The Actuarial Profession
making financial sense of the future

Networking Evening
Tim Sheldon, Legal & General and Peter Needleman, Towers Watson

Chairman: Trevor Fannin, Towers Watson

What keeps a With-Profits Actuary awake at night?

12 January 2012

Agenda

Role of the WPA	• What is my role? • How does my role differ to the WPC?
Financial Management	• Defining policyholders' risk appetite • What management actions are fair? • What investment strategy is appropriate/fair?
Closure/run-off	• When to close? • Intergenerational fairness • Dealing with non-profit business
Impact of Solvency II	• Will SII have any material impact on with-profit funds? • Who should bear the costs and consequences of changes?
Policyholder communications	• Communication challenges • What do they need to know?
Future of with-profits	• Is there a future for with-profits? • How could with-profits meet policyholders' needs in the future?

Role of the WPA

Role of the With-Profits Actuary

Defined in SUP 4.3.16A R

An actuary appointed to perform the with-profits actuary function must:

(1) advise the firm's management, at the level of seniority that is reasonably appropriate, on key aspects of the discretion to be exercised affecting those classes of the with-profits business of the firm in respect of which he has been appointed;

(3) at least once a year, report to the firm's governing body on key aspects of the discretion exercised…..

Only changes to SUP proposed in CP11/05 aim to ensure that reporting lines and the way in which remuneration is determined do not give rise to a conflict of interest.

Role of the With-Profits Actuary

CP11/05

3.25

It is not our intention to duplicate functions between the with-profits committee and the with-profits actuary.

The extent of any overlap will depend on the relative quality and forcefulness of the committee members and of the with-profits actuary.

Any governance system is only as effective as the people who hold positions within it.

In addition, the with-profits committee provides an informed challenge to the firm's decision-making as a second line of defence behind the actuarial function and the with-profits actuary.

Governance arrangements for with-profits business

COBS 20.3.2 G

…..a firm should maintain governance arrangements designed to ensure that it complies with, maintains and records any applicable PPFM. These arrangements should:

(1) be appropriate to the scale and complexity of the firm's with-profits business;

(2) include the approval of the firm's PPFM by its governing body; and

(3) involve some independent judgement in assessing compliance with its PPFM and addressing conflicting rights and interests of policyholders and, if applicable, shareholders which may include but is not confined to:

(a) establishing a with-profits committee;

(b) asking an independent person with appropriate skills and experience…..

(c) for small firms, asking one or more non-executive members…..

CP11/05 Governance arrangements for with-profits business

Proposed new COBS 20.5.3 R

A firm must ensure that the terms of reference contain, as a minimum, terms having the following effect:

(1) the role of the with-profits committee or advisory arrangement is, as relevant, to assess, report on, **and provide clear advice and, where appropriate, recommendations** to the firm's governing body on:

(a) the way in which each with-profits fund is managed by the firm, and, if a PPFM is required, whether this is properly reflected in the PPFM;

(d) any other issues with which the firm's governing body or with-profits committee considers with-profits policyholders might reasonably expect the with-profits committee to be involved;

(2) that the with-profits committee must:

(a) decide on the specific matters it will consider…, and

(b) **in any event give detailed consideration to** the following non-exhaustive list of specific matters:

[a list of 10 matters including how bonus rates, smoothing and MVRs have been calculated and applied, any significant changes to the risk or investment profile of the with-profits fund, the impact of any management actions, with-profits management and distribution plans, the costs incurred in operating the with-profits fund,]

CP11/05 Governance arrangements for with-profits business

Proposed new COBS 20.5.3 R (5)

that the with-profits committee or advisory arrangement must:

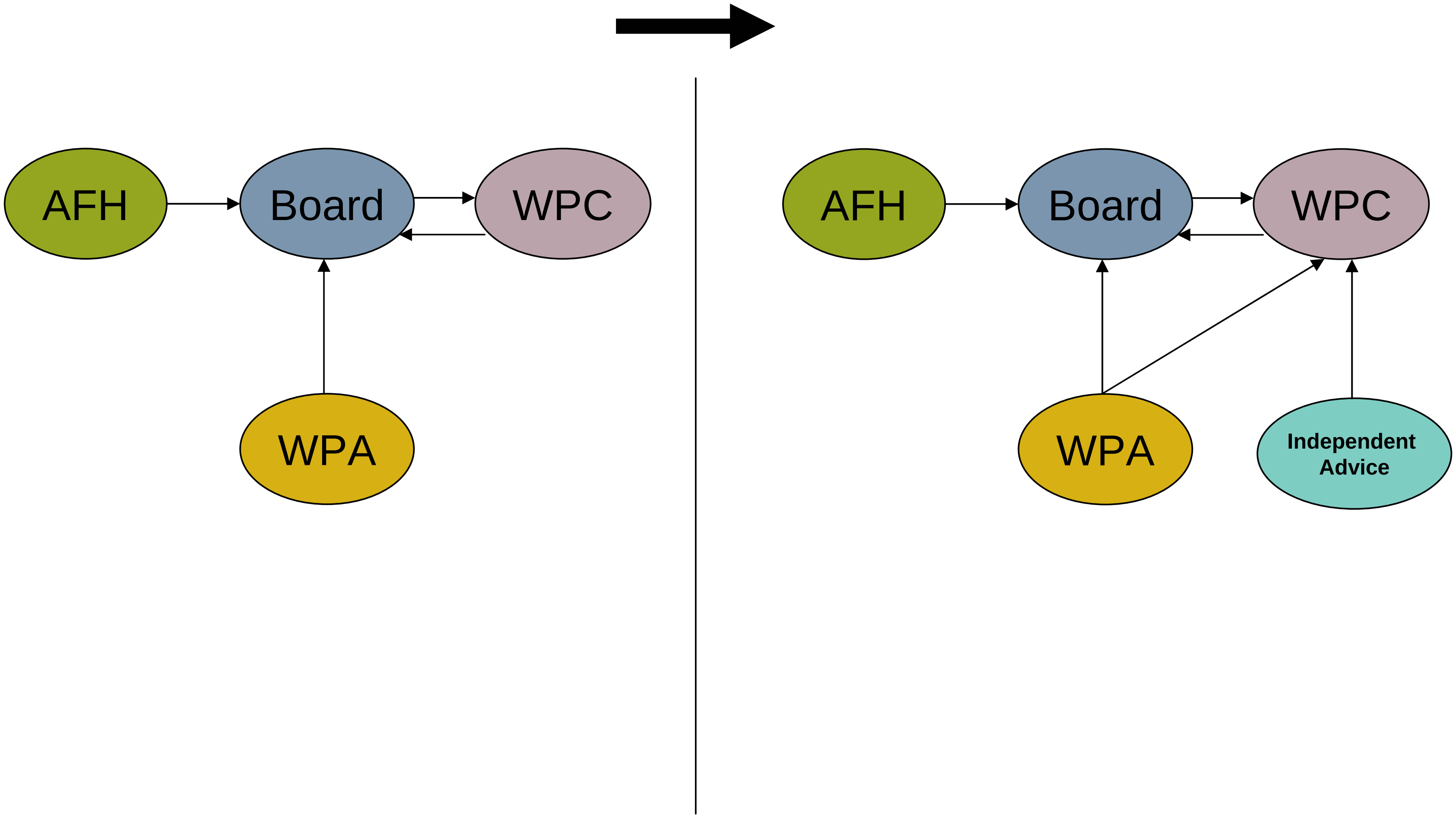
(a) work closely with the with-profits actuary, and obtain his opinion and input as appropriate;

(b) advise the governing body on the suitability of candidates proposed for appointment as the with-profits actuary;

(c) assess the performance of the with-profits actuary at least annually, and report its view to the governing body of the firm.

[3.24 of CP11/05 suggested that “all material discretionary actions proposed” be discussed by WPC and WPA – taken from one firm’s WPC ToR]

Governance – The Future ?



