Institute
and Faculty
of Actuaries

Sharing the benefits of mutuality

David Hare, Deloitte
Brian Murray, Royal London

3 November 2016

What the brochure promised

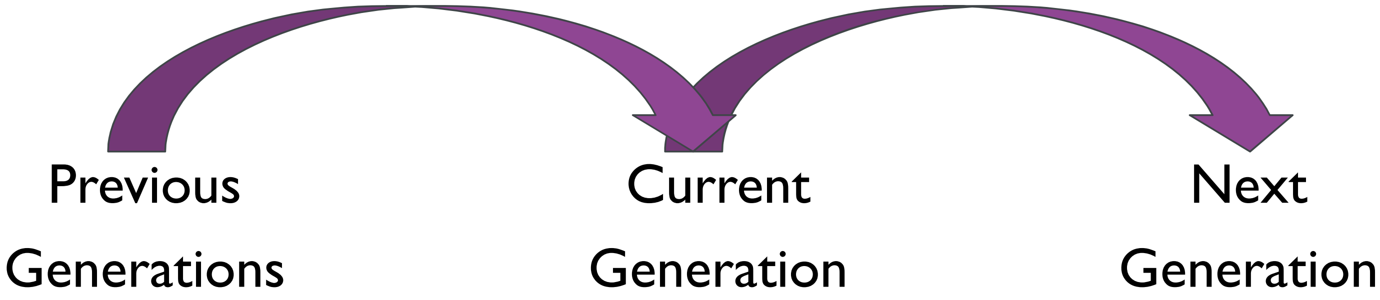
Royal London has taken mutuality to a new level. Since 2016, all new unit-linked pension plans come with a ProfitShare account, effectively turning the plan into a form of with-profits, but without the guarantees and smoothing that policyholders do not seem to value. What was particularly striking about Royal London's move was the extension of ProfitShare accounts to a large part of the unit-linked back book. This case study will tell the story of this significant development and also describe the challenges encountered in the independent review of the proposals that was required.

Agenda

- Mutuality under the Regulatory spotlight
- Mutual Capital Fund vs ProfitShare Accounts
- The development journey
- The role of the IE
- Putting it into practice

Mutuality in action

Mutual principle : inter-generation transfer of surplus



What happens to the 'surplus' when there isn't a next generation of WP policyholders?

FCA view (supported by their legal advice): CLOSE!

Key FCA Handbook section

Ceasing to effect new contracts of insurance in a with-profits fund

COBS 20.2.54 R A firm will be taken to have ceased to effect new contracts of insurance in a with-profits fund:

- (1) when any decision by the governing body to cease to effect new contracts of insurance takes effect; or
- (2) where no such decision is made, when the firm is no longer:
  - (a) actively seeking to effect new contracts of insurance in that fund; or
  - (b) effecting new contracts of insurance in that fund, except by increment; or
- **(3) if the firm:**

  (a) (i) is no longer effecting a material volume of with-profits policies (other than by reinsurance) **into the with-profits fund**; or

  (ii) is ceding by way of reinsurance most or all of the new with-profits policies which it continues to effect; **and**

  (b) cannot demonstrate that it will treat with-profits policyholders fairly if it does not cease to effect new contracts of insurance.

COBS 20.2.53 R A firm must:

- **(1) inform the appropriate regulator and its with-profits policyholders within 28 days; and**
- **(2) submit a run-off plan to the appropriate regulator as soon as reasonably practicable and, in any event, within three months;**

of first ceasing to effect new contracts of insurance in a with-profits fund.

Highlighting is ours for emphasis

Big decision…

Why not just close and give the surplus away?

Staying open and continuing to sell profitable policies is better for our policyholders in the long-run

