Institute and Faculty of Actuaries

C1 - Lessons Learned from the UK Industry and Asia Update

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UK with-profits landscape and thoughts on Asia

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Asia update

Agenda – John Jenkins – UK with-profits landscape and thoughts on Asia

- What is with-profits and why is it good for customers?
- Some UK history, and different types of with-profits
- Market issues and regulatory interventions in the UK
- Current UK regulatory regime
- Why has with-profits declined in the UK?
- Current UK challenges and consolidation
- Lessons for Asia – both market and regulators

What is With-Profits?

Non-profit

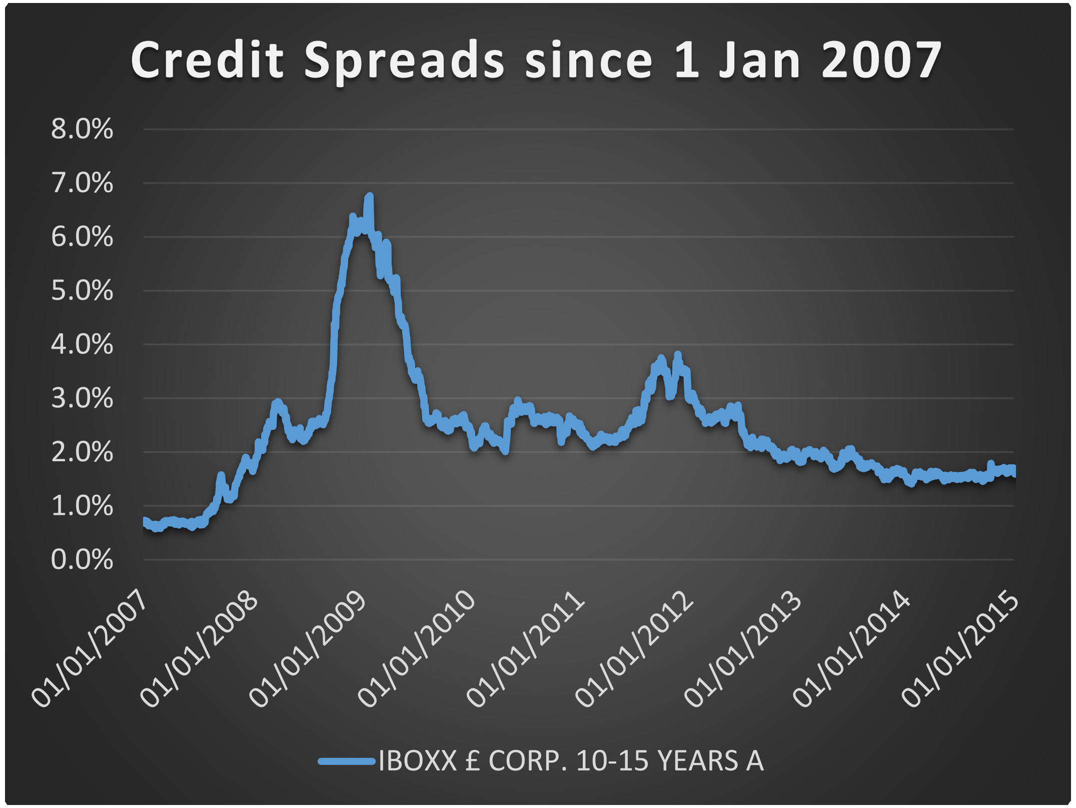
Fixed Benefits (Traditional)	Benefits linked to specific assets (Unit-Linked)