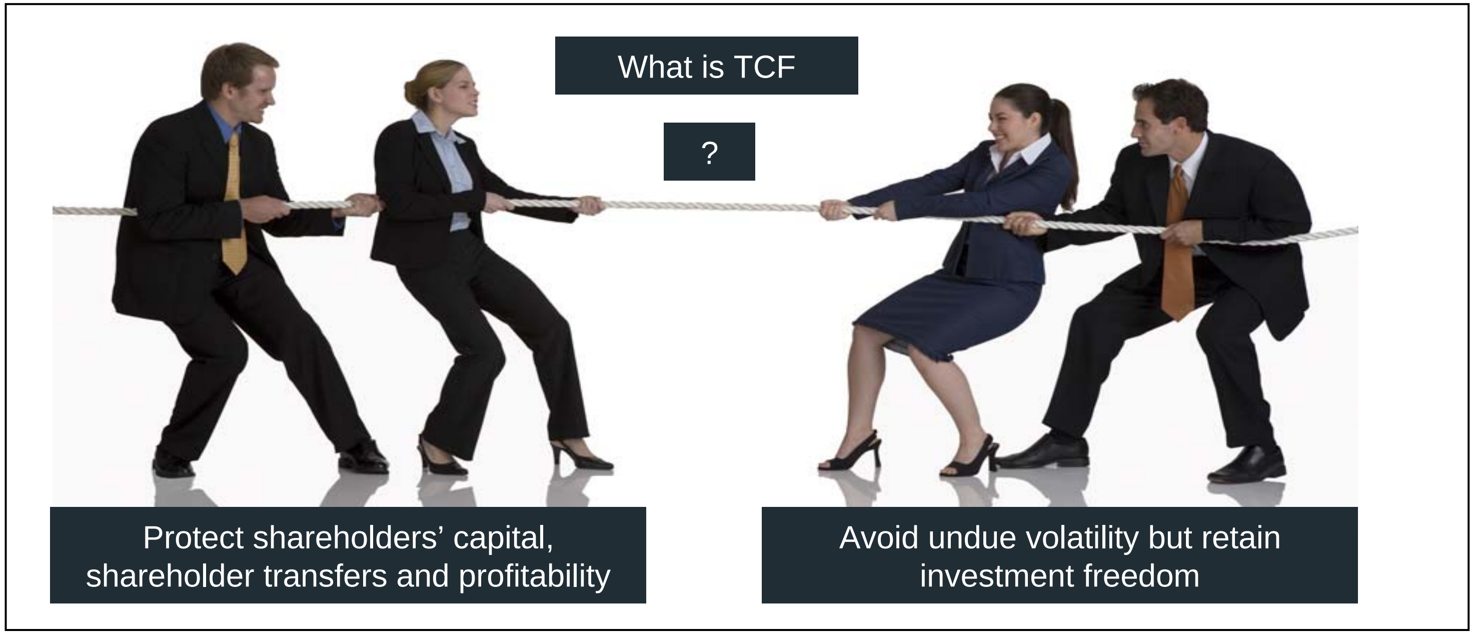
Role of the With-Profits Actuary – questions?

- Is the role clear?
- Does the more extensive role of the WPC proposed in CP11/05 affect the WPA's role?
- Are the roles of the WPA and WPC sufficiently distinct?
- Should the WPA advise the Board, the WPC or both?
- Does the role of the WPA need to be changed?

