

The Actuarial Profession
making financial sense of the future


Closed With Profits Funds

Chris Fordham
Charles Pickup

16 October 2006

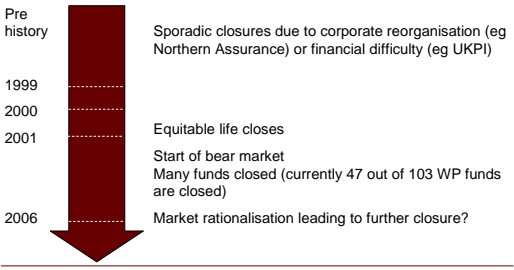
Agenda

- Brief History
- FSA Requirements
- Financial Management
- Q&A



The Actuarial Profession
making financial sense of the future

Brief History




Pre history: Sporadic closures due to corporate reorganisation (eg Northern Assurance) or financial difficulty (eg UKPI)

1999: Equitable life closes

2000: Start of bear market

2001: Many funds closed (currently 47 out of 103 WP funds are closed)

2006: Market rationalisation leading to further closure?



The Actuarial Profession
making financial sense of the future

FSA Requirements

- Treating Customers Fairly
- Conduct of Business Rules
- Sector Briefing, Notes, Speeches and Case Studies

Their interest in this topic is definitely increasing

The Actuarial Profession
making financial sense of the future

FSA Requirements

When is a with profits fund deemed to be closed?

- Ceased to effect new contracts of insurance
- No longer actively seeking to effect new contracts
- Only effecting increment contracts

Guidance also requires firms to discuss their status if no longer effecting a material volume of new with profits business in a fund.

The Actuarial Profession
making financial sense of the future

FSA Requirements

On closing, a firm must

- Inform FSA and customers within 28 days
- Submit a run-off plan to FSA within 3 months

These rules are not retrospective, but with profit funds closed before 2006 are likely to be pressed for a run-off plan, and much of their PPFMs will address this one way or another

The Actuarial Profession
making financial sense of the future

FSA Requirements Run Off Plan

- Funding a solvent run-off
- Investment Policy
- Expense issues, including operational risks
- Distribution of estate
- Bonus policy
- Changes to PPFM
- Revised ICA
- Financial Projections (revenue account, balance sheet, capital requirements) for at least three years

The Actuarial Profession
making financial sense of the future

FSA Requirements Information for customers

FSA considers that the information needs of customers in closed with profits funds are often poorly served.

- IFAs are not geared up to researching closed funds
- Company salesforces or appointed reps may be disbanded
- Press coverage is frequently alarmist

Accordingly customers often make ill-informed decisions despite about 20% of closed with profits funds being top quartile performers

The Actuarial Profession
making financial sense of the future

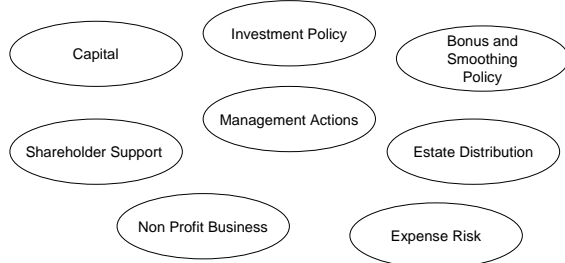
FSA Requirements Information for Customers

Examples of Good Practice

- Plain english guides
- Access to financial advice
- Early warning of guarantee dates or MVR free dates
- Pricing projections reflecting actual asset mix as well as the prescribed mix

The Actuarial Profession
making financial sense of the future

Financial Management



The Actuarial Profession
making financial sense of the future

Financial Management

Fairness to customers – many conflicts between generations/classes of policy.

For example:

Reduce EBR → Lower Capital Requirement → Can distribute estate more rapidly

- Good News – more for customers sooner
- Bad News – less for customers later, since less opportunity for growth, and more estate distributed earlier

The Actuarial Profession
making financial sense of the future

Financial Management – Estate Distribution

What do we mean by “Estate” in this context?

