Institute and Faculty of Actuaries

# Management of closed with-profits funds

## Considerations and best practice managing funds in run-off

by the Management of closed with-profits funds working party

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**Title**

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**Abstract**

This working party was set up in late 2020. The key objective of the working party is to understand the challenges being faced by closed with profits funds in the current macroeconomic and regulatory environment, with a view to sharing examples of good practice and making recommendations that can support the management of the run-off of closed funds for the benefit of with-profits customers.

The working party has reviewed existing research and publicly available information and supplemented this with a survey covering 60 closed with-profits funds across 16 firms. The research aims to build on rather than repeat similar research carried relating to the management of with-profits and focuses on the management of run-off and impact of sunset clauses.

**Keywords**

With-profits; Closed funds; Sunset clauses; Capital management; Run-off plans

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**Introduction**

The Management of closed with-profits funds working party was set up to provide a forum for with-profits professionals to discuss the current issues being faced by closed with-profits funds and consider how these can be managed.

The ultimate objective of the working party is to improve customer outcomes for those who have policies in closed with-profits funds through cross industry collaboration and the provision of best practice guidance.

The working party aims to build on previous work that has been carried relating to closed with-profits funds and the management of with-profits more generally. In particular, this report should be considered alongside the following:

- The Management of With-Profits Funds in Run Off ((IFoA, 2014) 2013-2015)
- Value of With-Profits for Consumers Working Party reports (2019-2020)

The specific focus of this working group was to consider:

- Impact of sunset clauses[1] on the effective management of the run-off

[1] A sunset clause is a rule set out in the governing documentation for a closed with-profits fund which states what should happen to the fund when it gets “too small” to continue to run as a separate fund in

- Developments in capital management techniques for closed funds
- Effective communications with policyholders in closed funds

Key drivers leading a need for this additional research are:

- The FCA thematic review in 2019 ("Review of the fair treatment of with-profits customers: TR19/3" (FCA, 2019)) and the focus on run off plans being "living documents".
- A high volume of schemes nearing sunset clauses over the next 3-5 years.
- Increasing popularity of Schemes of Arrangement as a capital management tool for closed funds.
- Value of With-Profits for Consumers working party research highlighting that very few policyholders understand whether their fund is open or closed. Can more be done on communications?
- The FCA new consumer principle (FCA, 2022) was finalised in 2022, and requires firms to act to deliver good outcomes for customers.

The remainder of this report covers the methodology used by the working party, to conduct desk-based research and market insights from practitioners before continuing to the main test of the report. The main test provides the results of the working party's analysis under the following headings:

- Executive summary (1.1) of the working party's findings and recommendations.
- Recommendations (1.2)
- Guarantees (1.3)
- Capital Support (1.4)
- Investment Strategy (1.5)
- Non-investment Expenses (1.6)
- Risk Management (1.7)
- Run-off plans (1.8)
- Goneaways (1.9)
- Sunset Clauses (1.10)

**Methodology**

The Management of closed with-profits funds working party was launched in late 2020; the working party was set up by the IFoA with the objective of making recommendations to actuaries working with closed with-profits funds that may improve the outcomes for with-profits policyholders.

The scope of the working party was to consider risks facing closed with-profits funds and possible approaches to manage these. Initial scoping specified this in three parts: sunset clauses, capital management, and run-off plans. The working party considered the latter two of these to be interconnected and considered them as a single workstream, while sunset clauses were considered by a separate workstream.

The working party commenced with desk-based research to identify information already in the public domain. This included a desk-based review of the Principles and Practices of Financial Management (PPFM), Customer Friendly PPFM and other online documents for closed funds published on firms' websites, and past publications or presentations in the actuarial domain.

Once the working party had collated this information, the working party identified areas where information was not publicly available but where there was a perceived interest in collating industry

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its own right. The sunset clause will often define, typically measured as the size of liabilities, when the fund should be considered to be too small and what should happen to the fund once this has been triggered.

data. A survey covering these topics was constructed and put to With-Profits Actuaries for submission by September 2021.

The working party received responses from 16 firms across 60 closed with-profits funds. The working party analysed the responses received at a fund level, except where there were clear firm-level practices, for example in the approach to risk management. To recognise the differences in circumstance, the responses were considered across the size of fund (small funds below £500m of assets, medium funds up to £5bn of assets and funds above this categorised as large), whether the fund was proprietary or mutual, and correlations were tested between separate questions.

