



# **The Actuarial Profession**

making financial sense of the future

consultation response

**Treasury Select Committee – Inquiry into inherited estate**

**Comments from the Actuarial Profession**

**April 2008**

# **“INHERITED ESTATES” OF WITH-PROFITS FUNDS**

## **Executive Summary**

1. This submission contains the following sections:
  - What is an inherited estate? Broadly this is defined as the excess assets in a with-profits fund not required to pay “reasonable” benefits to current policyholders which reflect the experience of the fund during the time their policies have been in force.
  - How has the inherited estate arisen? A number of common sources are listed including capital provided by shareholders and profits not distributed to former policyholders. The important point is that there can be many sources, and the source of the estate may have a bearing on the basis of any distribution.
  - Why are inherited estates useful? The prime use is to meet unexpected and exceptional losses but a number of other uses are listed.
  - Distribution of inherited estates. This section identifies the current controls and requirements on the distribution and reattribution of inherited estates in accordance with current Financial Services Authority (FSA) rules.

## **Introduction**

2. This submission to the Treasury Select Committee is made on behalf of the UK Actuarial Profession.
3. Actuaries provide commercial, financial and prudential advice on the management of a business's assets and liabilities, especially where long term management and planning are critical to the success of any business venture. They also advise individuals, and advise on social and public interest issues.
4. Members of the profession have a statutory role in the supervision of pension funds and life insurance companies, the latter arising from rules made by the FSA under Part XXII of the Financial Services and Markets Act 2000. They also have a statutory role to provide actuarial opinions for managing agents at Lloyd's.
5. The profession is governed jointly by the Faculty of Actuaries in Edinburgh and the Institute of Actuaries in London. A rigorous examination system is supported by a programme of continuous professional development and a professional code of conduct supports high standards reflecting the significant role of the profession in society.
6. The aim of this submission is to help the Committee understand what is an inherited estate, together with issues surrounding their provenance, uses and possible distribution. It is not restricted to the question of how a reattribution process should operate and indeed also covers the position of mutual life assurance companies.
7. When considering any issues concerned with the regulation of with-profits business, it is important to place them in the context of current U.K.

regulation on governance and controls on treating with-profits policyholders fairly. These matters are now covered in considerable detail in the FSA handbook and place far greater restrictions on the operation of this business than existed prior to 2004. It is understandable that some commentators have not appreciated the impact of these changes which, amongst other things, substantially strengthen the constructive liability for the payment of future bonuses from these policies (which generally must have regard to asset share) and require independent oversight into the way a company complies with its obligations. Asset share represents the accumulation of a policy's premiums less charges at the investment rate of return achieved by the fund. U.K. with-profits business is now subject to a regime which is much tighter than those found in, for example, many continental European markets.

#### What is an Inherited Estate?

8. The 'inherited estate' of a with-profits fund is perhaps best defined as the assets in a fund in excess of those required to make payments to its existing policyholders in accordance with past practice and statements made to those policyholders. Such statements include those contained in the company's Principles and Practices of Financial Management, which is a document prepared in accordance with rules prescribed by the FSA. Payments to with-profits policyholders include not just those guaranteed under a policy but also those in respect of future bonuses. These future bonuses must be in line with commitments made to policyholders and allow for smoothing of payouts. Typically this might involve paying bonuses so that the total payout on each policy on maturity or surrender broadly reflects the profits earned by the fund whilst the policy has been in force, subject, in particular, to smoothing and the cost of providing additional death benefits for those policyholders who claim on their policies.
9. Smoothing of payouts is a common feature of with-profits business and is an attraction of these contracts. Rather than the payout directly following the value of assets, on a day by day basis, payouts on with-profits policies are smoothed in a number of ways. Firstly, typically payouts are set for a group of policies, often by year of commencement, so that precise timing effects, both on exit and entry, are averaged. Secondly, large changes in payouts on policies are phased over time to a greater or lesser degree, so dampening the rate of change. This typically leads to larger payouts than otherwise when market values have fallen sharply, and lower payouts when market values have risen sharply. Falls in the market value of assets have often been sharper than rises, so that the cost of smoothing of payouts up from low values has typically exceeded amounts recovered from smoothing payout down from higher values, even though asset values tend to rise over time.