The Directors have a duty to pursue suitable sustainable options

ROYAL LONDON

Institute and Faculty of Actuaries

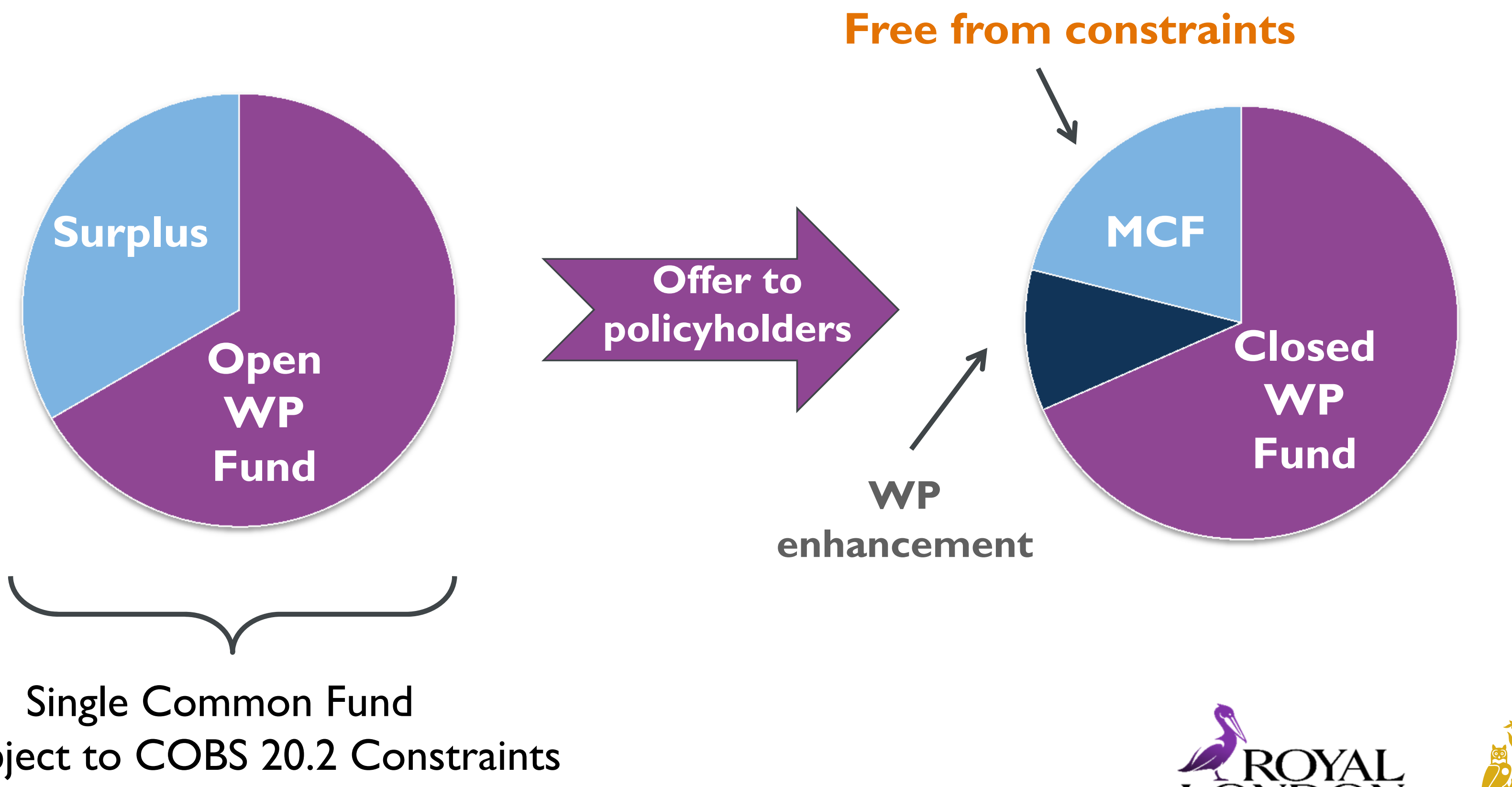
Possible viable alternatives

Two options

