments as a proportion of purchase price are more attractive to investors than policies with higher future premiums. This can be automatically built in to pricing if the multiple-discount rate approach is used. Otherwise a small increase in discount rates may be used for high premium policies. Such policies commonly arise from the practice of market makers shortening the term of a policy between purchase and resale.

#### **4.4.9 Supply and demand**

The market is, like other markets, subject to supply and demand. In particular, the demand created by substantial press coverage, maturing TESSAs and windfall gain prospects has combined with a limited supply to drive up prices substantially during 1996.

## **5. Which Policies are Traded?**

Many of the policies which are offered to the market by sellers are not actually tradable. The industry is attempting to reduce its costs by reducing the number of unsuitable policies presented to it in the first place. Measures taken include supplying IFAs with computer programs to assess the saleability of policies and automatically generate quotation requests.

Criteria are generally similar from market maker to market maker but may vary on some points. The following would be reasonably typical of current trading criteria.

- Only conventional with-profits policies are accepted, no unit-linked or unitised with-profits are traded.
- Policies must have been in force for a minimum period, typically 5-7 years.
- Policies must be of a minimum size. This is usually measured by surrender value with a minimum of £1,000-£2,000 being applied.
- The policies of some life offices will not be tradable if the maturity date is beyond a certain limit. This limit normally depends on the office's practice with regard to shortening the term of its policies.
- Policies from some of the smaller life offices and friendly societies may not be acceptable.

## 6. Policy Auctions

### 6.1 Saleroom auctions

Only one firm, Foster & Cranfield, operates traditional saleroom auctions. Auctions are generally held weekly, approximately half being held in London and the remainder in a number of other locations.

The process involves the prospective vendor or his professional adviser supplying the information required for the auctioneer to estimate the value of the policy. This information is a copy of the policy schedule, a copy of the latest bonus notice and a copy of the current surrender value quotation from the insurer. The auctioneer then provides an estimate of the policy's value using the valuation techniques described earlier in the paper based on a market discount rate. The estimate is usually given in the form of a range, together with a suggested reserve price at the lower end of the range.

If the vendor decides to proceed, reserve instructions will be required. Draft sale particulars will be prepared for the vendor's (or his adviser's) approval before inclusion in the auction catalogue. The catalogue will be distributed to parties on the auctioneer's mailing list in advance of the sale. An example of the details given for a policy in the catalogue is shown below.

#### Example of auction catalogue details

|                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                           |
|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <p style="text-align: center;">Lot 44</p> <p style="text-align: center;">An Endowment Assurance for <b>£14,420.00 (with-profits)</b><br/>Effected 28th May 1986 with the<br/><b>STANDARD LIFE ASSURANCE COMPANY</b></p> <p><b>Payable 28th May 2008</b> or earlier death of a Gentleman now aged 49 or a Lady now aged 48. <b>Bonus additions £7,691.00 to 15th November 1995.</b> (3.50 per cent on the sum assured and 4.75 per cent on attaching bonuses was declared for the year ending 15th November 1995. The interim bonus rate for 1996 is 3.25 per cent and 4.50 per cent respectively.) <b>Premium £69.60</b> payable on 28th of each month. <b>Surrender Value £11,155.00 approximately.</b> On the maturity at the present time of endowment assurances in force for 22 years this Company is currently paying a Terminal Bonus equal to 108 per cent of Sum Assured and attaching Reversionary Bonuses.</p> |
|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|

*Reproduced by permission of Foster & Cranfield*

Lots are auctioned in the saleroom subject to competitive bidding in the usual manner. If a final bid is received which exceeds the reserve price, the successful bidder is required to pay a 10% deposit and sign a binding contract pending completion. The purchaser is required to arrange and pay for the legal work involved in transferring the title. The work is described in detail in Chapter 8 and would typically cost in the region of £100 plus VAT.

When the legal work has been carried out satisfactorily, completion takes place and the balance of the purchase price is paid. Conditions of sale require the purchaser to complete within 28 days subject to forfeiture of the deposit or the application of a punitive interest rate on outstanding monies.

Vendors pay commission to the auctioneer which is currently one third of the difference between the sale price and the surrender value. Intermediaries introducing vendors would generally receive a third of the auctioneer's commission as their own commission.

## **6.2     *Postal auctions***

A postal auction of policies is carried out by Johnson Fry on a monthly basis. A catalogue is sent to potential purchasers containing policy details which also show the reserve price and a (higher) estimated value at a stated discount rate.

Bids may be received by post or fax on a pre-printed bidding form up to the day of the auction. Bids must not be lower than the stated reserve price and must be made in multiples of £25, £50 or £100 depending on size. Bids are logged on a secure computer system and are not divulged to other potential bidders.

In order to make the process more akin to a saleroom auction, the highest bidder acquires the policy not at the price he has bid, but at the price bid by the second highest bidder plus a small amount (the appropriate multiple in the previous paragraph). This reflects the saleroom situation where a bidder would only bid sufficient to acquire the policy and not go to the limit he had set himself unless he had to.

The legal work associated with assignment to the purchaser is carried out by the auctioneer.

## **6.3     *Electronic auctions***

In May 1996, Endowments Direct, a division of the Insurance Policy Trading Company, launched an electronic auction service on the Internet. The site is <http://www.endowments-direct.co.uk>.

Details of policies for sale are displayed to potential buyers and are guaranteed to be open to bids until the end of that business day. Bids may be made either via the Internet or via fax or telephone. The vendor is advised of any bids at the end of each business day.

Sellers are charged a registration fee and a commission on successful sale. Buyers are required to meet the legal fees associated with assignment to themselves.

## **7. Market Making**

### **7.1 *Background***

Since the first market maker commenced business in 1989, many more have appeared on the scene, though the number of new entrants has reduced in the past couple of years.

Market makers can be sub-divided into two categories, those who deal via intermediaries and those who additionally deal directly with members of the public. The latter are required to be regulated under the FSA, the former are not so required. There are also other organisations competing to purchase policies that do not then offer them for general sale but pass them direct to private investors.

At any one time, there may be up to 20 firms in the market to purchase policies. They all vary to some extent in the way they conduct their business. The following is therefore only a general outline of the way they operate.

### **7.2 *Purchasing policies***

The main challenge facing market makers is obtaining a supply of policies to meet demand. A substantial proportion of most market makers' costs relate to advertising and other marketing expenses in this area.

The following information would generally be required in order to ascertain if the policy is tradable, and, if so, to produce a quotation.

- Life office
- Basic sum assured
- Bonuses attaching and date of last declaration included
- Surrender value and date valid to
- Maturity date
- Commencement date
- Gross premium and premium frequency

This process can be time consuming, particularly when dealing directly with members of the public who may not be familiar with their policy documentation. The information needs validating. A large proportion of enquiries will not result in a purchase. The policy may not be tradable (e.g. because it hasn't been in force long enough), a better offer may be received from elsewhere or the policyholder might decide to keep the policy. The market maker may have in-house software to assist in the validation process and in at least one case supplies software to intermediaries to enable them to screen out unsuitable policies and provide the market maker with information which has undergone some validation.

### **7.3 Pricing for purchases**

The market maker will have a clear idea of the price at which he can sell the policy to an investor. He will also know the amount of commission that he will have to pay any intermediary involved in the purchase of the policy and the subsequent resale, although he will not necessarily know whether an intermediary will be involved in the resale. In his offer price he must also make allowance for his own legal and administrative costs of taking the policy onto his books and other overheads of his business. The balance of the difference between purchase and sale price will be his trading profit (ignoring any financing costs and change in valuation while the policy is on his books).

The price that a market maker offers may, to an extent, depend on his perception of the seller's negotiating position. A seller who is known to have obtained a number of competitive quotes might well receive a better offer than someone not known to be in that position.

From anecdotal evidence it appears that an average market maker's "turn" might currently be of the order of some 6-8% of the sale price. The "turn" tends to be lower on the shorter maturity dates. This is required to meet the market maker's own costs as well as profit. Commissions would account for the remainder of the difference between purchase and resale prices.

The market maker is exposed to some risk in taking on the policy, not least that bonus rates may change adversely between purchase and resale.

### **7.4 Policy "engineering"**

It is common practice to "engineer" the policies of certain life offices. This is market parlance for shortening the term of policies. This is done for two main reasons:

- shorter term policies are more attractive to investors - a policy maturing in 5 years time is of more interest than one maturing in 12 years time.
- the pricing method of discounting an estimated maturity value based on current bonus rates often results in a higher price based on the reduced term.