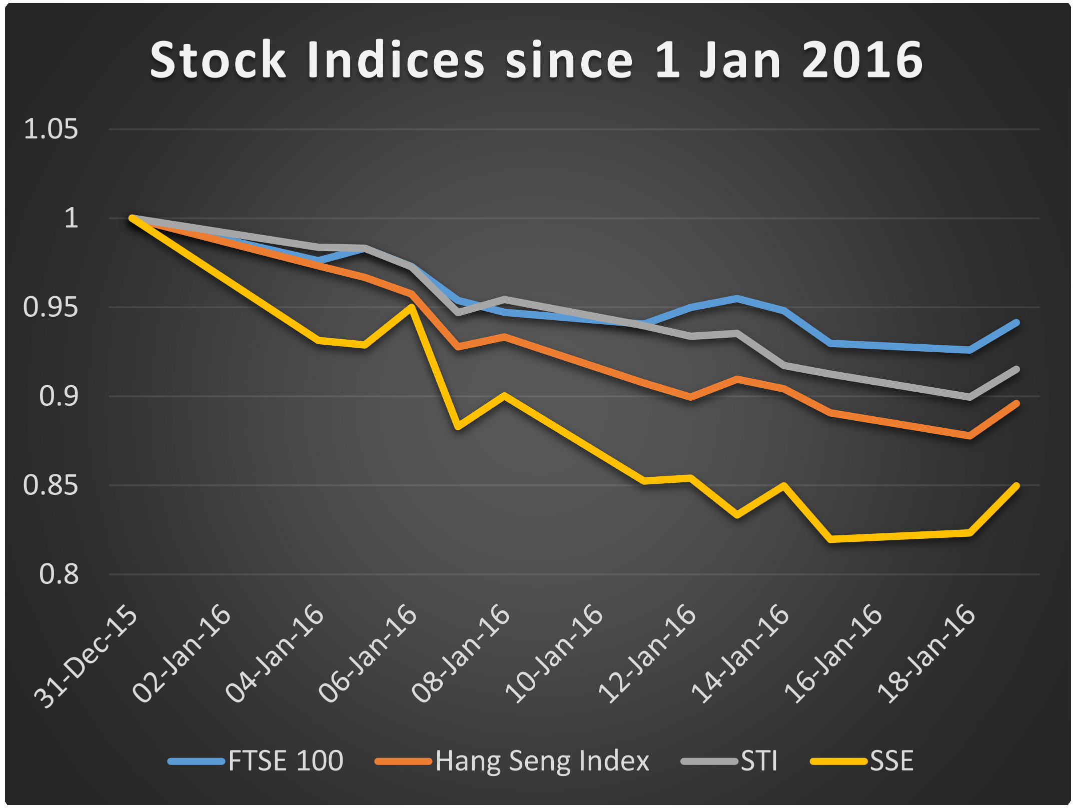
With-profits

Guaranteed benefits, usually at fixed point in time	Discretionary benefits -smoothed

With-Profits is also referred to as Participating in some countries. With-Profits exists in the UK, North America, Continental Europe, Asia, Australia & South Africa. With-profits products have similar features in these countries, with the main difference often being different types of assets backing the benefits.

This is why with-profits is good for customers …





Sources:
Bank of England – UK Commercial Bank Liability Yield Curves
iBoxx – Corporate Bond Redemption Yields

Sources:
Bloomberg – Hang Seng Index
Yahoo! Finance – FTSE 100, STI & SSE

Without guarantees and smoothing, customers are exposed to the full force of these asset fluctuations.

History of UK With-Profits (Part 1)

1762+
- Use of reversionary bonus and smoothing.

1950-1970
- Investment in equities; increased volatility.

1990
- Own charges used instead of current bonuses or industry charges.

2005-2010
- Endowment mis-selling issue.

2016
- Consolidation, de-risking.

1762
- Start of Equitable Life.

1950+
- Use of terminal bonuses.

1990s
- Guarantees become more valuable.

1995-2000
- Pensions mis-selling issue.

2004
- Current governance structure implemented.

2010-2016
- Fund closures, lower equity investments & mergers.

1700 → **2016**

Genesis of with-profits - Equitable Life Assurance Society:

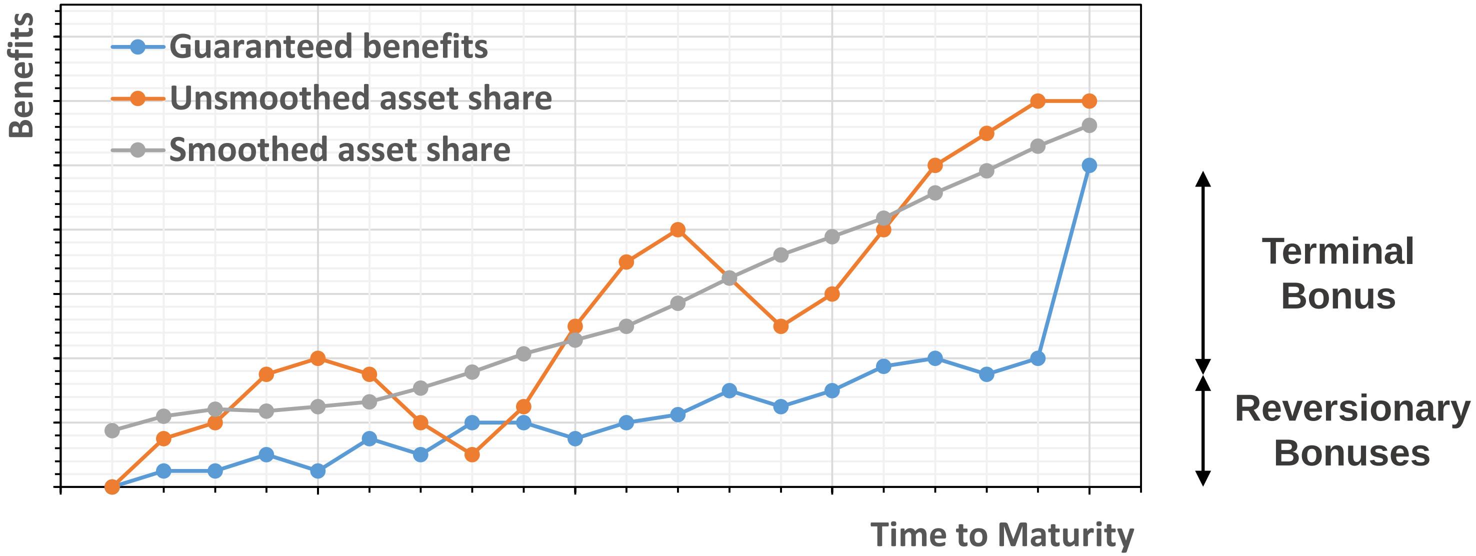
- Established in 1762, writing non-profit life business, necessarily priced with prudent assumptions.
- Profits emerged as actual experience was better than expected experience. These “accidental” profits were distributed to policyholders as benefit increases.
- 1950s to 1970s – Investment in equities resulted in higher profits, but concern that capital gains could fall away. Hence distributed as terminal bonuses paid on upon death/maturity of policies. No additional guarantees.

UK With-Profits – Bonus Approach

Features of a UK with-profits policy:

- Low initial guaranteed benefit and higher non-guaranteed benefits.
- Regular reversionary bonuses over policy term and terminal bonus at maturity.
- All bonuses are smoothed i.e. lower bonus declared during period of good investment returns and higher bonus declared during period of poor investment returns.
- Same applies on other aspects, e.g. surrender and expense experience.

Growth of Benefits with Time:



Types of With-Profits Products

Traditional WP

Fixed benefits at maturity date

Bonuses are % of these benefits

Terminal bonuses paid as % of sum assured and/or attaching reversionary bonus

Common Features

Regular reversionary/annual bonuses

Terminal bonus on claim

Surrender values not (usually) guaranteed

Ring-fenced portfolio of assets

Mixed fund of assets including equities/property

Unitised WP

Current fund value based on a number of units

Annual bonuses either increase the unit price or the in no. of units

Terminal bonus on claim

Easier to understand, and easier to sit alongside unit-linked policies

UK – Most in force business is now Unitised WP, as Traditional WP has largely matured.

Types of Entity and Profit Distribution

Mutual

- No shareholders – business is owned by its members/policyholders
- All profits go to policyholders
- Policyholder: shareholder profit ratio is 100:0

Proprietary (Type I)

- Company owned by shareholders
- Policyholder: shareholder profit ratio is typically 90:10

Proprietary (Type II)

- Company owned by shareholders
- Policyholder: shareholder profit ratio is 100:0 with all profits going to policyholders after deducting defined charges

Note: Can have a 100:0 mutual fund within a proprietary company – several examples of this.

History of UK With-Profits (Part 2)

1980s - Investment yields around 13%pa. Equity markets buoyant and with-profits sales high. Insurers offer reasonable guarantees to policyholders. Effect of charges is high (c2%pa or more) but not a real concern given high investment yields.

Increasing transparency

1990s onwards - Interest rates start to fall. Guarantees begin to bite. Pensions (1995-2000) mis-selling resulted in insurers paying compensation costs to policyholders out of the with-profits fund. Increased regulatory intervention.