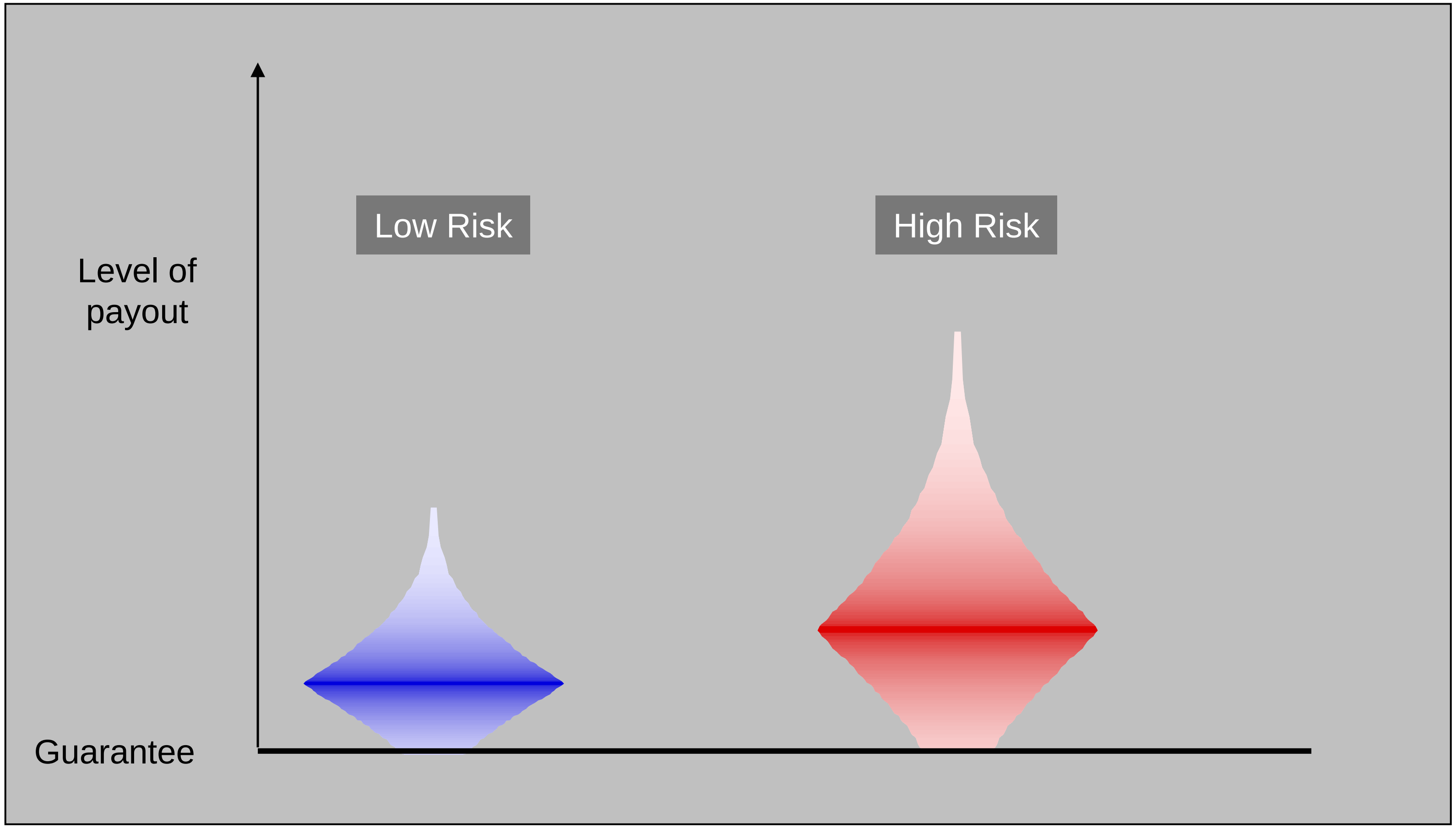
Financial Management

Risk appetite should address both policyholders' and shareholders' perspectives

- Risk appetite is often defined from a shareholder or 'entity' perspective eg
  - Ability to meet solvency capital requirements
  - Shareholder burnthrough cost
- Also needs to be considered from a policyholder perspective.
  - Expected payout level, volatility in payouts and distribution of outcomes
- How should the policyholders' risk appetite be articulated?