Offices vary in their approach to alteration. Some will not reduce terms, some will reduce terms only while the policy remains qualifying (i.e. has 10 years or more to run from the date of alteration) and others will permit reductions to maturity dates 5 years after alteration. In the latter case this will usually make the policy non-qualifying and offices will generally allow this to be done on traded policies only.

In pricing a policy for purchase, market makers will take account of the terms on which the term of the policy can be altered (which may involve obtaining a quote from the office concerned). If the policy is successfully purchased, the market maker will effect the necessary alteration before resale.

## **7.5     *Administrative aspects***

If the policyholder accepts the offer, he is required to sign and return a written acceptance of the offer. The policyholder would then be sent a contract note confirming the details of the transaction, a Deed of Absolute Assignment for signature and a Referee form (to enable a future purchaser to check whether the original life assured is still alive). He would be required to send the original policy document and any documentation relating to previous assignments.

The legal checks (described in Chapter 8) then proceed. At completion, the policyholder receives the payment, any commission due to an intermediary is paid and a Notice of Absolute Assignment is sent to the life office to assign the policy into the market maker's name.

## **7.6     *Financing***

A market maker may have many policies on its books awaiting resale. Although the policyholder will be effectively financing the policies until the purchase price is paid, the market maker must still finance the policies until resale. This is generally done in the greater part by a bank arrangement using the policies themselves as security.

The market maker must also arrange for premiums to be paid on the policies between purchase and resale. The policies, assuming market discount rates and bonus rates do not change, would increase in value between purchase and subsequent resale to offset premium payments and financing costs.

## **7.7     *Policy sales***

Many policies do not reach the retail sales lists prepared by market makers. They are sold directly to funds and other investors who have indicated to the market maker the type of policies they require and their purchase criteria.

Policies that do reach the retail lists have their details circulated on two types of list, one for the private investors and one for intermediaries and professional investors. The information provided is similar on each type but the information given to private investors does not include a Formula Maturity Value. Some market makers do, however, still provide FMVs to private investors where the term to maturity is less than 5 years.

An example of part of a (fictitious) market maker's list for other than private investors is shown opposite. The example is shown to give an indication of a typical layout. In practice the list would be much longer.

## XYZ ENDOWMENTS LIMITED

XYZ Mansions  
Veranda Street  
London SE3 3QP  
Tel: 0181 365 1234  
Fax: 0181 365 5678

Regulated by the Personal Investment Authority

Stock list: 12 Valuation date: 25/09/1996.

| XYZ<br>ref | Life Office       | Term<br>(years) | Maturity<br>date | Approx<br>SV | Basic Sum<br>Assured | Attaching<br>Bonuses | Premium<br>Amount | Premium<br>Freq. | Total<br>premiums to<br>maturity | FMV    | Terminal<br>Bonus % | ADR<br>% | Price   |
|------------|-------------------|-----------------|------------------|--------------|----------------------|----------------------|-------------------|------------------|----------------------------------|--------|---------------------|----------|---------|
|            |                   |                 |                  | £            | £                    | £                    | £                 |                  | £                                | £      |                     |          | £       |
| 1359       | Standard Life     | 25              | 16/08/97         | 21,429       | 3,696                | 7,147                | 16.00             | M                | 151                              | 27,915 | 58.0                | 10.00    | 25,527  |
| 1432       | Friends Provident | 13              | 04/12/00         | 4,923        | 3,273                | 4,456                | 62.00             | M                | 3,081                            | 13,938 | 35.3                | 10.50    | 9,700 N |
| 1357       | Norwich Union     | A 18            | 01/02/02         | 6,503        | 6,755                | 4,696                | 71.07             | M                | 4,477                            | 22,854 | 21.6                | 11.25    | 9,623 N |
| 1237       | Royal Life        | 21              | 24/05/04         | 7,766        | 6,777                | 5,922                | 33.64             | M                | 3,061                            | 29,735 | 39.9                | 11.40    | 10,958  |

The notes below refer to all policies:

1. The Formula Maturity Value (FMV) is calculated by XYZ to provide a consistent figure to discount back to a present market price. IT IS NOT A FORECAST. It has been calculated using current bonus rates for policies of the same original term. Where bonus rates are not available or there is an unconventional bonus structure then recent maturity results have been used. The actual maturity value will depend on future bonus rates. Past performance is not necessarily a guide to the future. Bonus rates may go down as well as up.
2. The Terminal Bonus Percentage is the proportion of the Formula Maturity Value represented by the terminal bonus element.
3. The ADR is the Average Discount Rate - the rate at which the Formula Maturity Value and future premiums have been discounted to calculate the price. IT IS NOT A FORECAST OF INVESTMENT YIELD.
4. The Premium Frequency may be Monthly (M), Quarterly (Q) or Annual (A).
5. Capital gains tax (after indexation) may be payable on TEPs by UK residents. TEPs marked with an N are non-qualifying under current UK tax legislation.
6. TEPs with an amended Term are marked with an A.

The investor, with the help of his adviser if appropriate, will select an appropriate policy from the list. Due to the strong demand it is common for policies to have been reserved by another investor, particularly if the list is not new. In such circumstances the market maker might recommend a similar available policy or note the investor's requirements and reserve a future incoming policy

When a suitable policy has been found, the investor can usually reserve the policy on the telephone and then submit an order form and payment to the market maker. The market maker will then issue a contract note and, following clearance of monies, can forward to the policyholder the original policy document, previous deeds of assignment and clearances, a Deed of Absolute Assignment to the purchaser and documentation relating to the continuation of premiums by the investor.

## **8. The Legal Process**

The legal process involved in transferring the title to the final purchaser is similar whether the policy is acquired via an organisation acting as an agent (an auctioneer) or as a principal (a market maker). The main difference is that in the first case the policy will be assigned directly from the original owner to the purchaser whereas in the second case the policy will be first assigned to the market maker and then to the final purchaser. The work may be carried out by an internal legal department or an external firm of solicitors.

The process is needed to establish that the details of the policy sold are as represented to the purchaser and that the vendor is legally entitled to sell the policy.

### **8.1 *Requirements from policy vendor***

The policy vendor is required to provide the following documentation:

- policy documents and endorsements
- previous assignment deeds and clearances
- proof of age (if not previously admitted)
- signed assignment document

### **8.2 *Checks with the life office***

The legal department will then write to the life office concerned to request certain details. These might typically include:

- confirmation that the vendor is the true policy owner
- verifying the policy details
- verifying the current surrender value
- confirmation that premiums are paid to date
- confirmation that there are no outstanding policy loans
- checking that there are no trusts in force
- confirmation that the policy is not assigned to a third party

### **8.3 *Bankruptcy search***

The buyer must ascertain that the vendor is in a position to sell the policy and this requires a bankruptcy search to be carried out.

## **8.4    *Timescales***

The speed of the above process, ignoring any problems brought to light, is largely determined by the ability of the life office to deal with the questions. The bankruptcy search, which does not involve the life office, may also be a factor. The average time taken to complete and pay the vendor is about 3 weeks. One market maker claims to have a cheque to the vendor within 3-4 days, though it seems improbable that the above process can be completed within that time.

## **9. Taxation**

The tax treatment of TEPs depends on whether the policy is qualifying or non-qualifying for tax purposes. Generally, policies are issued as qualifying policies and only become non-qualifying as a result of changes to the policy such as a reduction in the term. In many cases the reduction in term will be effected by the market maker before resale.

### **9.1 *Sale by original policyholder***

#### **9.1.1 Qualifying policies**

The tax position is the same as if the policy were surrendered. If the policy is sold after being in force for 10 years, or three-quarters of the term if less, there will be no tax payable. Otherwise the policy will be taxed as for a non-qualifying policy below.

#### **9.1.2 Non-qualifying policies**

The policyholder will be taxed on the excess of the selling price over the total premiums paid since inception. This will be taxed on the difference between higher rate and basic rate tax subject to top-slicing.

### **9.2 *TEP purchaser***

#### **9.2.1 Qualifying policy on maturity**

Qualifying policies are subject to Capital Gains Tax on the difference between the maturity value and the sum of the purchase price and subsequent premiums. Both purchase price and premiums are subject to indexation. The purchaser may take advantage of his annual CGT allowance to offset this charge. If the TEP is purchased in joint names, the CGT allowance can be effectively doubled. A higher rate taxpayer would generally seek a qualifying policy.