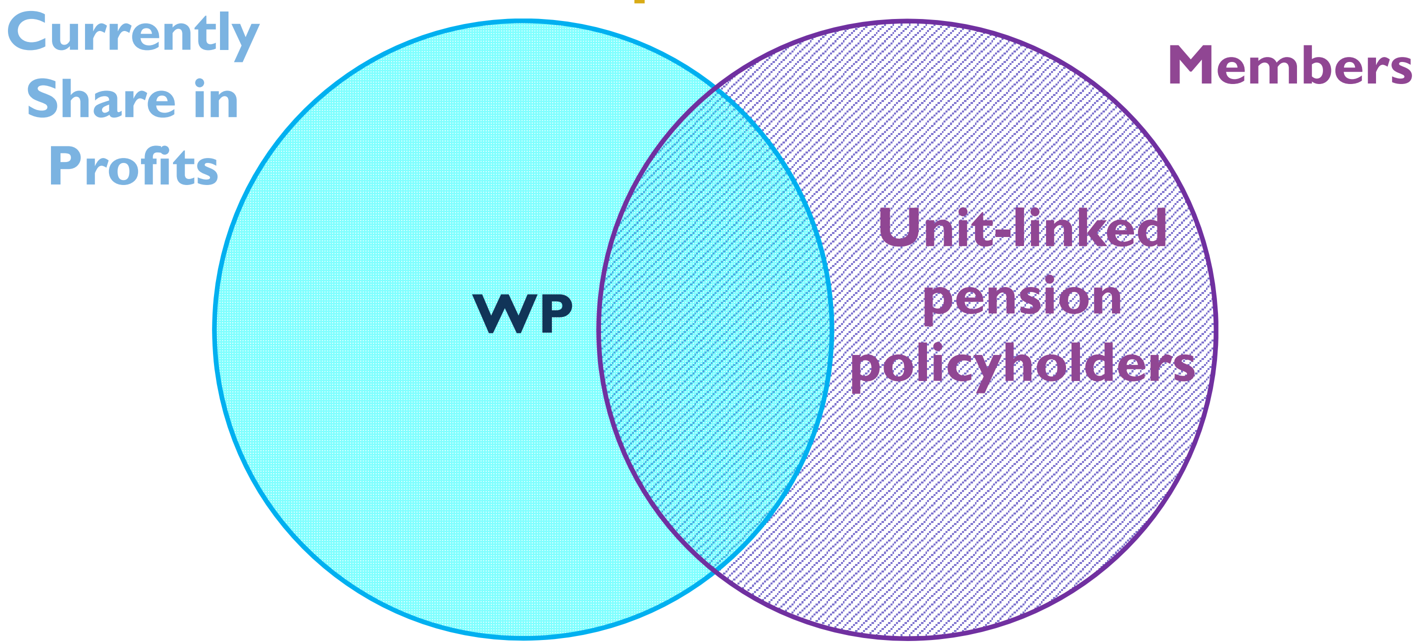
Mutual Capital Fund

ProfitShare Accounts

How an MCF might work

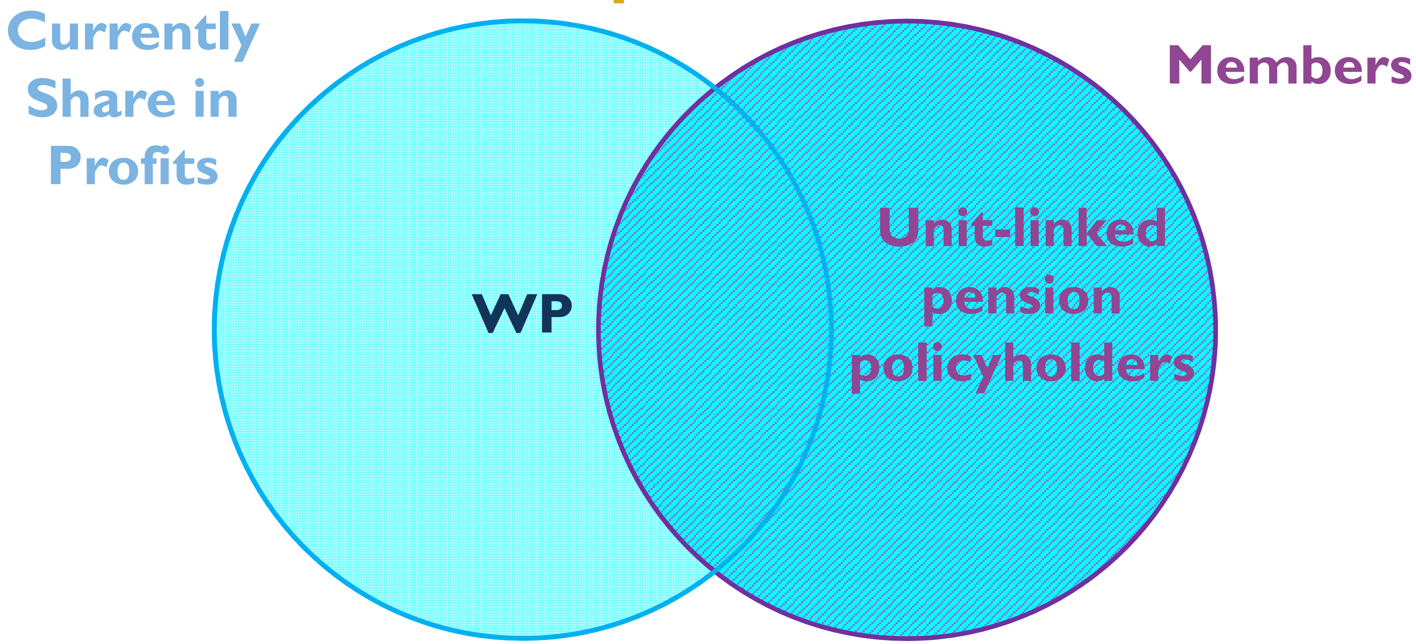


Disconnected membership



Of our 700,000 members only 250,000 share in our profits.