2000s to now - Interest rates around 2%pa. Some guarantees heavily in the money (e.g. Guaranteed Annuity Rates).
Endowment (2005-2010) mis-selling - further compensation costs, regulatory intervention & increased governance
Current with-profits environment reflects many with-profits fund closures and M&As, with fewer insurers writing new with-profits business. Effect of charges more of a concern.

Key Market Issues & Regulatory Interventions

1980

Early 1980s
- Current bonus projections (not sustainable).

Late 1980s
- Industry standard charge projections.

1990s
- With-Profits Guide & disclosure of earned rate.

1995-2000
- Pensions mis-selling.

2004
- New With-Profits governance framework following regulatory intervention.

End 2004
- Realistic valuation introduced under Solvency I rules.

2005-2010
- Endowment mis-selling.

1 Jan 2016
- Solvency II implemented.

2016

Mis-selling issues:.
- Compensation costs covered by policyholders, not shareholders.

Pressure on expenses/charges
- Especially in low yield environment.

New (and current) governance framework:
- Appointed Actuary replaced by Actuarial Function Holder and With-Profits Actuary.
- More on next slide.

Realistic valuations:
- Improved financial management of with-profits fund.
- Bonus declaration and valuation now properly linked unlike previously

Current UK With-Profits Regulatory Regime

Principles & Practices of Financial Management (PPFM)

- Sets out approaches on investment, smoothing, bonuses, pay-out ratios, charges & expenses
- Changes to Principles require 3 months notice to policyholders prior to effective date
- Changes to Practices can be implemented and policyholders notified post change within a reasonable time
- Payout range (eg 80%-120% of asset share) published
- Need to get 90% of maturity payouts in stated range
- Published on company website and usually 10-15 pages

Customer-Friendly PPFM

- Simplified version of PPFM, targeted for policyholders
- Published on company website

With-Profits Committee

- Typically consists of 3-5 members
- Chaired by independent member
- Reviews compliance with PPFM
- Reports to the Board

With-Profits Actuary

- Regulatory duty to advise on all discretionary aspects of with-profits issues, including bonus rates
- Attends WPC meetings and prepares annual WPA Report to policyholders

Annual Report for policyholders prepared by the company

- Covers events and performance in the year

This regime has operated since 2004. It is comprehensive, but fairly onerous, particularly for small companies. Companies have learnt to live with this pragmatically e.g. some small insurers have a one-man WPC.

The Decline of With-Profits

Over the past few decades, UK with-profits market has declined:

- Endowment & pension mis-selling issues reduced consumer confidence and lead to increased costs to shareholders
- Concerns about lack of transparency of product
- Investors & advisers still concerned and not willing to accept with-profits as a valuable investment product
- Hence a reduction in new business, fund closures and company M&A

With-Profits Suitability & UK Challenge

Is with-profits still a suitable product for customers?

- Gives exposure to equity & property markets but applies smoothing of bonuses to reduce volatility of benefits and provides guarantees - this should be appealing to customers
- Unitised with-profits in particular shows appeal - similar to unit linked but with smoothing
- Communications are clearly vital, but still difficult to persuade consumers!

Clearly a situation for Asia to avoid!

Challenges in the UK

- Run-Off - As a with-profits fund gradually runs-off, the per policy expense overheads increase; this issue has partly led to the consolidation of with-profits funds – see next slide
- Governance/Regulation has reduced the attractiveness of writing with-profits business to shareholders
- Low interest rate environment - difficult to offer with-profits products with high guarantees, and effect of charges/expenses more problematic
- Solvency II- generally higher capital requirements than Solvency I

The Diseconomy of Scale Problem

Fixed costs of running the fund	£1.00m	£1.03m	£1.06m	£1.09m
Number of policies	20,000	17,000	13,000	10,000
Cost per policy	£50	£61	£82	£109

- Hard to pass these rising per policy costs onto policyholders. Merger helps to delay this effect.