#### **9.2.2 Non-qualifying policy on maturity**

For a non-qualifying policy the TEP purchaser will be taxed under income tax legislation on the chargeable gain. The chargeable gain is based on the difference between the maturity proceeds and the total premiums paid on the policy since inception. The purchase price paid for the TEP does not enter the calculations, neither is there any allowance for indexation. The tax rate applied is the difference between the higher rate and basic rate subject to top-slicing. No income tax is therefore payable by a basic rate (at maturity) taxpayer.

Non-qualifying policies are of principal interest to basic rate taxpayers and overseas investors.

### **9.2.3 Death of the life assured**

If the TEP purchaser becomes aware of the death of the life assured, and makes a claim, the death benefit is taxed in the same way as the maturity benefits as described above.

### **9.2.4 Overseas purchasers**

Benefits from TEPs are paid to overseas investors free of any withholding taxes. The tax treatment of the returns in the hands of such investors depends on the tax regime to which they are subject.

### **9.2.5 LAPR**

No LAPR is available to TEP purchasers, even if the original policyholder received the benefit of relief.

## **10. Assessing a TEP**

### **10.1 *Background***

For a new policy, the assessment of which office's with-profits contract to select would usually be based primarily on consistent performance in maturity payout tables with the financial strength of the office as a further consideration. Service standards, the effect of charges and early surrender value levels would also be factors considered.

The assessment of a TEP is less straightforward. It cannot be assumed that a good performance record measured by maturity values will mean that a TEP from that office will represent good value. Value will depend on the price paid. This will in turn depend on the Formula Maturity Value (FMV) and the Average Discount Rate (ADR). Since the former is an estimate based on current bonus rates then, generally speaking, good performance will be reflected in a higher price. A TEP from a poor-performing office may still represent better value than one from a good-performing office if the former is sold on a higher ADR or has better prospects regarding future bonus rates relative to current ones.

For most informed purchasers, the process of selection involves matching the investor's needs with regard to policy characteristics and risk. A life office might be chosen on the basis of financial strength as reported in the trade press from time to time (or simply on the basis of being a household name). Finally, the purchaser would seek an ADR that represented good value with regard to the market as a whole.

Institutional and other large investors with access to specialist, primarily actuarial, advice would generally attempt a more thorough analysis of policies, focusing on specific life office factors and usually involving an estimation of asset share on a particular policy as a means of assessing relative value.

### **10.2 *Investor needs***

Investors would firstly seek policies which met their needs with regards to the following:

- Maturity date
- Purchase price
- Ongoing premium commitment
- Tax treatment (qualifying or non-qualifying?)

### **10.3 *Risk profile***

TEPs vary significantly in the degree of risk attaching to the final return. This manifests itself in how the various components of the FMV compare with the purchase price and future premium commitment.

### 10.3.1 “Locked-in value”

One measure of risk is the “locked-in value”. This consists of the sum assured and bonuses attaching at the date of purchase. Ignoring the small risk of the life office defaulting, this amount is guaranteed. It is possible to purchase TEPs where the locked-in value exceeds the purchase price plus future premiums and therefore offers a guaranteed positive return.

### 10.3.2 Bonus rate sensitivity tables

These tables examine the sensitivity of the rate of return on a TEP to the future level of bonus declarations. The starting point would be the ADR which represents the pre-tax return on the policy if current bonus rates are maintained. An example of what one might look like is shown in Figure 8:

**Figure 8 - Sensitivity of rate of return to changes in bonus rates**

| <i>Change in reversionary bonus rates</i> |      |      |      |      |      |      |
|-------------------------------------------|------|------|------|------|------|------|
| <i>Change in terminal bonus rates</i>     |      | +10% | 0%   | -10% | -20% | -30% |
|                                           | +10% | 12.9 | 12.4 | 11.8 | 11.3 | 11.0 |
|                                           | 0%   | 12.2 | 11.6 | 11.1 | 10.6 | 10.3 |
|                                           | -10% | 11.4 | 10.8 | 10.3 | 9.8  | 9.5  |
|                                           | -20% | 10.5 | 10.0 | 9.5  | 8.9  | 8.7  |
|                                           | -30% | 10.1 | 9.6  | 9.0  | 8.5  | 8.3  |

Such tables are useful in assessing the risk attaching to movements in future bonuses but would not be supplied on a personalised basis by all market makers. Where personalised tables are not supplied a table for a specimen policy may be given in the marketing literature of market makers.

### 10.3.3 Differential discount rates

The use of different discount rates to apply to the various elements (sum assured plus attaching bonuses, future reversionary bonuses, future terminal bonuses, premiums) making up the return on the policy was described in Section 4.4.5 above. This method may be used by the more sophisticated investor to assess a policy for purchase but would be too complex for most private investors and IFAs to contemplate.

## 10.4 Average Discount Rate (ADR)

This is the rate of return assuming that current bonus rates are maintained to maturity. Whilst it may be misleading if taken as a projection it is undoubtedly of use in quickly

assessing whether the policy is priced reasonably relative to the market for TEPs. A market maker's retail list would contain this information and an investor can readily compare how any prospective purchase compares with other policies on the market.

This would not be the case for a purchase at public auction. Examination of auction results indicates that there are occasionally policies purchased for sums which are significantly out of line with the TEP market as a whole.

### **10.5 Life office factors**

A key point to consider when assessing a TEP is the prospect for future bonus rates. It is not realistic to assume that the prospects for each office are the same. The judgement of the prospects of different offices are necessarily subjective and the factors that might be looked at are similar to those affecting the selection of a life office for a new endowment.

The following factors might considered:

#### **10.5.1 Free asset (Form 9) ratios**

The deficiencies of these ratios in isolation have been documented elsewhere on numerous occasions. However, they would be considered in the light of, amongst other things, the strength of the office's valuation basis and the proportion of with-profits business.

#### **10.5.2 Asset sector distribution**

The distribution of the investments of the with-profits fund by asset sector would be of interest to the potential investor where a higher equity exposure would be preferred.

#### **10.5.3 Measures of bonus rate sustainability**

One method is to calculate the maturity values for hypothetical policies commencing at the present day based on current bonus rates. This enables rates of return to be calculated. Higher implied rates of return might indicate that the rates will be more difficult to sustain in future.

#### **10.5.4 Special opportunities**

Interest in the TEP market has been fuelled by the possibility of windfall gains arising from demutualisations, take-overs and distribution of orphan assets. Investors will take into account any public statements by offices (e.g. the statement on 2nd October 1996 by Norwich Union). Such possibilities make an already difficult investment decision even more subjective. For example, is an office with a weak solvency position (and therefore, other things being equal, less attractive) more likely to be taken over by a stronger office with a payment to its policyholders?

It cannot be assumed that purchasers of TEPs would automatically benefit from any such distributions. This would depend on the office's constitution, with particular regard to membership rights in mutual offices.

## **10.6 Surrender value**

The proportion of the purchase price represented by the latest surrender value is also a factor. Although surrender values are not guaranteed, an investor would feel more comfortable if the price paid were closer to the life office's own "valuation" of the policy. This would also affect an investor's ability to use the policy as collateral for a loan where maximum advances are usually expressed as a proportion of the current surrender value.

## **10.7 Asset shares**

Although the above factors are useful, they do not, either in isolation or combination, provide a direct answer to the question as to whether the price paid is a fair one. Ideally, we would like to obtain some measure of inherent value with which to compare the price. The concept of asset shares has been dealt with in other actuarial papers in some depth. However, a brief summary might be useful.

An asset share is a measure of the underlying value of the policy arrived at by accumulating the premiums paid at the rate of return earned on the assets of the with-profits fund. The accumulation is net of charges such as expenses, mortality costs, tax and, for proprietary offices, shareholder distributions. There is some variation between offices in the way asset shares are calculated, in particular with regard to the way some sources of profit to the with-profits fund are dealt with. These miscellaneous profit sources include profits from non-profit business and the effect of paying out surrender values which may be significantly below asset share.

Asset shares are used by offices in the setting of bonus rates. Reversionary bonuses are generally added at rates which the office's Actuary believes can be sustainable in the future. Terminal bonuses are set such that the total return on a maturing policy reflects the estimated asset share of the policy. In order to introduce the smoothing of returns which distinguishes a with-profits policy from a unit-linked policy, the terminal bonus rates are set to reflect a smoothed asset share. The method of smoothing varies from office to office.

Current terminal bonus rates are therefore based on past reversionary bonus declarations and past investment performance. There is no implication that they are set at rates which the office expects to be able to maintain in future. A method of assessment which involves accumulating current bonus rates is therefore flawed, particularly in relation to the terminal bonus element. The degree to which current bonus rates used to price a TEP are sustainable will vary not only from office to office but from policy to policy.