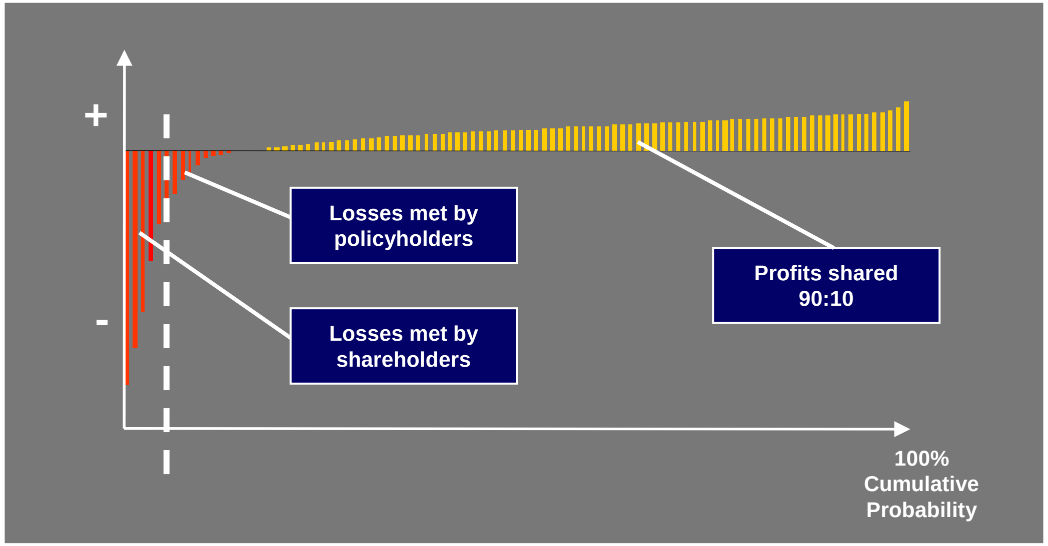


Defining policyholders' risk appetite



What management actions are fair?
- risk sharing between shareholders and policyholders

- Need to clarify how risk is shared between policyholders and shareholders.
  - Explicitly, via shareholder capital support arrangements OR
  - Implicitly, in terms of limits on acceptable management actions
- Main areas of potential conflict between policyholders and shareholders are:
  - Investment strategy and hedging
  - Cost allocation
  - Transactions between policyholder and shareholder funds
  - Other?



What management actions are fair?
- balancing the interests of different policyholders

- Fairness between different policies also needs to be considered:
  - Sharing of guarantee costs
  - Fair treatment of short term vs long term contracts
  - Defining and distributing ‘excess surplus’
  - Dynamic vs passive approach

All types of management actions can impact policyholders

- **Asset management**
  - Asset mix, hypothecation, lifestyling
  - Dynamic hedging, asset share shorting
- **Liability management**
  - Volumes and terms of new business
  - Bonus/smoothing policy, charges for guarantees
  - Reinsurance, compromise schemes, restructuring or sale
- **Cost management**: outsourcing; systems/process improvement
- **Capital management**: capital raising; shareholder support; excess capital

Need to consider cost v benefit and recognise potential policyholder vs shareholder conflicts

What investment strategy is appropriate/ fair?

- Asymmetry in sharing of investment risk creates conflict between policyholders and shareholders
- Also potential conflict between generations of policyholders
- Consider how to optimise potential returns for a given level of capital
- Management of risk can also lead to conflicts:
  - How much should you hedge? Who should pay?
- Consider relative costs and benefits of alternative strategies:
  - Reduce risk exposure vs high risk exposure + risk mitigation
  - Static vs dynamic hedging vs asset share shorting
  - Hypothecation and life styling
  - Removal or restructuring of guarantees

Financial management – questions?

- How can policyholders risk appetite be defined?
- What management actions are fair to policyholders?
- How can the conflicts relating to investment strategy be managed?
- Should funds be derisked as an alternative to expensive hedging programs?
- Who benefits and who should bear the costs of hedging?
- Are alternative hedging strategies more cost effective than purchasing derivatives?