Consolidation- The Shrinking Market

Few Funds Still Open to New Business:

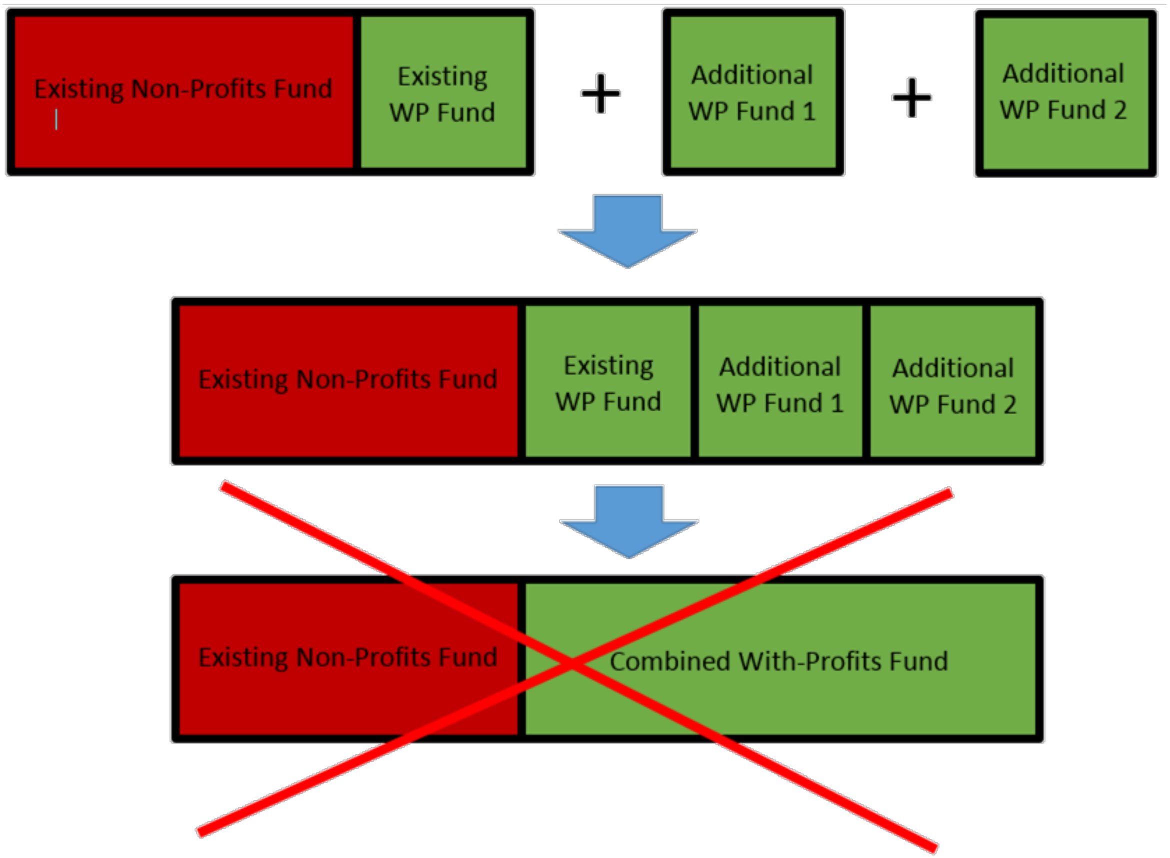
- 36 companies/funds open in 1997
- Now combined into form 6 major companies/funds
- Most funds now closed to new business
- Largest open funds:
  - Aviva
  - Royal London
  - Lloyds Banking Group
  - Prudential
- Plus a few smaller/niche insurers e.g. Wesleyan and Police Mutual, are still writing new with-profits business

1997		2016		
General Accident AXA Equity & Law Commercial Union Friends Provident Norwich Union Sun Life	→	Aviva	→	Open
Britannia Life London Life NPI Royal Sun Alliance Swiss Life	→	Phoenix	→	Closed
Royal London CIS Scottish Life Scottish Provident	→	Royal London	→	Open
Scottish Widows LBG Clerical Medical Scottish Mutual	→	LBG	→	Open
Prudential Scottish Amicable	→	Prudential	→	Open
Swiss Re National Mutual	→	Swiss Re	→	Closed
Scottish Equitable	→	Aegon	→	Closed
RNPFN	→	Liverpool Victoria	→	Closed
Ecclesiastical	→	One Family	→	Closed
MGM Assurance	→	Scottish Friendly	→	Closed
Tunbridge Wells Equitable	→	Forrester Life	→	Closed
Scottish Friendly	→	Scottish Friendly	→	Open
Wesleyan Assurance	→	Wesleyan Assurance	→	Open
Eagle Star	→	Zurich	→	Closed
Canada Life	→	Canada Life	→	Closed
Equitable Life	→	Equitable Life	→	Closed
Legal & General	→	Legal & General	→	Closed
Standard Life	→	Standard Life	→	Closed
Sun Life of Canada	→	Sun Life of Canada	→	Closed

36 companies/funds – all open to new business.