**Main text**

### 1.1 Executive Summary

The working party have considered the responses from 16 firms managing a combined 60 closed with-profits funds. While all with-profits funds are different, with their own heritage, product mix, scale and risks, they all share in their objective to manage the fund in the best interests of with-profits members. Many risks are shared by some or all with-profits funds, and although the materiality or approach may differ between funds, the working party consider it important to be aware of the range of approaches being taken so actuaries can identify appropriate, proportionate responses to the risks in each of their closed with-profits funds.

Throughout the report the working party highlight examples of good practice and areas where firms may wish to consider the appropriateness of their own approach.

Key observations:

- The majority of funds (38 of 60) have guaranteed annuity options - funds have adopted different responses to manage these, the most common management action is the monitoring of take-up rates and capital held to cover a 1-in-200-year event where take-up rates increase. However, more recently there have been examples of firms offering compromise schemes to policyholders or reinsuring the take-up risk. The capital support available to the fund and materiality of the portfolio of guarantees can alter the feasibility of de-risking in this way.
- The majority of funds have capital support available, either from a shareholder or a mutual main fund. This was not always on explicit terms, but the availability of capital support can provide funds with greater freedom to retain risks, and the associated returns, for policyholders.
- More funds had increased, rather than reduced, their equity backing ratios in recent years. Funds took different approaches to communicating the equity backing ratio to policyholders, but the information was typically available in a fund fact sheet, or consumer guide. The working party consider it important that firms consider the expectations of their policyholders both in terms of equity backing ratio, and information needs relating to the current asset mix.
- 51 of 60 funds have a sunset clause that applies. For those funds without a sunset clause, the long-term plan for the fund is generally considered as part of the Run-Off Plan.
- There is a wide variation in sunset clauses that apply in terms of both trigger points and what happens to the fund when the sunset clause is triggered.
- Responses suggest that the level of prescription within sunset clauses is generally about right, although 18 of 51 respondents suggested that the terms are too prescriptive and 31 of 51 would make changes to the clause if costs were not prohibitive.
- Firms would consider “advancing” their sunset clause, with the most common reasons being a growing tontine effect or disproportionate management time. Other reasons cited include issues with goneaways, unclaimed assets and non-profit policies growing as a proportion of the fund.

### 1.2 Recommendations

The working party have considered the findings of their report and provided the following set of recommendations for actuaries to consider the practical implications for their funds.

**1.2.1** **Read across and be proportionate with solutions**. Many of the recommendations can be applied to open funds, and/or will be more efficient to develop simultaneously across multiple funds, or while funds have scale to absorb costs. Otherwise, be proportionate with solutions.

**1.2.2** **Don't rely solely on a main fund or shareholder to lead the way**. Operational risks specific to the with-profits fund are at risk of being overlooked, e.g. succession planning, and legacy systems.

**1.2.3** **Engage stakeholders.** Stress the importance of recommended actions at Board and With-Profits Committee ("WPC"). Use the run-off plan to gain insight into the best actions to take next. Notify and discuss with regulators. Build policyholder engagement to get their buy-in, where appropriate and notify them of changes where they might reasonably expect to be informed, e.g. a change in Equity Backing Ratio (EBR).

**1.2.4** **Don't wait**. Being proactive is likely to produce better outcomes and some solutions take years to implement. Avoid causing foreseeable harm through inaction. This is particularly relevant to sunset clauses (section 1.10), where firms should also consider whether it is appropriate to accelerate the sunset clause or run the fund as with-profits in perpetuity to avoid potentially significant costs.

**1.2.5** **Understand when the sunset clause is likely to be triggered**, but also consider a range of scenarios including market falls and / or lapses and changes to policyholder behaviour that could impact this timing. Review actions that would be taken if the sunset clause is triggered earlier / later than expected.

**1.2.6** **Consider what response will be taken to a sunset clause.** If a sunset clause requires a merger or a conversion to non-profit, in most cases this is likely to lead to a complex balance of sharing risk and reward across different groups of policyholders (and potentially shareholders). Firms should consider how risks (rewards) will be treated. For sunset clauses where there is less prescription, this is likely to be subject to significant subjectivity, therefore early engagement with an independent actuary and regulators is recommended.

**1.2.7** **Develop a goneaway policy.** Goneaways present a material tontine risk if funds lack a plan to manage the identification and distribution of dormant assets, but the problem is difficult to tackle alone. Industry-wide solutions have to be the way forward.