Closure/run-off

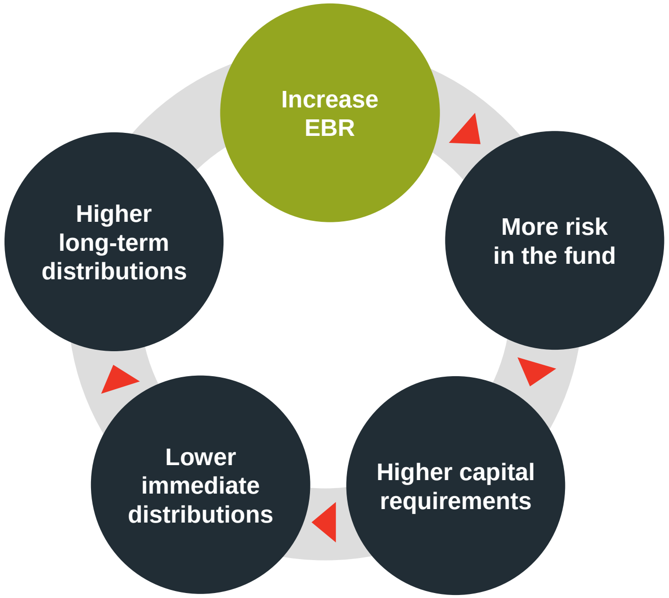
When to close to new business?

- Proposed rule changes require that new business should have no adverse effect
- Also, proposals to avoid binary ‘open/closed’ position
- Significant cost implications to consider:
  – closure costs
  – managing ongoing costs

How should surplus be distributed in a closed fund?

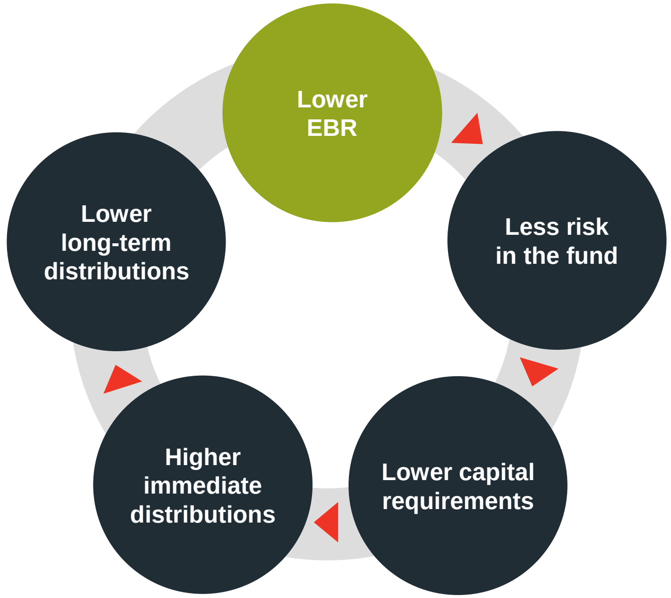
- The distribution of surplus and run-off plan should reflect the agreed risk appetite
- Need to define approach now – even if no excess surplus this position can change
- Allocation approach:
  - ‘release from risk’
  - uniform percentage of asset shares
  - proportionate to maturity benefits
  - proportionate to ‘terminal bonus’
- Should surrenders receive a share of the excess surplus?
- Form of distribution
  - terminal bonus
  - guaranteed benefits
  - cash payout?
- Pace of distribution and impact on risk sharing between policyholder cohorts is a crucial consideration