19 companies/funds - only 6 Open to New Business.

Consolidation In Practice



Options for with-profits funds

- To transfer to another company
- To convert to non-profit
  - Several examples of funds converting to NP.
- Or both
- All require court intervention/process

Merging with-profits funds

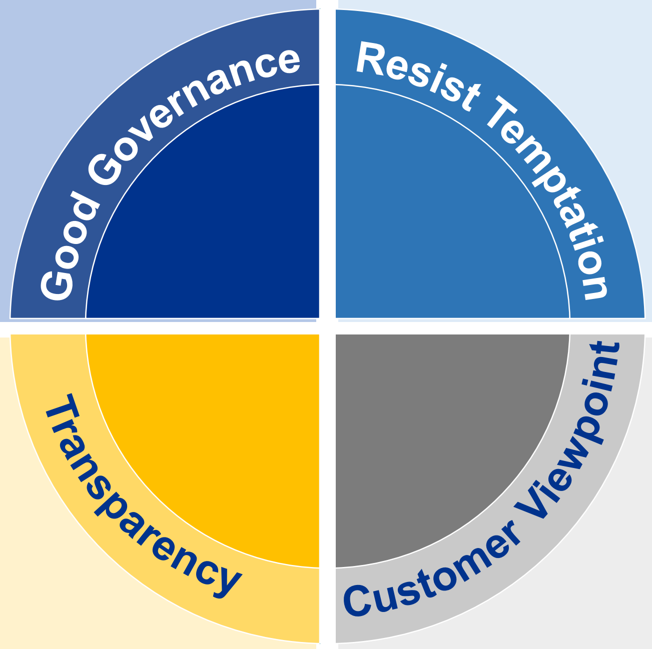
- Difficult and rarely successful (one success & one failure so far)
- Need to consider policyholder interests of both funds which is a complex issue – funds need to be similar from all major viewpoints - rare

- Hence funds are thus usually closed and stacked side by side – ring-fenced and self supporting – within the consolidating entity

With-Profits in Asia- Lessons which could be learned from the UK

With-Profits in Asia- Lessons which could be learned from the UK

- Have a good governance structure
- eg Independent committee to look after with-profits policyholder interests



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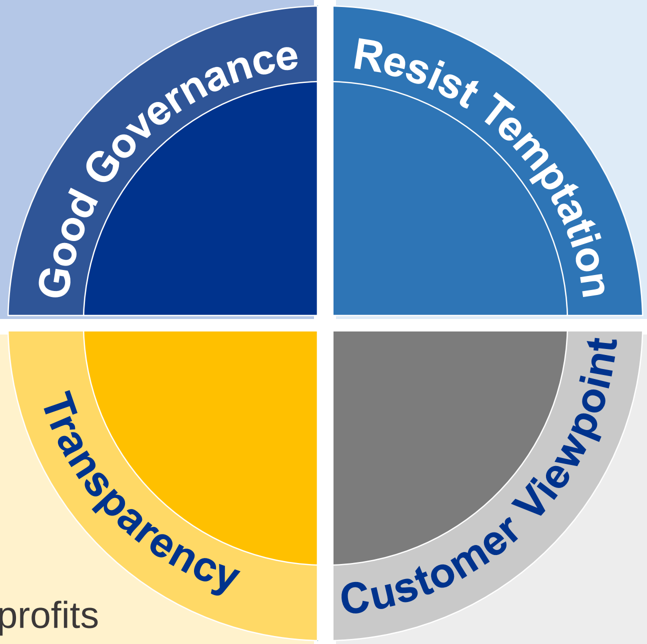

- Be transparent
- eg Disclose how bonuses are calculated
- eg Consider disclosing PPFM type document
- eg Report to policyholders
- eg Disclose earnings and their impact on with-profits business to policyholders
- Demonstrates powerful honesty message to regulator