There is also a suspicion that, for marketing reasons, some offices may be declaring bonus rates which exceed those justified by asset share calculations. This can be a particular

temptation when volumes of maturing policies are low and the costs of over-declaration are small. This practice cannot be sustained indefinitely.

Asset share calculations are also used to assist in other areas of life office financial management. In particular, an office might look at them when reviewing surrender value bases and should be aware of how surrender values compare with asset shares from time to time.

### 10.8 *Estimating asset share on a TEP*

If asset shares are used by life offices to set their final maturity payments and would be the office's own internal measure of the intrinsic value of a policy, then it seems that an estimate of the asset share on a TEP would be a more suitable basis for assessing the value of the policy. Unfortunately, offices do not provide details of their asset share calculations. With-profits guides will contain some limited general information on how they are calculated and used in determining bonus policy. This will generally be similar to the descriptions given in the previous section.

Some actuaries have attempted to estimate asset shares on policies from specific offices by using information on expenses and investment returns from DTI returns. This is laborious, involving going back many years and must involve some fairly crude assumptions. In addition, there are differences in the way that offices calculate asset shares which are not published information e.g. the treatment of miscellaneous profit items.

A simpler method is to use the maturity values payable on currently maturing policies as a basis for estimating asset shares. For example, the asset share on a 25 year policy that has run for 20 years should be similar to that on a 20 year policy for the same premium commencing at the same time. Rates of return on investments would be identical and renewal expenses would be identical. Commissions and mortality costs would differ, being somewhat higher on the policy with the longer term. Offices might also load some non-commission initial expenses in proportion to commission and reflect this in their asset share calculations.

There are a number of ways of making the approximation but one method uses the approximate relationship (which works reasonably well for most, but not all, offices)

$$\frac{SA}{n} \approx \text{annualised premium} \times k$$

where  $n$  is the term of the endowment and  $k$  is of the order of 0.9.

The asset share of an endowment  $t$  years into its term  $n$  is approximated by:

$$\frac{t}{n} \times ((SA \times TBSA_t) + (ARB \times TBRB_t))$$

where SA = basic sum assured

|                          |   |                                                                                                   |
|--------------------------|---|---------------------------------------------------------------------------------------------------|
| ARB                      | = | attaching reversionary bonus                                                                      |
| TBSA <sub><i>t</i></sub> | = | terminal bonus rate on sum assured for maturing policy of term <i>t</i> years                     |
| TBRB <sub><i>t</i></sub> | = | terminal bonus rate on attaching reversionary bonuses for maturing policy of term <i>t</i> years. |

An interpolation needs to be made for non-integral values of *t*. The method needs to be modified for offices whose pricing cannot be carried out by reference to current bonus rates. The method also needs modification in respect of altered policies where the policy details need to be those applying immediately prior to alteration.

## **10.9 Other methods based on estimated asset shares**

Some practitioners use methods which use the estimated asset share as a starting point and then project the maturity value of the TEP using rates of return which depend on the current published asset distribution by sector of the with-profits fund. A higher rate of return would be assumed on equities than fixed interest for this purpose. Future premiums and expenses would be allowed for. The maturity value is then discounted back to arrive at a maximum price. This method aims to quantify the effect of asset allocation on the future return as well as the effect of the current asset share.

### **10.10 In summary**

No valuation method is ideal. All must contain a number of sweeping assumptions. Any method based on current maturity payouts to estimate asset share would not be consistent from office to office if some office's payouts were significantly above current asset share. Such methods do, however, protect against acquiring a policy which is significantly overvalued by the market pricing approach. A number of variations on the methods are used and these might be supplemented by visits made to life offices by the advisers to investors.

## 11. Are TEPs good value?

### 11.1 *The opposing views*

This is a controversial area. The proponents of TEPs point to the returns available on the assumption that current bonus rates are maintained and the fact that these returns in many cases still remain attractive if the rates are cut substantially.

The main doubts as to the underlying value of TEPs have been raised by some life offices. In particular, Standard Life, the office whose policies are most frequently traded, have been particularly active in voicing their concerns that investors may be paying too much for their policies. Their argument is that surrender values are set to broadly reflect asset share and therefore in themselves represent a fair value of the underlying policy.

### 11.2 *My approach*

My approach to answering the question is to try to compare a TEP with a more conventional investment of similar properties. The properties commonly quoted as being attractive features of TEPs are:

- They are written by secure financial institutions.
- They are invested in a broad range of underlying assets with generally a high equity content.
- Returns are smoothed to reduce risk.
- They contain a substantial guaranteed element at the time of purchase that cannot be taken away.
- They provide attractive relatively stable returns.
- They offer the prospect of windfall gains if the life office concerned is involved in demutualisation, restructuring etc.

All of these are features of a single premium with-profits product (a “with-profits bond”) from a life office. This therefore seems the best investment to compare a TEP with. There are of course, some differences. A TEP involves paying future premiums. This may or may not be regarded as an advantage. The tax treatment will also be somewhat different and the guarantees within the products will differ. The two investments are, though, essentially similar and anyone considering purchasing one should consider whether they would be better off with the other.

The development of the comparison is helped if one thinks of a TEP as a form of single premium with-profits bond. The latter usually carries an initial charge of some 5% and may sometimes also carry an annual management charge. A TEP might be thought of as a with-profits bond where the investor does not know the charges. An investor acquiring a with-profits bond would, after the initial charge, acquire an asset share of some 95% of the investment. It is therefore not unreasonable to consider a TEP priced at in excess of the underlying asset share. The comparison of the effect of ongoing charges is more difficult

since it would depend on how the expenses charged against the TEP in an office's asset share calculations compared to any annual management charge or expenses charged against the bond's asset share. One could make a case that a TEP priced at 105% of asset share might compare reasonably with a with-profits bond.

### **11.3 The current TEP market**

I have taken six policies at random from a current (September 1996) market maker's list to illustrate the comparison. I have calculated estimated asset shares using the method of Section 10.8 which is based on the maturity value of an equivalent policy at the same duration as the TEP has run. This estimate is crude and no allowance has been made for the effect of higher initial expenses etc. If anything, the estimate will tend to overstate the true asset share.

| Life Office        | Maturity year | Price<br>£ | Surrender value<br>£ | Excess of price over SV<br>% | Estimated asset share<br>£ | Excess of price over est. asset share<br>% |
|--------------------|---------------|------------|----------------------|------------------------------|----------------------------|--------------------------------------------|
| Royal Life         | 2004          | 7,421      | 4,559                | 63%                          | 6,151                      | 21%                                        |
| Standard Life      | 2002          | 9,752      | 6,979                | 40%                          | 8,345                      | 17%                                        |
| Scottish Provident | 2004          | 11,509     | 8,300                | 39%                          | 10,125                     | 14%                                        |
| Prudential         | 2007          | 5,915      | 4,527                | 31%                          | 5,364                      | 10%                                        |
| Scottish Amicable  | 1998          | 73,586     | 59,722               | 23%                          | 70,059                     | 5%                                         |
| Legal and General  | 2002          | 9,116      | 7,328                | 24%                          | 9,058                      | 1%                                         |

The examples given above are, I believe, reasonably typical of the current market. All the policies above are unaltered. I believe that some of the worst comparisons with asset share occur in policies that have had their terms shortened. There are some policies which compare reasonably with a with-profits bond on the basis of the analysis in the previous section. The majority of policies compare unfavourably. I believe that some investors may be buying what is effectively a with-profits bond with a heavy initial charge. There are few policies around in the current market which I would regard as an unquestionably good buy.

Some offices have stated that they aim to pay out surrender values which approximate to the asset share on a policy and these therefore represent a fair value to the investor. The evidence of Table 1 in Chapter 1 is that for virtually all offices maturity values on some policies exceed early surrender values on longer term policies taken out at the same time by more than can be explained by higher initial expenses etc. It may be that the remaining difference is explained in part by the inclusion of some profit items in the maturity asset share that are not included in the asset share for surrender purposes e.g. profits on non-profit business. The asset shares estimated above are on a maturity rather than surrender value basis.

## 11.4 *Standard Life*

One office that has stated that its surrender values are a fair reflection of asset share is Standard Life. Table 1 shows surrender value discounts to the equivalent maturity value in the range 13-19% for this office. These figures are amongst the lowest in the table. A significant part of these discounts will be due to the effect of initial expenses etc.