#### How has the inherited estate arisen?

10. There is no single answer to this question and it will depend on each fund's individual circumstances. Sources which have occurred fairly commonly are:

- Capital originally provided to the fund by shareholders or a general insurance fund or added subsequently. (For example, sums might have been added as seed capital to fund overseas expansion, or in times of crisis).
- Profits from with-profits business which were not distributed to holders of exiting policies.
- The share, if any, of past profits from any source to which the shareholders were entitled but which, for whatever reason, whether deliberate, accidental, temporarily or permanently, was not removed from the fund. (It is sometimes contentious whether such shares were waived, passed to policyholders, or were deferred; at the time, management may have seen no reason to be explicit on this point).
- Profits from non-profit policies in the fund or other activities which neither the fund's constitution nor the company's statements to its with-profits policyholders require to be distributed to with-profits policies – and which have been left within the fund for whatever reasons in the past.
- Investment return earned on the above amounts since they emerged (though on what exact basis returns are allocated might be the subject of debate).

The significance of the contribution by the last point should not be overlooked. For example, if £1m of capital was added to a fund on a particular date and the fund had earned an average 5% p.a. investment return net of taxation, the inherited estate from this source alone would be over £131m one hundred years later. If the average annual return after tax had only been 3% then the same £1m would have grown to only £19m, whilst at 7% net the figure rises to an enormous £868m.

11. Most inherited estates originated many years ago. Given the long history of most with-profits funds, and in particular the lack of historical data, it can be very difficult to determine the sources of the inherited estate with any certainty. Prior to the Second World War, whole life assurances were the most common form of policy and mortality, rather than investment, was the predominant component of surplus.
12. It is also somewhat debateable the extent to which some items necessarily survived. This is particularly true of funds which existed before periods of crisis of one form or another, and which might have been “spent”, only to be replaced by inherited estate from other causes. Differing viewpoints can see this as reimbursement of the previous amounts from those who benefited, or as unrelated freshly emerging capital. There is scope for significant debate over the historical development of the fund.

#### Why are inherited estates useful?

13. The future is never certain, and a with-profits fund can suffer hard times as well as good. The inherited estate is a buffer to protect the current generation of policyholders from harm in those bad times. Over a long period there will be such bad times, and the philosophy of the with-profits funds has been that those who enjoy the years of comparative plenty will

tend to contribute to the estate, whilst those who experience leaner years may benefit from its protection. This does not refer to absolute levels of return seen, but more to the effect of the guarantees, smoothing and other financial structures seen in with-profits business, and with exceptional losses which may occur from time to time.

14. A critical feature usually followed by with-profits funds is that when guarantees cause financial losses to the fund the cost should not fall disproportionately on one generation of policyholders. Without such capital in the estate there is no choice if bad times arrive other than to reduce benefits.
15. It is important to remember the inherited estate was generally never intended to protect policyholders from poor investment returns – other than by means of smoothing. However, it can and often does protect policyholders from losses incurred by the fund on other policies.
16. The main reasons a with-profits fund needs an inherited estate are to support key elements of the with-profits proposition:
  - to provide capital to fund losses arising from options, guarantees and other risks, which may include some business risks, including the writing of new business,
  - to enable investment strategies to be less constrained by the presence of guarantees, and hence typically to allow a higher proportion of equity-type investments than would otherwise be possible,
  - to enable the fund to spread the change in policy payouts over time, so smoothing over shorter term investment fluctuations whilst allowing changes in long-term investment returns to come through, and
  - to allow a proportion of bonus payments to be guaranteed in advance (as ‘reversionary or annual bonus’) – before there is certainty about the ultimate proceeds of the underlying investments. This increases the level of guarantees in the fund.
17. These uses of an estate in smoothing and to fund guarantees see it called on when investment markets are weak and contributed to when markets recover. In the absence of an estate it would be necessary to reduce the level of smoothing and/or to invest the fund more cautiously.
18. Another important purpose is to enable a fund to meet unforeseen costs or losses without affecting policyholders’ expected benefits.
19. It was argued by some in the 1980s and early 1990s that inherited estates were a consequence of an inappropriate failure to distribute profits in a timely fashion. Much was made of the possibility of running a with-profits fund without such capital, most notably by the management of Equitable Life, but also by commentators outside the industry. Some of the consequences of this strategy were amply demonstrated by the events which befell that company. Whilst Equitable’s problems were not related solely to the management of the estate, a major cause, the level of losses arising from the presence of guarantees in the policies, would have been

significantly mitigated by the presence of an inherited estate of a reasonable size.