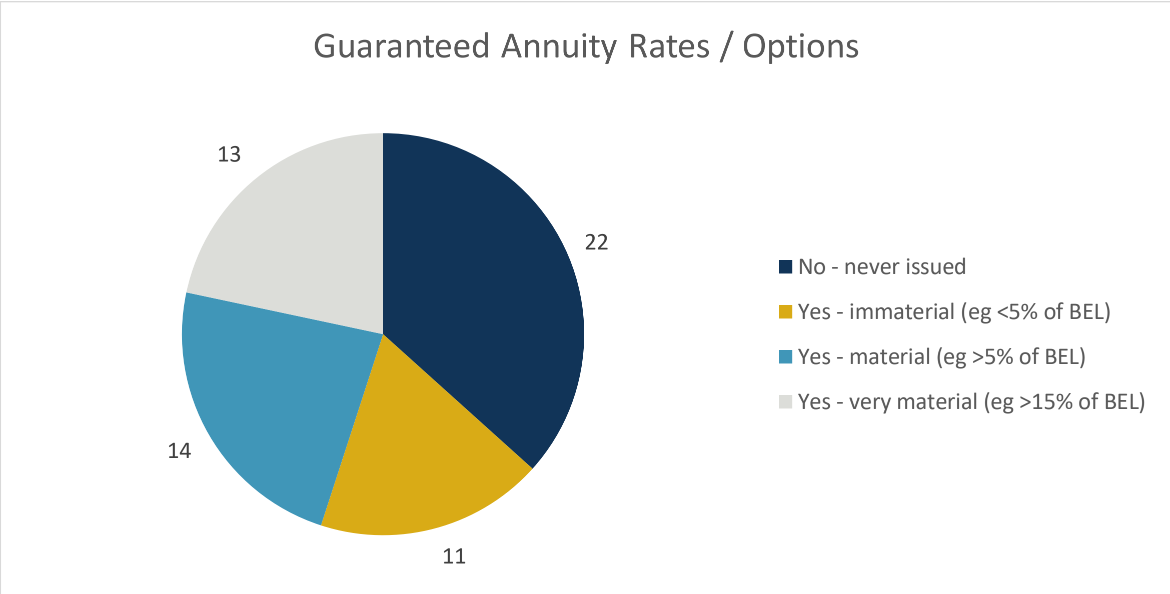
**1.2.8** **Consider compromise arrangements and / or reinsurance to manage fund risks and accelerate capital distributions**. There are several examples where firms have effectively implemented a compromise agreement and where reinsurers have shown an appetite to reinsure risks such as GAR take up rate risk.

### 1.3 Guarantees

One of the differentiating benefits of with-profits business is the provision of financial guarantees. Most forms of with-profits provide a capital guarantee at policy maturity. Many policies had additional guarantees that were thought to be immaterial when originally sold. With dramatically lower interest rates now, compared to pre-1990s conditions, many of these guarantees have become significant features of closed with-profits funds.

#### 1.3.1 Guaranteed Annuity Rates/Options (GAR/GAO)

A common feature of with-profits pensions business from the 1970s, 1980s and 1990s is a Guaranteed Annuity basis. This typically came in two forms; a set rate that had to be taken; or a minimum income option that only applied if market annuities were more expensive.




38 of 60 funds included in the survey had at least one form of annuity guarantee. 13 funds had more than 15% of their Best Estimate Liabilities in respect of annuity guarantees.

These guarantees can introduce significant elements of longevity and long-term interest rate risk. Another significant risk is the rate at which policyholders take their benefits in the form of an annuity - the so-called GAR Take-Up-Risk. Even where these guarantees provide benefits that are heavily in the money, some policyholders may prefer to take cash, particularly those with small pots. Legislation (UK Legislation, 2015) requires anyone with more than £30,000 in their policy that is subject to annuity guarantee to take regulated advice before giving up the benefit.

Even so, a significant proportion of with-profits policyholders - typically between 25% and 50% - are still opting not to take up their guaranteed annuity rate. In many cases, Funds are holding sufficient capital to withstand a material increase in this take-up (somewhere close to 100% take-up in a 1-in-200-year stress) which can hamper a fair distribution of the residual estate.