Standard Life have also been outspoken in questioning the prices paid for its policies on the TEP market. I analysed the mark-up of TEP prices to surrender value for the Standard Life policies on a recent (September 1996) market maker's list.

| Mark-up range   | No policies |
|-----------------|-------------|
| 0-10%           | -           |
| 10-20%          | 6           |
| 20-30%          | 12          |
| 30-40%          | 17          |
| 40-50%          | 8           |
|                 | <hr/>       |
|                 | 43          |
| Average mark-up | 32%         |

The highest mark-up on the list was some 45% and the lowest some 10%.

Given Standard Life's stated approach to surrender values and the figures from Table 1, it is difficult to justify valuations in the higher bands. The policies in the lower bands might not be unreasonable after considering Table 1 figures and charges on alternative investments. There is little evidence to suggest that any of the above policies are an obviously good buy on the TEP market in the current climate.

## 11.5 *Conclusion*

At the time of writing, many TEPs appear to be overpriced relative to with-profits bonds which have most of the attraction of TEPs, including the possibility of windfall gains. Some policies may compare reasonably but there are very few that stand out as obvious bargains.

The market is subject to the laws of supply and demand and recent demand has been fuelled by special factors such as maturing TESSAs and takeovers/demutualisations of life offices. My conclusions would not have been the same in the past and I believe that many investors have purchased attractive policies on the TEP market (although not as attractive as some may believe them to be). The nature of the pricing of TEPs does mean, however, that at any one time there will be a larger variation in the attraction of individual TEPs which would not be apparent to the uninformed investor.

## **12. Regulatory Issues**

### **12.1 *Background***

Regulation of the market consists of the statutory regulation under the Financial Services Act plus the voluntary regulation provided by the trade associations in the market place. Any regulation should seek to protect the interests of both buyers and sellers of TEPs.

### **12.2 *FSA regulation***

In February 1992, a FIMBRA briefing note stated that those dealing directly with the public must be authorised under the FSA via FIMBRA or SIB.

The larger market makers and auctioneers are now regulated by the PIA. Some of the smaller market makers have opted to remain outside FSA regulation by dealing only via IFAs and excluding direct dealing.

### **12.3 *Voluntary regulation***

#### **12.3.1 The Association of Policy Market Makers (APMM)**

The APMM was established in April 1992 with the intention to “initiate and maintain the best professional standards for dealing with the public and their financial advisers”.

Its stated objectives are:

1. To establish and maintain an orderly market in Traded Endowment Policies - TEPs.
2. To provide objective information to financial advisers and the public so that they can assess the different policies and the factors affecting their pricing and evaluate their investment potential.
3. To develop a working relationship with the life offices and to ensure effective information flows on key data such as bonus rates and surrender values, and help minimise their administration.
4. To increase awareness and understanding of the market in TEPs.
5. To act as a focus and voice for the market.
6. To ensure the highest professional standards are maintained by members.

Members are required to conform to a code of practice governing the conduct of their business. In particular all members must be regulated by the FSA.

### **12.3.2 The Association of Policy Traders (APT)**

This organisation covers some of the smaller market makers. Unlike APMM it does not insist that its members are regulated under the FSA.

## **12.4 Sellers**

The principal needs of sellers, including potential sellers who are considering surrendering their policies are:

- They are aware of the market as an alternative to surrender.
- They obtain the best price.
- The process of transferring ownership is carried out swiftly and they receive their money quickly.
- The buyer does not get into financial difficulties before they receive their money.

### **12.4.1 Awareness**

Market awareness is not high but is growing. There is no regulatory requirement for life offices to inform policyholders who approach them for a surrender quotation of the market's existence. This issue is discussed more fully in Chapter 14.

The position regarding IFAs is clear. In March 1993 FIMBRA issued Note No. 7 which has subsequently been adopted by PIA as Note F7, Appendix F6 of its rule book. This states:

*“when a Member is asked to arrange surrender of a with-profits endowment policy it should advise the client, where appropriate, that it may be possible to obtain a higher cash value through the second-hand market”.*

### **12.4.2 Obtaining the best price**

A policy seller approaching an IFA expects that IFA to use reasonable endeavours to obtain the best price. FSA regulation also requires this. To achieve the very best price might involve contacting maybe 20 different organisations - a great deal of effort. Using a trawler cuts down on the effort but not all market makers deal with trawlers. There is also the auction alternative to consider. It is interesting to speculate what might be considered an acceptable degree of effort in this area.

A market maker approached directly by a seller would be acting in an “execution only” capacity and not be obliged to advise of other market players who might pay a higher price.

#### **12.4.3 Speed of service**

The APMM addresses the issue in its code of practice and requires its members to complete the necessary legal processes “as quickly as reasonably practical” and to make payment within 5 working days of completion of this process.

#### **12.4.4 Financial supervision of traders**

Traders regulated by the PIA are required to be Category 1 members which imposes requirements of financial reporting, maintenance of solvency levels and indemnity cover.

### **12.5 *Investors***

The principal needs of investors or potential investors in a TEP are:

- They are sold an investment of a type that best meets their needs.
- They are given sufficient information to understand and assess what they have purchased or are considering purchasing and the risks involved.
- The particular investment represents good value both in itself and relative to other investments of that type.
- They are not encouraged to have unrealistic expectations.
- They obtain good title to the policy.
- The trader is not going to get into financial difficulties before the investor receives the policy.

#### **12.5.1 Suitability**

TEPs have some attractive points relative to other investments and, assuming they are acquired at a favourable price, there is no reason to assume they are not an investment which will meet the needs of the investors. Most investors will buy TEPs via an IFA who would assess the general suitability relative to other products.

### 12.5.2 Information

The information given to financial advisers comes from the list of the market maker. An example was shown in Chapter 7. The key figures given are the FMV based on current rates and the ADR. The information given on a retail list supplied directly to private investors is similar but no FMV is quoted. Instead they would usually be given the current rates of reversionary and terminal bonus applicable. Some market makers do still, I believe, quote FMVs to private investors for policies with less than five years to run. The giving of an FMV to private investors based on current bonus rates in cases with less than five years to run is a throwback to the old Lautro rules on projections

Life offices themselves must now provide maturity projections for new and existing business based on rates of return of 5% and 10% before charges. They are not permitted to provide projections based on existing bonus rates.

Section F29.8.3 of the adopted FIMBRA rules in the PIA rule book states:

*“You must not publish or provide to a client, for a life policy.....any projection of benefits unless it is a projection.....which complies with the requirements of the applicable Adopted Lautro Rules”.*

This does not appear to distinguish between a new policy, an existing policy (with its original owner) or a TEP. I understand that TEP market makers are operating within a system that has been approved and agreed by their regulator (currently PIA). This approval predated the change to LAUTRO rules which introduced the current life product projection basis. I am not aware of any market maker receiving an official objection from the regulator to the quoting of FMVs to private investors for policies with less than five years to maturity, although some market makers have, of their own volition, now ceased to provide this information.

In situations where only the ADR is quoted, I believe this could also be interpreted as effectively providing a projection, it being the rate of return on the TEP if the current bonus rates are maintained. It certainly seems easier to explain to the layman in these terms, rather than as a discount rate.

The above information is supplied with attaching notes which explain that the figures quoted are there as an aid to arriving at a price and should not be interpreted as a forecast. There would also be statements relating to “bonus rates going down as well as up” and that “past performance is not a guide to the future”.

The information supplied might be sufficient to enable someone to gauge whether the policy is priced reasonably with respect to the market. It does not, I believe, enable a reasonable judgement of the inherent worth of a policy, nor a comparison between policies. This is due to the deficiencies in the pricing basis.

### **12.5.3 Reasonable expectations?**

Life offices are prevented from providing projections based on current bonus rates or past performance in order to avoid giving unreasonable expectations to policyholders. It is felt that, even with warnings about the past not being taken as a guide to the future and bonus rates going down as well as up, clients would interpret the projections as a “best guess” of future performance. The marketing literature of the TEP industry generally addresses the possibility of bonus rate cuts in some detail but it is not difficult to imagine the thought processes of someone seeing ADRs which may currently exceed 12%.

In the current low-inflation environment it is highly unlikely that life offices would expect to earn such high future returns on the underlying assets backing the policy. To make the projections realistic TEPs would have to sell at a large discount to asset share. This would not appear to be the case for many policies currently traded.

It is inequitable that investors who may wish to compare the relative merits of TEPs and with-profits bonds receive projections based on 5% p.a. and 10% p.a. growth before charges from the life offices whereas the main figure they receive when considering a TEP is a double-digit return after charges.