With-Profits in Asia- Lessons which could be learned from the UK

- Have a good governance structure
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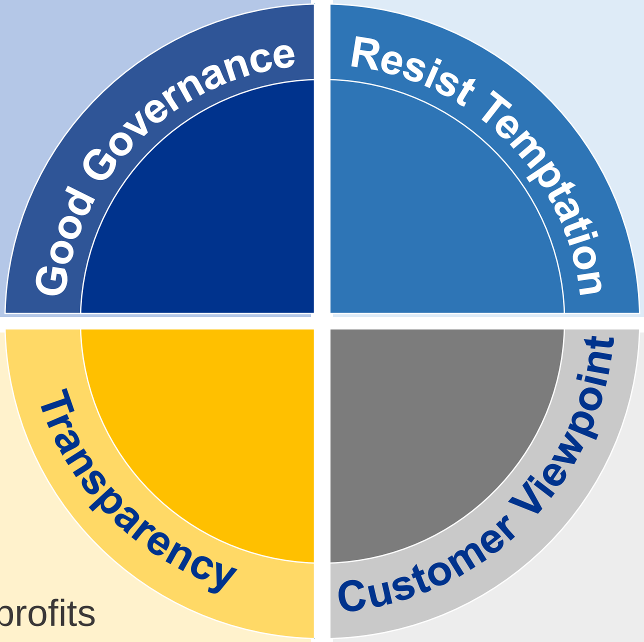
- Resist temptation to pass on costs to policyholders which are really shareholder costs
- Learn from mistakes of other financial sectors e.g. PPI



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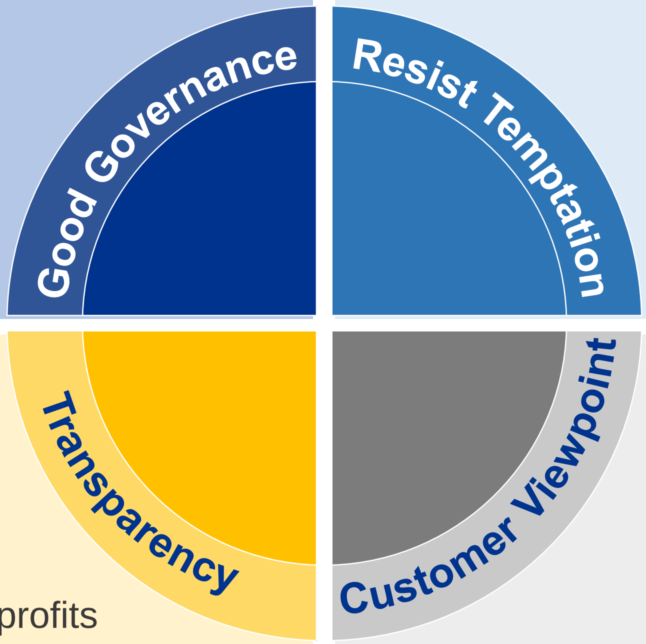

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- Consider issues from customer viewpoint
- eg Customer advocate

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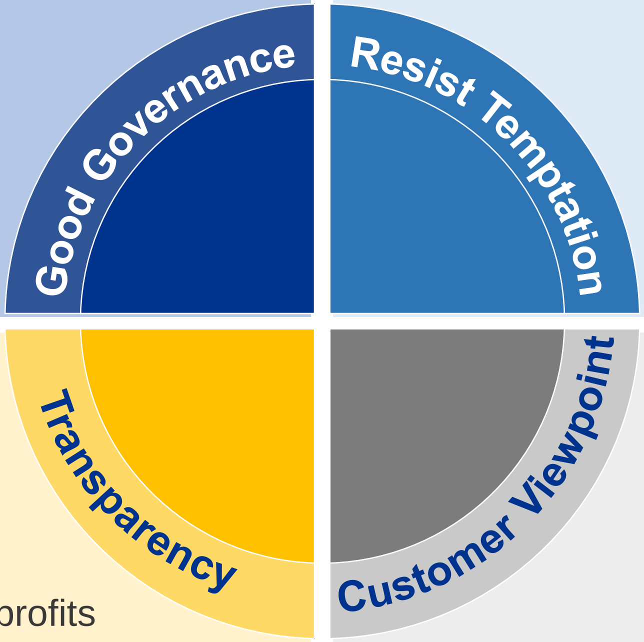

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COMPANIES: All this should reduce regulator pressure and/or ensure new regulations are reasonable & proportionate.

REGULATORS: Good regulation clearly needed, but be careful of over-regulating what is fundamentally a good product.

Agenda – Paul Beresford – Asia update

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