Reconnected membership - ProfitShare



Add ProfitShare to the new unit-linked pension policies and to the unit-linked pension policies taken out since mid-2001.

How much?

- Our pensions policies typically have charges of 0.35%pa - 0.75%pa.
- We believe we can generate profits each year that would enable us to give 0.15% - 0.25% back to policyholders.
- We'll do so by adding extra units.
- We'll only make those additions if we
  a) make sufficient profits, and
  b) are sufficiently strong to afford them.
- We can't guarantee them in advance, but, once allocated, we won't remove the extra units.

Institute and Faculty of Actuaries

Is this fair to the existing WP policyholders?

- We were very careful to ensure that we did this WITHOUT harming the interests of the existing WP policyholders.

- Our With Profits Committee commissioned an Independent Expert to review our plans.

- The Regulators followed the development and the results of the Independent Expert's review.

ROYAL LONDON

Institute and Faculty of Actuaries

The development journey (1)

- This was a long journey with a lot of twists and turns along the way.
- The process started back in 2007 with Project Chrysalis.
- This was followed by a series of FSA Dear CEO letters from 2009-2011.
- The legal analysis was crucial in this and quite contentious.

ROYAL LONDON

Institute and Faculty of Actuaries

The development journey (2)

- Royal London decided that ProfitShare was the way forward in September 2012.
- We fed our thoughts into CP12/38 then studied PS14/5 carefully.
- On 8th May 2014 we agreed a number of key principles with the FCA.
- Key to this was enlisting the help of an Independent Expert to assess fairness.

The Independent Expert Terms of Reference

- David Murray was appointed by WPC, but with report going to regulators as well
- ToR set in light of FCA PS14/5, with scope divided into:
  - Analysis that is needed by the WPC and the Board, *(under Chapter 20.2 of the FCA's Conduct of Business Sourcebook (COBS)),* to support a decision to implement the Proposition; and
  - Additional analysis that, whilst not formally required by COBS 20.2, will assist the WPC and the Board in deciding whether implementation of the Proposition is consistent with RLM's other obligations, including its requirement to treat all RLM policyholders fairly.
- The WPC were of the view that the current generation of with profits policyholders should have no expectation of inheriting the estate of RLM where a viable and fair route existed to maintain the mutual company as a going concern.
- The WPC were also of the view that the Member Accounts Proposition represented such a viable and fair route.

Deloitte. Institute and Faculty of Actuaries

The IE Terms of Reference – COBS 20.2 matters

- Analyse whether the new category of policies which will incorporate Member Accounts **will be 'with profits policies'** for the purposes of the FCA's rules, including whether the Proposition reflects the provision of a benefit which is, in his opinion, material (and not, as set out in the FSA's 13/10/2009 Dear CEO Letter, **"illusory or not of a material kind")**.

- Analyse *(for the purposes of COBS 20.2.28),* whether the introduction of Member Accounts in line with the Proposition is **likely to have no adverse effect on the interests of with-profits policyholders** whose policies are written into the RLM Main Fund. For the purposes of his analysis, the Independent Expert should have regard to relevant factors, including those specified in COBS 20.2.28, 28A and 29 , legal advice as described above, the factors listed under 4. below and the Committee's views above.

- Analyse *(for the purposes of COBS 20.2.28A),* whether new policies incorporating Member Accounts are **likely to be financially self-supporting** over the periods during which they are expected to remain in force and are likely to add sufficient value to the RLM Main Fund to offset the cost of acquiring the business and any associated cost of capital arising from the business.

Highlighting is ours for emphasis

Deloitte.