In practice the take-up rate will vary over time, depending on societal norms and economic conditions. Such changes are likely to be slow, and closed funds may be able to manage this experience effectively. A 1-in-200-year stress is more likely to result from a further change to legislation or regulation (for example the introduction of a secondary annuity market), which could flip a well-capitalised fund into difficulty in a short timescale. This runs completely counter to the aim of achieving a smooth run-off.

Firms may choose to mitigate this risk by offering policyholders the option to trade their GAR benefits for an increased pension pot on an individual basis. Alternatively Schemes of Arrangement can be used to complete such an exchange on a cohort of policies. Such exercises require extreme care to ensure sufficient information and advice is made available for policyholders to make informed choices and avoid harm. However, if done well, these can mitigate the tontine risk and help ensure a fair distribution of the estate.

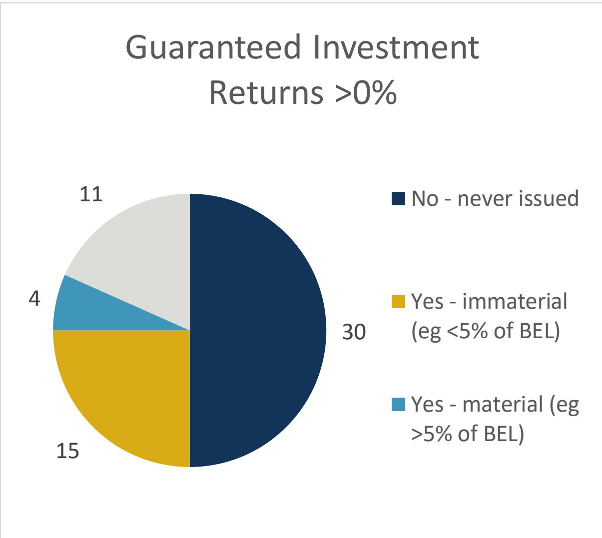
Pearl in 2010 (Pike & Palmer, 2010) and Royal London in 2018 (Valentine, et al., 2018) carried out successful GAR compromises on funds with heavy GAR exposures.

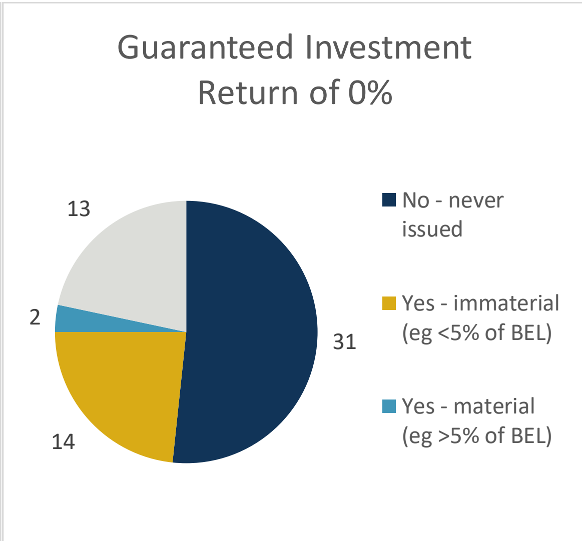
Finally, there have been recent examples where firms have secured reinsurance to cover persistency risk, including those relating to GAR take-up. These can help manage the risk profile within the closed fund. These arrangements also need to be carefully designed to ensure that providers remain incentivised to promote good outcomes for individual policyholders.

The recent HMT Solvency II consultation (HMT, 2022) raised the possibility of introducing Matching Adjustment eligibility to suitable long-term guarantees in with-profits funds, which may improve the capital efficiency of funds retaining longevity risks. However, it is difficult to see a use case for many closed funds as the own fund restrictions limit the use case to either reducing burn-through risk to the supporting shareholder or main mutual fund, or to accelerate (not increase) the distribution of surplus. Based on the existing Matching Adjustment application process, small, closed funds may struggle to get a Matching Adjustment Portfolio through their own cost-benefit analysis.

### 1.3.2 Guaranteed Investment Returns

Most forms of with-profits provide a capital guarantee that is equivalent to at least a return of premiums paid.




Around half of the funds surveyed provided valuable guaranteed investment returns. Eleven funds had more than 15% of their Best Estimate Liabilities in respect of guaranteed investment returns.

High rates of guarantee produce a challenge in managing closed with-profits funds. In order to reduce investment risk, assets with more certain roll-up can be selected. This form of asset-liability matching can reduce the capital that needs to be held back, but it would be expected to cost the fund more in the long-run compared to higher risk/reward assets. Conversely, trying to minimise the cost by investing aggressively will necessitate higher levels of capital being held back. Ultimately a compromise is required that minimises the disruption to fair estate distribution.