20. Inherited estates have also been used to meet the up-front costs of issuing new policies. This can be seen as a choice of investment for these funds. Provided (and the importance of this proviso is critical) that policies are issued at an adequate price, the estate should receive a return commensurate with the risk it took in providing this capital support. As with any business venture, this is never certain, but this should be the expectation. Investing the estate in this way can defer the opportunities to release estate; such distribution would in most cases benefit the present generation of policyholders, though this may not always be true. However, as their own policies will have received similar support from the previous generation of policyholders, this use of the estate is generally regarded as fair between the different generations of policyholders. Further, these costs are usually fairly short term. The new policyholders supply sufficient money to release this support in a few years in the form of charges to cover the expenses of setting up their policies.
21. It is understood that in the past, before the introduction of relevant FSA rules, there were instances where subsidies to new business from the inherited estate occurred. Whilst the scale and incidence of this may have varied, and indeed in some cases it might have had a legitimate purpose in protecting past investment in infrastructure, such instances raised legitimate concerns over fairness.
22. In accordance with FSA rules introduced earlier this decade, companies may also use the estate to meet compensation payable to with-profits policyholders, for example for poor service or misleading financial advice. FSA has recently announced that it intends to consult on whether this practice should be allowed to continue where a company's shareholders have assets which could meet these costs instead. In principle it seems reasonable for such costs to be allocated in the same way as the corresponding profit opportunities, and that the alternative costs of mitigating the risks that gave rise to compensation would have been allocated. The issues here are not straightforward, and it is tempting to see the proposed consultation in simple terms as a consumer protection measure. There is a counter argument, in that a change in the FSA rules will probably result in increased compliance costs as shareholders will wish to limit their exposure to such compensation payments. These costs will be passed on to consumers through charges, and with the shareholders bearing all the risks and at most 10% of the costs, there will be an incentive to be overly conservative in this area.
23. Finally a common use of the inherited estate in a proprietary company is to meet additional tax which may become payable on the fund because of the existence of shareholders. This is permitted only when it was already established practice to make this charge at the time of the introduction of the FSA rules codifying the fair treatment of with-profits policyholders. Prior to that time some companies deducted this tax from asset shares, but this practice is no longer permitted.

24. When assessing the pros and cons of this FSA rule regarding tax, it needs to be borne in mind that the tax charged to the fund is a unitary assessment on both policyholders and shareholders. The FSA rules in this area reflect a compromise view between those who view the tax on a pure unitary basis and those who would see the marginal additional tax as being effectively an imposition on shareholders. Other arguments relate to the proportion of profits being assessed after all taxes – the tax due on policyholder profits is deducted before the apportionment under the 90:10 rule, and it is arguable that the same principle should apply to the tax arising from being a proprietary company. It is also the basis upon which the 90:10 division was set, and it is arguably unfair to disturb such a fundamental agreement.

#### Distribution of Inherited Estates

25. Having an inherited estate enables a fund to withstand unexpected shocks and to smooth over periods of relatively poor investment return. However, if investments prosper and no other shocks occur, it sometimes becomes clear that an inherited estate has become larger than necessary. This is not an easy assessment to make, with many variables and issues to consider, but it can become particularly obvious if the volume of new with-profits policies requiring financial support reduces. FSA now requires the distribution of any inherited estate in excess of that reasonably required, either by distributing it to policyholders and shareholders through the normal mechanisms, or else by a reattribution exercise. Reattribution is a process which has emerged over some fifteen or more years and is now covered by FSA rules.

26. Does the presence of an excess estate mean that past policyholders have been underpaid? Not necessarily. Each year, the fund's management will have had to decide on the profits to be distributed to policyholders as bonuses (and the amounts to be paid on policies which terminated early). When doing so, they will have had to make their best estimate of the estate needed to be built up for all the reasons we described earlier. Whether their judgements were correct or not, only hindsight has been able to tell.