Institute and Faculty of Actuaries

The IE Terms of Reference – other matters (excerpts)

- Assess the extent to which the general premise of the Proposition and the proposed associated financial benefits would fit within the **Treating Customers Fairly** regime. In particular, the IE will consider, inter alia:

  a) The differences in terms between the new member account policies and the existing with-profits products;

  b) The relationship between the expected distributions to member accounts and the expected profits generated by those policies;

  c) The impact on existing with-profits policyholders of distributing part of those expected profits to member account policies;

  d) The likely distribution strategy to be adopted for both the new member account policies and the existing with-profits policyholders on a range of scenarios and sensitivities; and

  e) the **existing legal opinions** obtained by RLM and the FCA and the differences between those opinions, to the extent that the Independent Expert considers that those differences (i) have not been satisfactorily addressed, having taken account of any further legal advice obtained by him; and (ii) are relevant to the introduction of the Proposition.

The IE will specify, as soon as possible, the tests he would like to apply, the range of projection scenarios and assumptions, and the range of sensitivity testing, that he would like to consider to enable him to formulate his views on the proposals, and this information will be shared with the FCA when available.

Deloitte.

Institute and Faculty of Actuaries

The IE Terms of Reference – other matters (excerpts)

- Assess the proposed **internal governance structures** of RLM as they will apply to the Proposal, in particular whether they are robust and designed to ensure fair treatment of all classes of policyholder.

- Assess the appropriateness of RLM's **plans to communicate and involve policyholders** in developing and implementing the Proposal.

- Assess also the draft marketing material to be used to support the Proposal, in particular, considering the explanation of participation features, **having regard to the risk of consumer confusion** and the risk of mis-selling arising from that material.

- At a high level, consider and comment on RLM's analysis of whether the interests of members and/or with-profits policyholders of RLM may be better served via an **alternative approach** to Project Chrysalis, such as the creation of a Mutual Members' Fund as per PS14/15.

Deloitte.

Institute and Faculty of Actuaries

The IE’s analysis – some key considerations

- Are the new ProfitShare policies “with-profits policies”?
  - Materiality of impact on individual policies and also on fund as a whole
- “Business Case” to justify the Existing Business Proposal
  - Materiality of lapse & re-enter risk and consequential brand impact
- Financial analysis of the Proposal
  - “no adverse effect” on the interests of existing WP policyholders
  - Central scenario
  - Closure and run-off scenario
  - Historic Comparator scenario

Direct line: 0207 066 8186
Local fax:
Email: Caroline.Gardner@fca.org.uk

Mr P Loney, CEO
Royal London Group
55 Gracechurch Street
London
EC3V 0RL

Financial Conduct Authority
25 The North Colonnade
Canary Wharf
London
E14 5HS

Tel: +44 (0)20 7066 1000
Fax: +44 (0)20 7066 1099
www.fca.org.uk

2 October 2015

Our Ref:

Your Ref:

Dear Phil,

Royal London - Profit Share Account Proposals

I am writing to confirm that following our review of Royal London's Profit Share Account product proposals, as set out and reviewed by David Murray, Independent Expert, in his report dated 4 September 2015, the FCA does not propose to raise any objections.

This non-objection reflects the outcome of the FCA's Executive Risk and Issues Committee (ERIC) meeting on 7 September 2015. ERIC is a sub-committee of the FCA's Executive Committee and is responsible for taking decisions on regulatory issues escalated to it from across the FCA including Markets, Authorisations, Supervision and Enforcement.

We will continue over the coming months to engage with Royal London, via our usual supervisory approach, over your progress in relation to the operational implementation of the PSA policies.

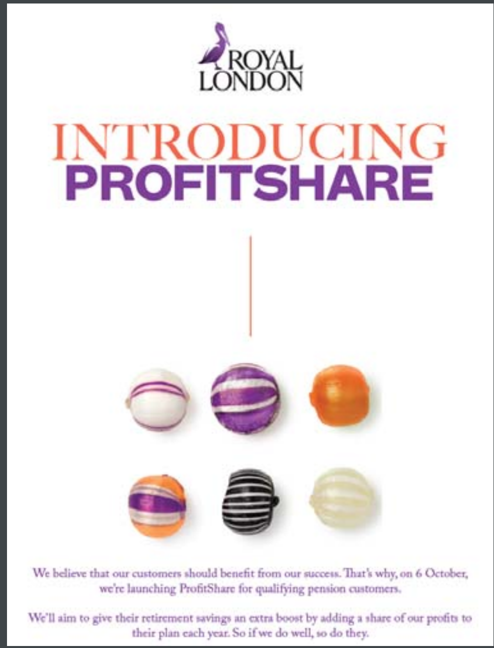
Yours sincerely,

Caroline Gardner

Caroline Gardner

Head of Department, Pensions & Retirement Income

FOLLOWING FCA NON-OBJECTION



WE WENT PUBLIC

Positive reaction from the Press

The way we manage **existing With Profits policies** will not change.