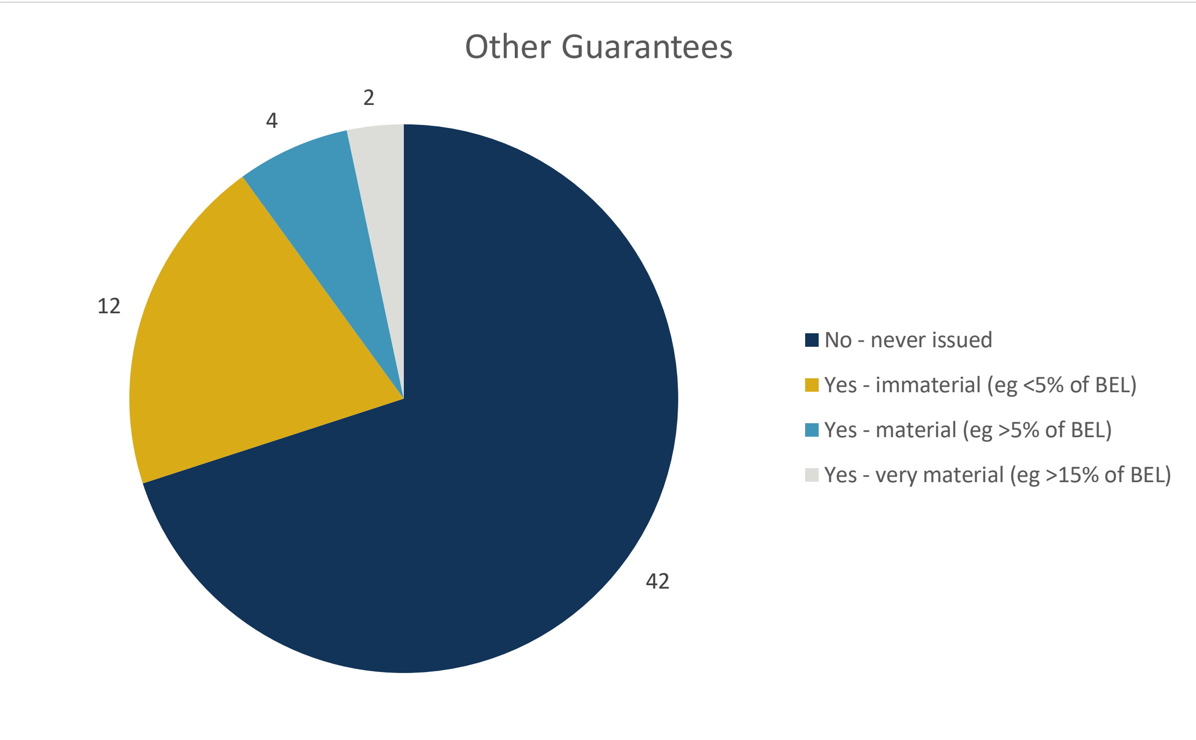
An added complication is the potentially open-ended nature of guaranteed investment returns. Where these are provided on bonds with no fixed term and where the rate of guarantee is in excess of risk-free the fund will be exposed to the risk of policyholders staying invested for longer. In contrast to the guaranteed annuity rates mentioned above, where the value can only be assessed relative to an open market annuity, customers will be able to readily grasp when a guaranteed investment return is valuable by comparing to the returns being offered on high-street investments such as savings accounts or cash ISAs, which are widely publicised.

Equitable Life in 2020 ((Eldred, et al., 2021)) carried out a compromise exercise on its block of guaranteed investment return business ultimately converting from with-profits to unit-linked in order to distribute the assets in the fund more equitably and improve the marketability of the business to secure a buyer.

### 1.3.3 Other Forms of Guarantee

18 of 60 closed with-profits funds identified other forms of guarantee that needed to be considered when managing their run-off. These included Guaranteed Minimum Pensions, Guaranteed Minimum Fund Values, Deferred Annuities, Pension Review Liabilities and MVR-Free Guarantees. Two funds had more than 15% of their Best Estimate Liabilities in respect of these other guarantees and four funds had between 5% and 15%.

In general, these other forms of guarantee combine aspects of annuity and/or investment guarantees so do not introduce additional considerations in addition to those covered above.