Impact of investment policy on pace of distributions



'Favours' Longer-Term Policies

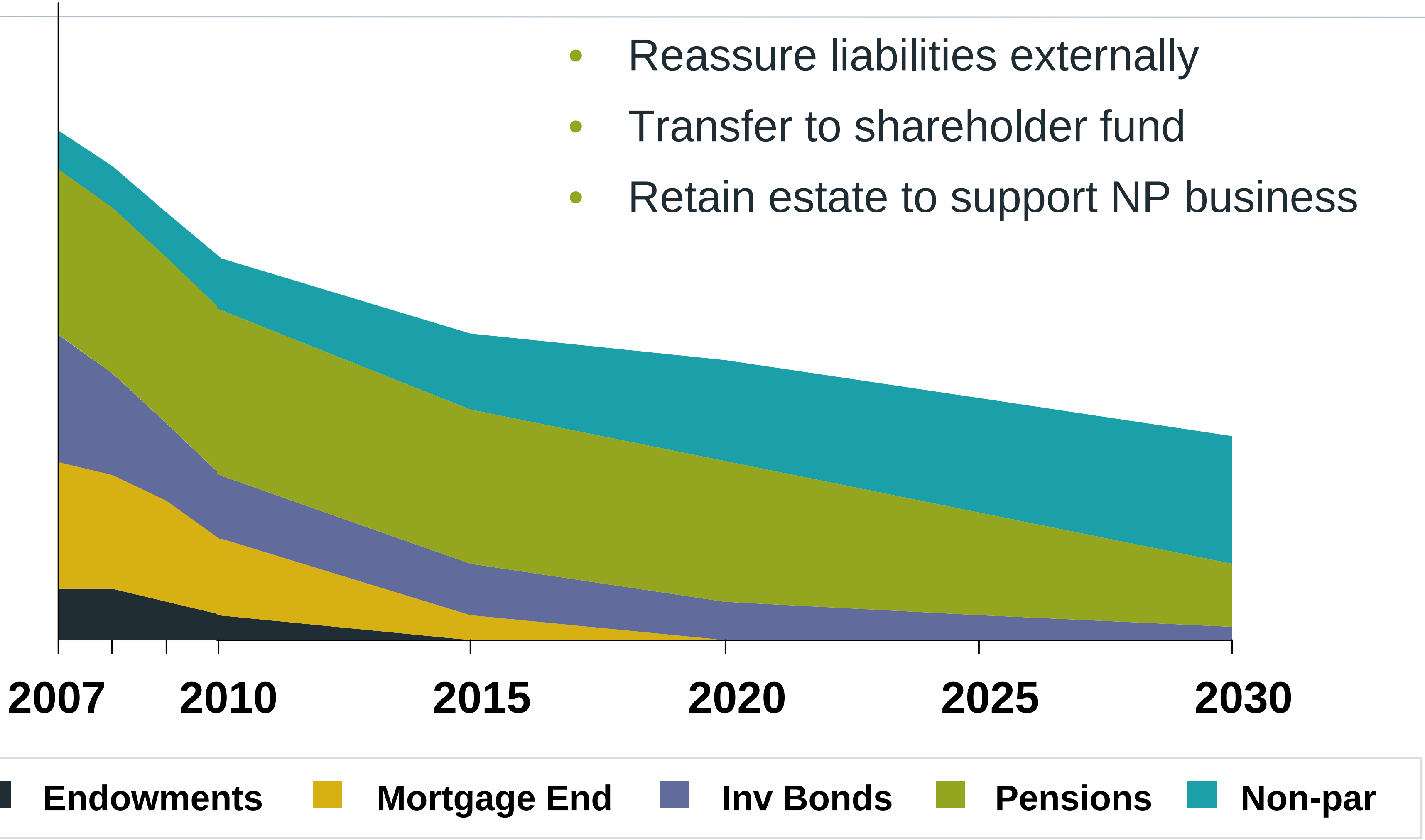
Investment policy can create a real intergenerational tension…which cannot be reversed as fund runs off



'Favours' Shorter-Term Policies

Dealing with non-par business

- Reassure liabilities externally
- Transfer to shareholder fund
- Retain estate to support NP business



Closure and run-off – questions?

- When to close to New Business?
- How should the impact of new business be measured?
- How should surplus be distributed in a closed fund?
- How can conflicts between short term and long term maturities be managed?
- What is a fair price to pay to buy out non-profit business from the WP fund?