### **12.5.4 Good title**

The APMM code of practice requires:

- Any policy offered for sale should be owned or contracted to be owned by the member unless otherwise stated.
- Members will ensure that all prudent checks and searches are carried out and will disclose all material matters of which they become aware.
- Upon completion of any sale documentary evidence will be made available to enable purchasers to satisfy themselves that good title is being conveyed to them.

### **12.5.5 Financial supervision**

This was discussed under the issues for sellers above.

## 13. Collective Investment Vehicles

### 13.1 Introduction

A number of collective investment vehicles have been launched to invest in the TEP market. The principal advantages of investing via the collective route rather than acquiring a TEP direct are as follows:

|                       |                                                                                                                                                                                   |
|-----------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Diversification       | by life office, maturity date, policy term.                                                                                                                                       |
| Expertise             | TEPs are difficult to assess and collective investments will have access to specialist, including actuarial, advice.                                                              |
| TEP acquisition costs | bulk investors can negotiate deals with market makers to acquire policies on more favourable terms than private individuals.                                                      |
| Simplicity            | the investor does not need to pay future premiums, monitor death claims etc.                                                                                                      |
| Liquidity             | generally, it will be easier, quicker and cheaper to sell holdings in a fund than a TEP if cash is required. It is possible also to sell part of a holding but not part of a TEP. |
| Tax                   | there may be tax advantages e.g. holdings can be “bed and breakfasted” to make use of annual CGT allowances.                                                                      |

There are also disadvantages relative to direct investment, the main ones being:

|                |                                                                                                                                                                                                                      |
|----------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Expenses       | any collective vehicle will incur management expenses. The size of the market restricts the size to relatively small funds with relatively high expenses.                                                            |
| Investment lag | the limited market means that a fund cannot all be invested immediately and may take some months (or years) to invest.                                                                                               |
| Share price    | the funds launched in recent years are investment trusts and other closed funds whose share price may not reflect the underlying market value of the assets. This could, of course, work to an investor’s advantage. |

### **13.2    *Open or closed fund?***

Until recently, all the major publicly quoted TEP funds have been closed funds. TEPs have been bought essentially with a view to holding to maturity and costs on earlier sale have been relatively high. In addition, the market has been relatively small and the realisation of a large block of TEPs to fund redemptions might cause some problems. The market is now several times larger than at the time the first funds were launched and is more efficient in terms of resale costs.

In recent months, a new open-ended investment company (Oeic) has been announced. The company aims to mitigate any liquidity problems by investing in a spread of maturity dates ensuring a steady flow of maturity proceeds and by the use of borrowing. An open fund would also need fallback provisions in the event of large redemptions. The above fund may suspend dealings for up to three months if this is considered to be in the general interests of shareholders and may make payouts on large redemptions based on the actual realisation value of assets rather than estimated market value. It will be interesting to see how this fund progresses.

### **13.3    *Payments to investors***

TEPs do not generate income and none of the publicly quoted funds pay dividends. With the exception of the Oeic, all funds pay money back to shareholders via redemption of shares. This might be done in stages spread over a number of years or by a single payment. Any spreading reflects the fact that policies on the market have a range of maturity dates. The spreading of payments will also reduce exposure to the possibility of a single bad year for maturity payouts. A range of redemption dates will allow the fund to acquire policies more rapidly by not restricting purchases to a narrow band of maturity dates. However, funds can take advantage of their ability to alter the term of a policy in order to better match a single repayment date. It is also usual to allow the fund's directors to select the exact repayment date within a specified range (say six months).

### **13.4    *Acquisition of policies***

Funds vary in the methods they use to acquire policies but this would usually involve an arrangement with one, or possibly two, market makers to purchase policies on behalf of the fund from the public or other sources such as an auction. These arrangements involve the market maker receiving a future income based on the net asset value of the fund or receiving a fixed commission and possibly an additional payment in respect of administration expenses. Other approaches are possible. The market is limited and acquiring policies does take time especially if competing funds are in the market. To fully invest a large fund can take years rather than months. The first large publicly quoted fund came to market and raised £30m at a time when the total market for TEPs was £60m p.a. Closed funds usually take share subscriptions in more than one instalment.

### **13.5     *Gearing***

The use of gearing or “leverage” to improve returns is tempting especially with the current differential between market discount rates and financing costs. Policies are excellent security and banks should be keen to lend on attractive terms. The use of borrowing obviously increases the variability of returns. One approach is to invest the initial fund in TEPs and fund the ongoing premium payments and administration expenses using a borrowing facility.

Funds generally state in their issuing particulars a maximum level of borrowing e.g. as a percentage of shareholder funds. Use of borrowing varies from very little to 50% of shareholder funds.

### **13.6     *Diversification***

There will usually be a stated restriction on the maximum proportion of the fund that can be invested in any one office, typically 20-25%.

### **13.7     *Policy selection***

Typically, funds attempt to ensure that all policies are acquired on terms that are attractive relative to the market pricing basis i.e. attractive ADRs. They would then attempt to “cherry-pick” the most attractive policies on the market by using other techniques, usually based around an estimate of underlying asset-share.

### **13.8     *Administration***

#### **13.8.1   *Premium payments***

This can be a difficult area as a fund may be exposed to the administration vagaries of perhaps 40 life offices. Offices prefer to collect premiums by direct debit but this takes an element of control away from the fund administrators. Standing order arrangements have been used. Conversion of all premiums to annual may also be considered.

#### **13.8.2   *Death claims***

Funds generally consider it worthwhile to try to make death claims on policies. Two main approaches are used. The first involves writing to the two referees nominated by the original policyholder to check that the life assured is still alive. This would typically be done annually. The second approach is to offer a bounty to the beneficiaries of a deceased life assured to inform the fund. This would be done via a notice which the life assured would be asked to place with his will and related papers.

## **13.9 Valuation of funds**

This is an area of actuarial involvement in TEP funds. There is currently no consistent approach used by actuaries valuing such funds. The valuation method would usually be based on market valuation rather than any other judgement of worth such as an estimated asset share. No special considerations arise with regard to non-policy assets. The issues concern the valuation of the policy asset and, in particular, the source of the market data.

### **13.9.1 Desirable features of a valuation method**

The following features are desirable in any method used. The method should:

- be based on actual transaction prices rather than the prices at which policies are offered;
- be based on a sufficient volume of market data to reliably represent the underlying market;
- represent market conditions at the valuation date;
- reflect any variations in the market pricing of different sections of the portfolio e.g. by maturity year or life office;
- be consistent from valuation to valuation;
- minimise the element of judgement on the part of the valuer; and
- minimise the time and effort involved.

### **13.9.2 Basic method**

The basic valuation method for policy assets is, I believe, used across all funds. This involves applying the market pricing method to individual policies. Formula Maturity Values are projected for each policy in the portfolio using current bonus rates. These and future premiums are discounted at the Average Discount Rate (ADR) considered representative of the market for that category of policy. Policies in closed funds are valued at a prudent estimate of market purchase price i.e. an offer price basis. The main issues relate to:

- the source of market data
- the degree to which the portfolio is sub-divided for the purposes of reflecting market conditions in each sub-division
- the degree of prudence

### 13.9.3 Data sources

The two sources of data are market makers' retail lists and auction data.

Foster & Cranfield publish an auction catalogue giving policy details prior to auction and a further sheet showing realised prices after the auction. The two enable an ADR to be calculated for each policy sold. The main advantage of auction data is that it relates to actual documented transactions. Market makers' lists show prices at which policies are offered for sale, not necessarily the price at which the policies are actually traded. It is believed that most policies currently sell readily at the list price but this may not have been the case in the past, nor necessarily in the future.

The disadvantage of auction data is lack of volume and variability. Typically there might be one public auction per week. At each auction only, say, 35-50 lots may be sold. These will be spread over a range of maturity dates, many of which might not be relevant to the fund.

In order to increase the volume of data it will generally be necessary to analyse the results of more than one auction. This needs to be balanced against the need for the data to be representative of conditions at the valuation date. Typically, one might consider the results of three auctions, either immediately preceding the valuation date or straddling the date if deadlines permit. It may be necessary to go back further if there is little data for particular maturity years but this cannot be taken too far.