## 1.4 Capital Support

It is common for with-profits funds to have capital support arrangements in place with other funds, whereby capital can be made available from the supporting funds and called upon by the with-profits funds where necessary. Such arrangements are often made between with-profits funds and shareholder funds.

The approach to managing risks within closed with-profits funds depends on the ultimate guarantor. Twelve closed funds were within Friendly Societies or Mutuals where other groups of policyholders bear the burn-through risk from the closed funds. None of the twelve required support at the time of the survey or had required support in recent times. There was a common approach of running each fund to be self-sustaining to ensure fairness between policyholders.

Forty-eight funds were within Proprietary firms where capital support was provided by a combination of policyholders in other with-profits funds and shareholders. Six of these funds were in receipt of capital support or had been in recent times.

The approach to charging for support was mixed with roughly a third of responses in each of the three possible formats. Twenty funds had capital available at no charge. Twenty-one funds had capital available on pre-determined terms, typically as set out in a transfer scheme. Nineteen funds had capital available on terms to be determined as and when required.

The availability of capital support is a significant aspect in firms' consideration of Risk Appetite. Where capital can be supplied readily and at broadly commercial terms then firms can be more aggressive with estate distribution, investment strategy and so on. Conversely the lack of capital elsewhere in a group should rightly lead to a more conservative approach to Risk Appetite with de-risking and 'living within a fund's own means' becoming more important.

Consideration of capital support arrangements has become increasingly common. Some of the closed funds covered by the survey were subject to schemes of transfer dating back several decades, when capital measures were much less sophisticated than they are today. More recent transactions have been explicit in setting out terms for capital support up front. This has been evident where funds have been acquired in a weak state by a stronger consolidator.

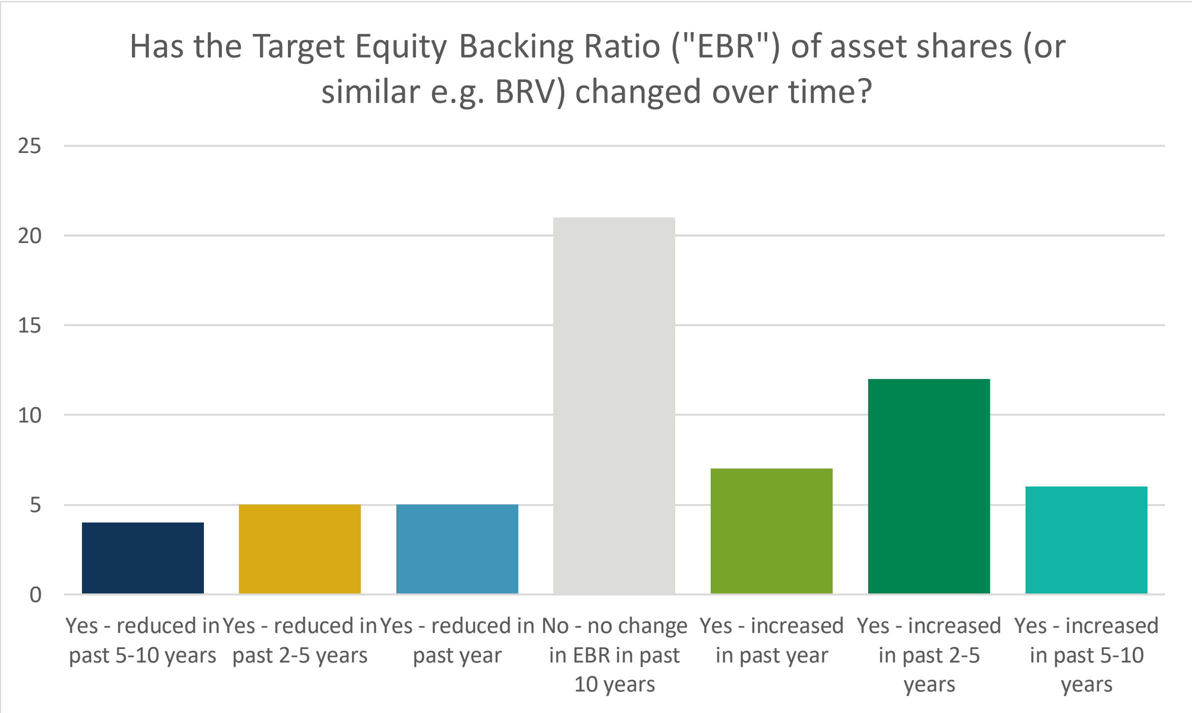
### 1.5 Investment strategy

This section of the report considers the investment strategy for closed with-profits funds in run-off in further detail.