Impact of Solvency II

Potential effects of Solvency II

- Changes in available and required capital and capital ratios (eg inclusion of risk margin in technical provisions)
  - Need to redefine solvency metrics and trigger levels for management actions
  - If surplus ratios reduce this may force more conservative management action
- Potential impacts on investment strategy
- Split of technical provisions between guaranteed and discretionary benefits
- More formal requirements for documenting and challenging management actions

How material will these changes be and how will they impact management actions and policyholder benefits?

Management actions: greater requirements for Solvency II

- Changes may be enforced by removal of Peak 1
- More formal, documented and challenged
- Required to assess whether they are objective, realistic and verifiable

Objective	Realistic	Verifiable
• A clear plan of what, when, how and by whom • Board and WPC sign-off • Backtesting controls • Reporting procedures	• Reflect market conditions at that time • Reflect commitments to p/holders and supervisors • Be consistent with current principles and practices and SCR • Should not overstate their value	• Sufficient evidence that management actions are objective and realistic

There is an opportunity to review management actions in the light of revised solvency position and risk appetite arising from Solvency II

Solvency II – questions?

- Will Solvency II have any material impact on with-profits funds and their policyholders?
- Will better risk and capital management bring any benefits to policyholders?
- Who should bear the costs and consequences of changes?

Policyholder communications

CP11/05 – Final paragraph

CP11/05

3.28

These proposals will ensure that with-profits policyholders' interests are given greater weight in a firm's decision-making. As a significant part of the industry moves into a phase of consolidation and run-off, difficult decisions will need to be made about identifying and distributing surplus. We wish to protect policyholders by forcing funds to do more to demonstrate how their decisions affect their with-profits policyholders' interests.

Communications to with-profits policyholders

"One of the biggest sector-wide failings the WPPR identified was the poor quality of communications provided to with-profits policyholders."

FSA had concerns over:

- Quality of event-driven communications such as surrender and transfer notices
- Making policyholders aware of relevant changes (eg to investment mix)
- CFPPFM
- Governance relating to policy literature
- Responsibility for the relevant documents

Communication challenges

- Infrequent purchases (compared with motor and household insurance)
- Lack of knowledge and experience with financial products and providers
- Do policyholders read what they are sent?
- With-profits is perceived to be more complex and harder to understand than other forms of savings

So would a change in communications be any more successful?

Communications - current documents

- CFPPFM
- Annual bonus statements/policy values
- Surrender quotations
- Key features

- How useful are these?
- But are there other things that are better?
- When people surrender with high guarantees should we be warning them against it?

Communications – what do policyholders need to know?

- Is my policy performing as expected?
- Am I on track?
- What has changed?
- Am I getting the information I need to take decisions regarding my policy?
- Am I being treated fairly?

Policyholder communications – questions?

- Are policyholders getting the information they need?
- If not, what is missing and what can be improved?
- Would a change in communications be any more successful?

The Future of With-Profits

Is there a future for with-profits?

- Is there really a need for with-profits post RDR?
- If not, what should happen to surpluses?
- Return to its origins?
- Lower bonus loading products
- Sandler model

Or is it a lost cause?

- Out of favour — customers, media, financial advisors (FSA)
- With-profits “brand” discredited — anyone for a mortgage endowment?
- Tax disadvantageous
- Not transparent – too much discretion
- Attractive alternatives available?
- RDR
- Limited new product innovation
- Little savings anyway
- With-profits is now just too difficult to manage

New business volumes have continuously fallen over the past decade

How could with-profits meet the needs of policyholders in the future?

- Simplicity, not complexity
- Regular premiums, not single
- New designs – eg annuities (longevity, asset risk, gender neutral pricing)
- Smoothed investment return (with guarantees?)
- Move away from discretion to transparency
- North American/European contribution method
- Can with-profits be sold direct to customers?

The Future of With-Profits – questions?

- Is there a need for with-profits any more?
- Can with-profits products meet the needs of policyholders in future?
- Can with-profits survive RDR?
- Can with-profits be sold direct to customers?

Questions or comments?

Expressions of individual views by members of The Actuarial Profession and its staff are encouraged

The views expressed in this presentation are those of the presenters