Phil Loney
Group Chief Executive

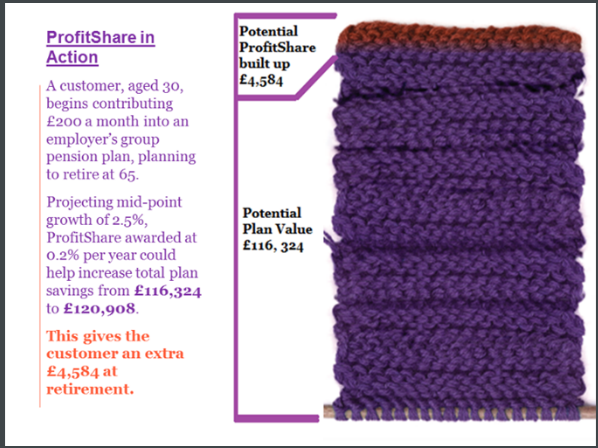
Royal London is the UK's leading customer-owned insurance and investments provider. We've been around for 150 years and we plan to be around in 150 years' time, not by staying the same but by evolving to meet the changing needs of our customers. We aim to have the best products, service and investment outcomes in the market, and translate these into the best outcomes and experience for our customers.

For a number of years we've boosted the savings of existing With Profits customers, by sharing some of our profits with them. However, the number of existing With Profits customers is falling. So, we think that the best way to respond to this is by making sure that more of our customers can share in our success, without diluting what we share with existing With Profits customers.

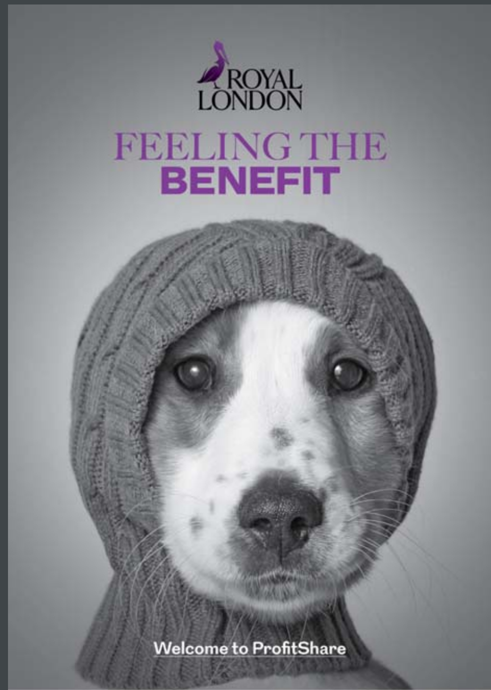
To do this, we're expanding our profit sharing approach to offer a new form of With Profits to all new customers who purchase a **Royal London** workplace or individual pension from the start of 2016. We're then extending this new form of With Profits to the existing customers who've bought these types of products from **Royal London** since the middle of 2001. The policies that qualify for the new form of With Profits will receive a smaller benefit than existing **With Profits policies**. The way that we manage existing **With Profits policies** will not change.

This approach will significantly increase the number of **Royal London** customers who will see their savings benefit from sharing in our profits. We believe that this change will ensure **Royal London** remains a strong, independent, customer-owned organisation with our customers' interests at the heart of everything we do.

MAILED WP CUSTOMERS



ILLUSTRATIVE BENEFITS



CREATIVE INPUT

Business performance since and final reflections

- In 2016 Royal London has achieved record levels of new business.
- And the new "low for longer" post-Brexit economic conditions have begun to bite.
- We are having a lively debate at Board and WPC about the level of ProfitShare!

- This was a long and crucial development for Royal London.
- The alternatives were potentially very negative for RL and the wider market.

- We were only successful as a result of a strong, challenging and effective relationship between the business and the IE.

ROYAL LONDON

Institute and Faculty of Actuaries

Questions

Comments

The views expressed in this presentation are those of invited contributors and not necessarily those of the IFoA. The IFoA do not endorse any of the views stated, nor any claims or representations made in this presentation and accept no responsibility or liability to any person for loss or damage suffered as a consequence of their placing reliance upon any view, claim or representation made in this presentation.

ROYAL LONDON

Institute and Faculty of Actuaries