#### 1.5.1 Changes in target EBR over time

We might expect the investment risk appetite for closed with-profits funds in run-off to reduce over time as the term on guaranteed benefits reduces. The target EBR[2] is often used to reflect the risk appetite of a with-profits fund, and hence it is also expected that these may reduce over time. This hypothesis has not been borne out in practice among the funds reviewed.

The survey asked participants how the target EBR of asset shares (or similar) has changed over time. The graph below indicates the results of the survey.




Interestingly, the survey responses indicate a range of changes in target EBR over time across closed with-profits funds. In particular, the number of funds for which the target EBR has increased over time is perhaps larger than expected, however there may be valid reasons which justify why this is the case for such funds. For example, the target EBR may have been consciously increased to align with policyholders' reasonable expectations following a historic reduction, or due to an expectation of achieving higher returns for policyholders. Conversely, the increase in target EBR may have been based on a less conscious decision driven by market movements and the change in actual EBR over time.

[2] Equity backing ratios are the proportion of equity (or equity-like) assets that a fund invests its asset shares. The definition includes equity and property investments with several firms also including emerging market debt, derivatives or other higher-risk-higher-yield assets. While there are some differences in definition, these assets represent only a small proportion of funds' investment mix and are not considered to invalidate its use as a risk metric.

### 1.5.2 Frequency of EBR reviews and actions taken

The survey asked participants how frequently they conducted EBR reviews and what actions participants took if the EBR for a with-profits fund fell outside of a tolerable range of its target EBR.

Most participants indicated that they monitor the EBR of a with-profits fund regularly (i.e., at least on an annual basis), though a couple of participants indicated that they monitor it relatively infrequently (i.e., every three years). Of those participants that monitor the EBR relatively infrequently, it may be in the best interests of policyholders for such reviews to occur more frequently (i.e., at least on an annual basis), in line with most other participants.

### 1.5.3 Policyholder communication of EBR

The survey asked participants how the EBR is communicated to policyholders, including communication of any changes made to the EBR over time. The results of the survey indicated that the EBR is commonly communicated via company websites and in annual communications to policyholders in the form of annual statements or reports, with 11 participants using each of these methods. Another common form of communicating the EBR is via PPFMs, which is used by 7 participants. A small minority of the participants indicated that they either provided communications to policyholders on request, at the point of sale or made no explicit communications to policyholders.

The results of the survey indicate that there is a mixed level of policyholder communications taken by participants. Some participants could improve their policyholder communications in this area by ensuring that the EBR and any associated changes made to it are communicated more directly to policyholders, e.g., via annual communications.

### 1.5.4 Relationship between EBRs and capital support arrangements

For those with-profits funds that have capital support arrangements in place, the survey responses indicated that there is a strong relationship between how a fund's target EBR has changed over time and whether capital support has been called upon recently. Of the funds that have not recently called upon their capital support, the majority of these have either increased or not changed their target EBRs. Conversely, of the funds that have recently called upon their capital support, all funds have either reduced or not changed their target EBR.

This relationship is not overly surprising, since the level of target EBR for a with-profits fund (which reflects a fund's risk appetite) should depend on the solvency position of the fund. In cases where a with-profits fund has recently called upon their capital support, this may indicate that the fund is in a relatively weak solvency position and hence a reduction to the EBR will reflect a reduction in risk appetite until the solvency position improves.

### 1.6 Non-investment Expenses

Non-investment expenses cover a wide range of activities including policy administration, actuarial services, compliance, financial reporting etc. With increasing demand from regulators and customers the upward pressure on expenses may become a material risk for closed funds during run-off, as the diseconomies of scale can give rise to unfair outcomes. This is often a driver for a sunset clause to merge a closed fund into a bigger fund, in many cases into an open fund. This can help to mitigate the potential harm that increasing unit costs can have on customer outcomes.

Prior to this sunset clause, the risk of expense inflation is often mitigated through a pre-determined expense agreement with the shareholder, the open fund (in a mutual) or with a third-party administrator. Of the 60 funds surveyed 49 had explicit expense agreements in place. Three of the remaining funds had an annual management charge that funded expenses that were met by the shareholder, and the shareholder was at risk for expenses exceeding AMC. Two funds had outsourced administration The remaining funds were at risk for their own expenses and mitigated by the existence of the sunset clause. This highlights that although expense risk may have been a key driver for a sunset clause, in the vast majority of cases, this expense risk has been mitigated to some extent.