27. FSA rules, based on targeting asset shares for maturity and surrender value payouts, now make it unlikely that policyholders are systematically underpaid. Indeed, since asset share techniques became accepted practice as a means of controlling payouts around the late 1980s it is unlikely that systematic underpayments of claims on death or maturity have been commonplace.

28. When must an inherited estate be distributed? An inherited estate must be distributed in full, or else a reattribution attempted, for a fund which no longer accepts new business (a 'closed fund'), over the remaining lifetime of the in-force policies. This is because the fund must be managed so that the assets are fully utilised by the time the last with-profits policy terminates. Complications arise where there is non-profit business in the fund (typically annuities) which are expected to survive the with-profits business. The FSA requires appropriate planning for this, but the solutions may not be straightforward, and could require the sale and

transfer of that non-profit business. It is not usually possible to distribute the whole estate at once, as it is still “working”, but the company must have a valid reason to postpone the distribution.

29. A fund which is still accepting new business is also required to have reasons for holding an inherited estate. To the extent to which the estate is more than adequate to cover reasonably foreseeable future risks and to finance new business acquisition, then the fund must make plans to distribute the excess, or else risk the FSA considering that it contravenes Principle 6 (which covers the fair treatment of customers).
30. Who “owns” the inherited estate? This question, too, has no single answer, certainly not for every company, and not usually a simple answer for any one company. Even in the case of a mutual fund (i.e. one without shareholders) the surplus may belong to the with-profits policyholders or to those with-profits policyholders who are members of the mutual, or even to all members of the mutual irrespective of their policy types. Governing documents may make this clear, or it may vary with the event causing the ownership to be determined (for example between a winding up and within an on-going entity).
31. Factors which are likely to be taken into account in a shareholder-owned company include the source of the estate (e.g. does some derive from an original investment by shareholders?) and the determinants of the relative interests of the policyholders and shareholders in future profits. The current in-force with-profits policyholders may only themselves have contributed materially to the estate if some aspect of the financial management involves charging their policies to increase the estate.
32. For a closed fund, if it has operated on the usual 90:10 principles (i.e. 90% of profits go to policyholders and 10% to shareholders), then it is likely that the estate must be distributed in that same 90:10 ratio, unless any special arrangements exist under which any portion which derived from past shareholder investments can be repaid to them. Similar considerations may also apply to the excess estate of funds still open to new business, though as this results in a windfall for the current generation of policyholders who may have made no, or very little, contribution, some argue that this is an inappropriate interpretation of the situation. To a degree this is analogous to a demutualisation, whether of an insurer, a building society or even a motoring organisation. The windfall rarely goes to those who financed the build up, but does that alter the rightful recipients?
33. Policyholders would normally expect little or no distribution of that part of the estate of an open fund deemed necessary for prudent management purposes. However, where part of the estate is being invested in the writing of new business so as to preclude its distribution, shareholders may be inclined to offer existing with-profits policyholders an immediate distribution of a proportion of the estate (typically less than 90%), in return for establishing ownership rights of the balance for the shareholders. This balance would then most likely be transferred out of the with-profits fund and used as capital to support existing business as it runs off as well as



future new business, eventually being released to shareholders if and when no longer needed.

34. In the event of such an offer being made, policyholders might be given the option of whether or not to accept. Those not accepting might be permitted to retain their existing contingent right to a share of 90% of natural future distributions, if any, of the estate. A proportionate amount of the estate would be retained for their benefit and possibly also for the benefit of future policyholders. This was the pattern used in the AXA Equity and Law case but it is not the only possible route.
35. Under the reattribution rules introduced by the FSA at the end of 2004, the company must now appoint and pay for a 'policyholder advocate' to represent and bargain on behalf of the policyholders. This individual will be someone with the skill and authority to negotiate with the company. They will be provided with their own, independent actuarial support and will consult with policyholders. The intention is that at the end of the process a deal ought to have been struck which provides a worthwhile benefit to both parties. This is not, however, guaranteed.
36. Whilst attributions of inherited estates are primarily commercial matters, actuaries can be found working both for the companies concerned and for their policyholders to ensure that the correct information is used and appropriate and relevant analyses carried out to help achieve a fair deal.
37. For further information please contact: Pauline Simpson, Secretary to the Life Practice Executive Committee, The Actuarial Profession, Napier House, 4 Worcester Street, Oxford OX1 2AW  
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