Assets minus Liabilities	Asset minus Liabilities minus RCM	Assets minus Liabilities minus ICA/ICG
Gives the biggest result soonest	WP fund has to hold back minimum regulatory capital	With profit fund fully self supporting

The Actuarial Profession
making financial sense of the future

Financial Management – Estate Distribution

Estate definition – what does FSA say?

“To ensure a fair and prudent distribution, a firm may have to distribute a lower proportion of any inherited estate [...] to policyholders whose with-profits policies mature in the shorter term as compared to those whose with-profits policies mature in the longer term”

The Actuarial Profession
making financial sense of the future

Financial Management – Estate Distribution

Pace of distribution

- Ultimately the goal is to distribute all the assets to policyholders (and shareholders)
- Ignoring the effect of different investment policy, it is just a matter of timing
- Need to balance the interest of those policies that have contributed to the estate and those that are left bearing the risks
- Defining the estate as excess of assets over liabilities and ICA will result in a relatively slow estate distribution, and if the ICA runs off more slowly than the business can lead to a tontine effect
- The role of shareholders in providing capital support can also be a contentious issue

Can you clawback any distribution?

The Actuarial Profession
making financial sense of the future

Financial Management – Estate Distribution

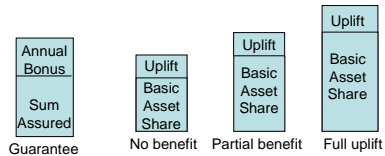
Entitlement

Maturities/Vesting	}	Probably uncontroversial
Deaths		
Surrenders		Opinions vary

The Actuarial Profession
making financial sense of the future

Financial Management – Estate Distribution

- Uplift all eligible claim payments
or
- Uplift asset share – three outcomes



The Actuarial Profession
making financial sense of the future

Financial Management – Non profit Business

- With profits funds often contain material volumes of non-profit business – for example from pensions in payment
- The value of the profits from such NP business is part of the estate and falls to be distributed
- The run off of NP business (and hence emergence of profits) is typically longer than that of the With Profits business

FSA says

"..... A firm should take reasonable steps to ensure that the economic value of any future profits expected to emerge on the non-profit insurance business is available for distribution during the lifetime of the with-profits business"

The Actuarial Profession
making financial sense of the future

Financial Management – Non Profit Business

Options

- Sell (for example Equitable's annuity book)
- Reinsure

Both these reduce risk and may realise value

But is the price fair?

The Actuarial Profession
making financial sense of the future

Financial Management – Investment Policy

- Many closed funds are forced to adopt a low risk investment policy because of their weak capital position
- Others are not so constrained, and the stock market recovery and modest rise in interest rates has produced a further improvement recently
- Nevertheless, having a significant proportion of assets in equities/property presents a challenge in a closed fund if the funds are to deliver the price with profit objective – a smoothed return

The Actuarial Profession
making financial sense of the future

Financial Management – 20 years on

- Most funds contain a mixture of endowments and pensions business
- The bulk of the endowments will mature in the next few years, leaving a relatively slow run off of the pension business
- Eventually there comes a time when a fund becomes too small to be viable
- Many demutualisation schemes which created closed with profits funds provided for the business to convert to non-profit (or guaranteed bonuses) when the funds fell below a certain size

The Actuarial Profession
making financial sense of the future

Financial Management – 20 years on

- This seems a sensible course of action for other closed funds, although the legal route is uncertain
- Few precedents for the terms of such a conversion
 - How are the residual risk takers to be rewarded?
 - Should surrender values be guaranteed?
 - What allowance should be made for "lost" policyholders (particular issue for industrial business)

The Actuarial Profession
making financial sense of the future

Summary

- Treating Customers Fairly
- Judgements required in setting a pace of distribution
- Managing the closed book not easy

 The Actuarial Profession
making financial sense of the future

Questions and Answers

 The Actuarial Profession
making financial sense of the future