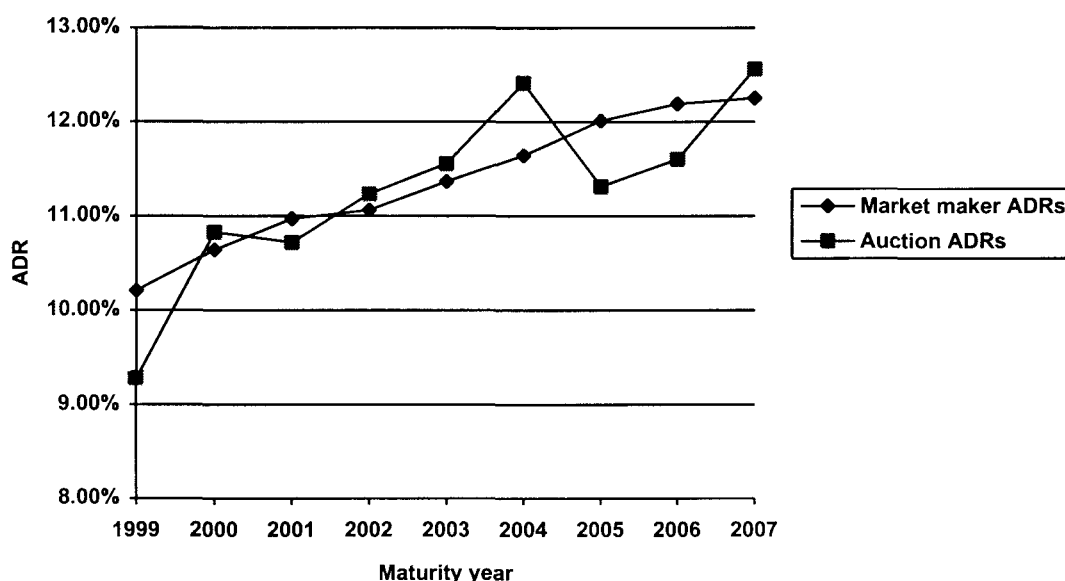
Market ADRs derived from auction data tend to be more widely dispersed than market makers' ADRs. There are also occasional freak auction results if two bidders get carried away. A consistent approach needs to be devised with regard to the elimination of extreme values.

At the end of this process a table of average auction ADRs for each calendar year of maturity can be assembled.

A similar table of ADRs can be produced more readily using market makers' lists current at the valuation date which will already have the ADRs printed on them. This will be based on data from several hundred policies and be free of any freak figures. This approach has the advantage of a reasonable volume of data applicable to the valuation date. It is also simpler as ADRs are already calculated. It is not however based on actual transaction prices. A comparison of ADRs derived from the two approaches is shown in Figure 9 for 30th June 1996.

It is possible to use a combination of the two types of data. For example, the valuation could be based on auction data with the market maker data used as a guide to fit a curve through the auction data.

Figure 9 - Auction ADRs and Market Maker ADRs at 30 June 1996



#### 13.9.4 Segmentation of portfolio

Practice varies in how far the portfolio is segmented by maturity year to arrive at different valuation ADRs for each segment. Funds with all policies maturing within a small number of years might value all policies using a single rate. Where maturities are further spread, it seems reasonable to differentiate by date of maturity, at least. If the auction data route is taken, paucity of data might prevent any further segmentation.

#### 13.9.5 Prudence

Approaches vary with regard to the final setting of valuation ADRs at prudent levels. One approach would be to simply round up market rates. One large fund currently values by looking at ADRs at which policies are acquired and resold by market makers and using resale ADRs increased by 25% of the difference. The actuary also considers an estimate of levels of underlying asset shares as part of the process. The acquisition ADRs are estimated by deducting an estimate of average mark-ups from the prices at which policies are offered

### 13.10 Existing funds

A short summary of the existing funds is set out below.

#### **13.10.1 Kleinwort Endowment Policy Trust (KEPT)**

This approved UK investment trust was launched in July 1992 and raised £30m. It will be wound up in 2003 with a single payment. It used a single market maker to purchase policies on its behalf. It uses maturing policies to fund future premium payments and borrowing levels are low (c £1m at 31/3/96). The fund is valued by reference to auction prices.

#### **13.10.2 BZW Endowment Fund**

This is an offshore fund registered in Jersey. It was launched in October 1993 and raised £20m. It aims to redeem one fifth of shareholdings in each year between 2001 and 2005. It acquires policies via an arrangement with two market makers. It uses a bank credit facility to fund premiums and management charges. The maximum amount of this facility was initially set at £12m. The fund is valued by reference to market makers' list prices.

#### **13.10.3 Kleinwort Second Endowment Policy Trust (KSEPT)**

This is an approved UK investment trust of similar structure to KEPT. It was launched in December 1993 and raised £20m. It will be wound up in 2006 via a single capital payment. Borrowings were expected to be modest and not to exceed 10% (now increased to 25%) of total asset value, most premium payments being funded by maturing policies. The fund is valued by reference to auction data.

#### **13.10.4 Life Office Opportunities Trust (LOOT)**

This was launched in March 1996 and raised £25m. Its aim is specifically to invest in offices with prospects of policyholder gains arising from restructuring, demutualisation or take-over (which can't exclude too many in the current climate!). It intends to provide a single capital payment in 2008. It acquires policies via an arrangement with a single market maker. It aims to fund premiums using borrowing up to a maximum of 50% of shareholder funds at the time of borrowing.

#### **13.10.5 Recent developments**

The With-profits Plus Fund has been launched as the first opened-ended TEP fund as already discussed. It has also recently been reported that one of the leading market makers has plans to launch a single-company PEP which invests in the TEP market.

## **14. Issues for life offices**

The life industry has generally viewed the emerging TEP market with some suspicion. The market is becoming too large to ignore and a number of offices are now considering in some detail what their approach should be.

### **14.1 Administration**

The major administrative work will occur at the time of the transfer of ownership. Various confirmations will need to be supplied to enable the conveyancing stage to be completed satisfactorily. New premium paying arrangements will need to be established. In addition, many policies will have their terms shortened to be more attractive to the market.

It is usually more efficient if this process is carried out in a single area where the necessary specialist knowledge can be concentrated. A number of offices have established specialist teams to deal with the TEP market. Some offices will make a charge to market makers in respect of supplying information and making policy alterations.

### **14.2 Treatment of surrendering policyholders**

This is the most controversial area. It is clearly in the interests of surrendering policyholders to be made aware of the fact that the TEP market exists. Are offices betraying the interests of their customers by not allowing them the opportunity to obtain a better price elsewhere?

Awareness of the TEP market is growing but is still estimated to capture only 25% of tradable policies. The “big breakthrough” would come if offices were persuaded to inform all policyholders on applying for a surrender quote that they may obtain a better deal on the TEP market. A further development might involve all policyholders who opt to surrender being referred to the TEP market and being provided with a quote automatically. Offices would need to be satisfied that such quotes were competitive in market terms. The APMM are pursuing some initiatives in this area.

Friends Provident have probably been the most supportive office to the TEP market in recent years and include the following statement in a leaflet sent out with all surrender value quotations:

*“Your policy is a valuable asset and, if it is “with-profits”, you may be able to sell your policy for its market value rather than its surrender value. The market value will be lower than the potential maturity value of the policy. There are specialist companies who offer this facility, although the service will not apply to unitised “with-profits” policies.*

*On request we can supply you with a list of companies which either buy or arrange the sale of “with-profits” endowments. The inclusion of a company on this list does not constitute a recommendation on the part of Friends Provident”*

Other offices are sending out similar leaflets but are reluctant to be seen as providing any advice with regard to who to approach to sell the policy. The main objections of life offices towards directing surrendering policyholders to the TEP market are:

1. Offices are concerned that policyholders may be encouraged to sell in the TEP market where they would have otherwise held the policy to maturity and not take the surrender value.
2. It is difficult to avoid the conclusion that some offices are subsidising returns on maturing policies by paying surrender values well below asset share. If these surrender profits disappeared the maturity values would suffer.
3. Life offices might feel uneasy about explaining that an outside party might pay substantially more for their policy than they do.
4. They do not see it as their place to give advice on policy disposal.
5. TEPs require a considerable administrative effort by the life office at the time of sale which will add to office's costs. This objection can be overcome, however, if an appropriate charge is levied.
6. TEP purchasers are receiving projections (albeit with warnings) that the offices themselves cannot provide and would generally show TEPs in a favourable light versus their own products.
7. As previously discussed, the pricing method of TEPs can lead to many policies being traded at values significantly in excess of asset share. The offices can see this happening and have commented as such in the press. Some have circulated new TEP policyholders to the effect that they cannot be held responsible for any disappointment.

It is understandable that offices have concerns if an incoming policyholder who would be paid a surrender value of, say, 90% of asset share, receives 105% of asset share from a market maker who then sells on the policy for 120% of asset share. The obviously good deal for the vendor has been at the expense of a poor deal for the purchaser. The difference is that the vendor can see he has got a good deal whereas the purchaser cannot tell he has a poor deal. In fact he probably believes he has a wonderful deal on the basis of the figures given to him. His disappointment will only be evident when he receives his maturity proceeds.

I have much more sympathy with the last two objections to the TEP market than the others. If the sort of figures given above were true at all times, for all offices and for all policies then one might conclude that offices should not support the market. This is not the case and many purchasers have acquired policies in the past on attractive terms.

Perhaps offices would find it easier to support the market if the current problems of the pricing method and the information given to investors were overcome.

### **14.3     *Legal risks***

Market makers report that a number of enquiries have been received from solicitors requesting valuations of policies at the time they were surrendered. They are seeking to establish the extent to which policyholders have lost out as a result of not being informed of the alternative. Is it inconceivable that a case against a life office will be brought to court and open the floodgates for a spate of similar claims?

### **14.4     *Treatment of TEP purchasers***

Offices report receiving calls from TEP purchasers seeking to blame the office for disappointing returns received. I am aware of two offices that have written to TEP purchasers to highlight that the returns they eventually receive might disappoint due to falling bonus rates.

### **14.5     *Funds under management***

There are financial advantages to the life office to keep the policy in force rather than allow it to be surrendered. From the point of view of remaining policyholders, better persistency will improve returns via spreading of fixed expenses. From the point of view of shareholders in a proprietary office, better persistency will also give them a share of investment profits on the policies which remain in force.

The above benefits will be offset by any loss of “profits” from penal surrender values.

### **14.6     *Surrender values***

As the penetration of the TEP market grows, offices who set surrender values at large discounts to asset share may find that “profits” which go to maturing policyholders and shareholders are substantially reduced. This reduction would be particularly marked if they choose to advise the policyholders about the TEP market.

### **14.7     *Terms for alteration of policies***

The practice of “engineering” policies by reducing their term is widespread. Offices should be satisfied that their terms for such alterations are equitable to all policyholders.

#### **14.8     *Projections***

Offices should consider the growing influence of the TEP market in future cashflow projection work. If current growth in the TEP market is sustained, surrender values paid will decrease significantly, particularly if an office actively supports the market.

Mortality levels might also be affected since many TEP purchasers will not be aware of the death of the original life assured.

## **15. Other Traded Policies**

### **15.1     *Whole of life***

Certain with-profits whole of life policies are traded. These would generally be acquired with a view to conversion to an endowment policy. The market maker would obtain a quote for conversion to an endowment and then value the policy on this basis in the usual way. It may also be possible to trade whole of life assurances on very elderly lives without the need for conversion.

### **15.2     *Single premium bonds***

There is also a small market in some single premium guaranteed equity bonds where it is not the practice of the insurer to pay a mid-term surrender value.

### **15.3     *Viatical settlements***

#### **15.3.1   What are they?**

A viatical settlement is the payment of a cash consideration to a terminally ill person in exchange for the assignment to the purchaser of a life assurance policy on that person. The name arises from the word *viaticum*, a Latin word meaning “payment for a journey”. The expectancy of life must be short, generally up to two years, although up to five years will be considered in some circumstances.

#### **15.3.2   Development of the market**

The market first appeared in the US during the mid-1980s. It was very much motivated by the growth of the AIDS epidemic which resulted in a large number of terminally ill young men, many with no dependants. The market in the US has developed, though not without controversy, into a business which currently estimated to be trading annually some \$400 million of policies.

The attractions to a person with a short time to live are obvious. In the US, much of the money is used to pay medical expenses. This is not such a problem in the UK given the existence of the NHS but the person may still wish to pay for a higher standard of nursing care. As well as allowing the person to pay for day to day expenses (when they may have been forced to give up work or chosen to do so) a large sum can enable them to make the most of their remaining lifetime, by taking “dream holidays” etc.

The market covers other terminal illnesses such as cancers, motor neurone disease etc., although much of the market remains AIDS-related.

The first viatical company in the UK entered the market in 1992. There are now four firms operating in the UK. The UK market is still very small compared to the US. The US market has been plagued by bad publicity, particularly relating to delays in the settlement of monies due.

### **15.3.3 The ethical dimension**

The viatical market raises some ethical issues that do not exist in the TEP market.

- Sellers are in a vulnerable position and may be making decisions on sales at a time of great stress, emotional upheaval and desperate need. The potential for exploitation is obvious.
- The sale of a policy may deprive dependants of their means of future support.
- The assessment of the policy's value will require access to confidential medical records.
- The purchaser is making a calculated investment in the imminent death of another person. The thought of someone making a profit from the terminally ill causes unease to many.

### **15.3.4 Overcoming the objections**

Approaches to overcoming the objections vary between the firms in the market and include the following:

- Policies are not traded on to private investors as in the TEP market but are placed in a large portfolio where the returns are averaged over many policies.
- Such funds may obtain reinsurance cover to stabilise returns and further distance the investors from the accusation of profiteering on an individual's death (although many reassurers are reluctant to accept such business).
- Individuals may be encouraged to obtain independent financial, legal and medical advice before committing to a sale.
- Depositing of sale proceeds with an independent Escrow Agent on the day an offer is accepted pending legal completion of sale.
- Use of a 15 day "cooling-off" period following release of funds during which the vendor may return the money and have the policy reassigned at no cost.
- Provision of confidentiality guarantees regarding who will be contacted
- Insistence that a part of the proceeds is used to provide an annuity at a minimum level for any children under 18.

- Consent of adult dependants may be required.

#### **15.3.5 Policies purchased**

Policies purchased for viatical settlement include term assurances, endowment and whole of life assurances and unit-linked policies where the guaranteed sum assured exceeds the surrender value.

#### **15.3.6 Purchase process**

The purchase process reflects the special features of the business compared to TEPs.

The purchaser will request details of the policy and medical condition on an application form. They will then approach the vendor's doctor and/or consultant to obtain further details and a prognosis. Medical notes would then be sent to the purchaser's own medical specialists for an opinion. A medical is not usually required.

Some special features need to be checked with the insurance company. For example, if the policyholder has ceased to pay premiums the life company may not be able to reinstate the full cover on the policy.

The purchaser will then make an offer if it is reasonable to do so.

#### **15.3.7 Pricing**

A thorough pricing would involve projecting forward the death benefit expected in each future time period. This is straightforward for a term assurance or other conventional non-profit contract but would involve a projection of future reversionary and terminal bonus additions on with-profits contracts.

The probability of death would need to be assessed in each future period with regard to the particular medical condition. The mortality curve by duration from onset of a particular condition may vary considerably in character from one condition to another.

The projected value of death benefits can then be discounted at a risk rate of return to arrive at a present value. The possibility of developments in medical treatments needs to be allowed for. The discovery of a cure for a particular condition or a treatment that significantly prolonged life expectancy could ruin returns for investors. The viatical market is a high risk business for investors and reinsurers.

I understand that in practice the pricing of individual settlements is often more rough and ready than described above, although the above considerations should underlie any more practical basis.

Settlements tend to lie in the range 55% to 85% of claim value, depending on life expectancy, with an average of about 70%.

#### **15.3.8 Life offices**

Offices considering their attitude to the TEP market might also consider this much smaller market. Terminally ill policyholders may well be surrendering their policies to raise urgent cash when they could make use of this market.

## **16. The Future**

### **16.1    *The short term***

The development of the market over the next few years will depend very much on the approach taken by life offices. Offices which do not already do so might well conclude that, to avoid at best criticism and at worst legal action, it is appropriate to advise surrendering policyholders of the possibility of obtaining more on the TEP market.

Further progress, such as actively passing details of policies to market makers to provide a quote is a possibility. This would be more acceptable if offices could see that their policies were provided to investors at what they believed to be reasonable prices and with reasonable information.

Technology is sure to impact on future developments. An on-line method of providing policy information to obtain competitive quotes may not be too far away.

### **16.2    *The long term***

The TEP market seems doomed to eventual decline as with-profits endowments have lost their popularity as a means of saving and mortgage repayment. Furthermore, the majority of such products are now unitised and these are not currently traded. There are technical difficulties in developing a pricing basis and it seems likely that the “surrender value discounts” on such policies will be less than on their conventional cousins.

There is scope for a significant market into the next millennium until the large volume of mortgage-related endowments written in the 1980s, typically for 25 year terms, have disappeared.