The approach to reviews and benchmarking of expense agreements was broadly consistent within each firm but different firms took quite different approaches. About two-thirds reviewed expense agreements at fixed intervals - typically annually or every three to five years. Some were not reviewable except in extremis - where an external factor had made previously sensible agreements no longer tenable. Most expense agreements had a fixed approach for a specified term, then reverting to actual costs, subject to external benchmarking.

The final approach seen in responses was to limit increases in expenses to RPI plus 1% - which helps to limit the negative impact on the fund of diseconomies of scale over time. As expenses are passed on to policyholders, either explicitly or implicitly where met by the estate, it is important that funds with inflation linked expense arrangements recognise and manage this risk. Funds may match the inflation linked liabilities with suitable assets, such as inflation linked gilts, or accept the risk exposure based on the risk appetite of the fund.

In the face of current[3] inflationary pressures, it is important to consider the impact of high inflation on the fairness of uncapped inflationary linked expense arrangements. This impact will depend upon the duration of the current period of high inflation.

In general, there is an advantage to having alignment of interests between policyholders in the closed funds and the body responsible for meeting excess costs (the shareholder or members). This alignment incentivises the drive for efficiency - which should be good for both sides. The application of external benchmarking also helps ensure that firms continually strive for efficiency.

[3] The working party conducted its survey in 2021, prior to the high inflation environment of 2022. We did not explore the prospective impacts of high inflation on with-profits funds, however we would consider it a possible topic for further research.

### 1.7 Risk Management

This section considers the different risk management approaches taken for a variety of risks facing closed with-profits funds. With-profits funds each have unique specific circumstances, but they typically share several common risk themes. The findings in this section are separated into the following topics:

- Market risk
- Tontine risk
- Expense risk
- Policyholder behaviour risk
- Operational risk

Actuaries working with closed with-profits funds may recognise several risk responses from their own fund while others may seem quite different. The working party encourage the reader to consider the findings in the context of a range of possible approaches of differing sophistication. The ideas contained are intended to prompt debate over the proportionality of a fund's risk management solutions and how these may evolve over time.

The survey concludes that while there are a range of risk management solutions being adopted, actuaries continue to lean heavily on stress and scenario testing to manage quantifiable risks. This is not surprising as stress and scenario analyses will form part of a fund's run-off plan. The fund is projected over its lifetime with conditions that result in the risk materialising and their likelihood of occurring. Firms then consider the management actions available to them to mitigate these risks, should they emerge. Other areas requiring focus were the distribution of a proportion of dormant assets, merging into an open fund, and reinsuring tail risk. A number of respondents say that their operational risk is insignificant, which the working party found surprising, and an in-depth investigation of operational risk could be in order for a number of firms.

The survey showed significant correlation between the actions taken in funds managed by the same firm. Several firms adopted relatively advanced risk management techniques across all funds even for those where the risk was deemed relatively immaterial to that fund. The working party considers it natural to consider the approach taken by other with-profits (and non-profits) funds operated by the firm when determining management actions for a closed fund. The results are therefore presented at a firm, rather than fund, level within this section to avoid giving undue weight to the approaches taken by firms with multiple funds.

#### **1.7.1** Market risk management

With-profits funds are exposed to market risk from the assets in which they choose to invest. Most of the market risk comes from the invested assets used to back with-profits liabilities, in particular the selected equity backing ratio (EBR) of policies. Unlike their unit-linked cousins that pass market risk directly on to policyholders, with-profits pay-outs are often smoothed or include guarantees that protect policyholders from (a portion of) market risk. This results in the need to hold capital against the market risk for the fund.

As funds run-off, there can be pressure to reduce market risk by altering the fund's investment strategy. This can be challenging as funds often set policyholders reasonable expectations based on the supportable investment strategy while the fund was open and need to consider the appropriateness of any updated investment strategy carefully.

This was reflected in the responses that the 16 firms provided. Half of the firms foresaw a change in risk appetite as the fund runs-off, and five of these anticipated the EBR gradually reducing over time. Firms also cited the fund's solvency ratio, investment performance, moneyness of guarantees, regulatory changes, duration, and business mix changes as drivers for EBR changes over time.

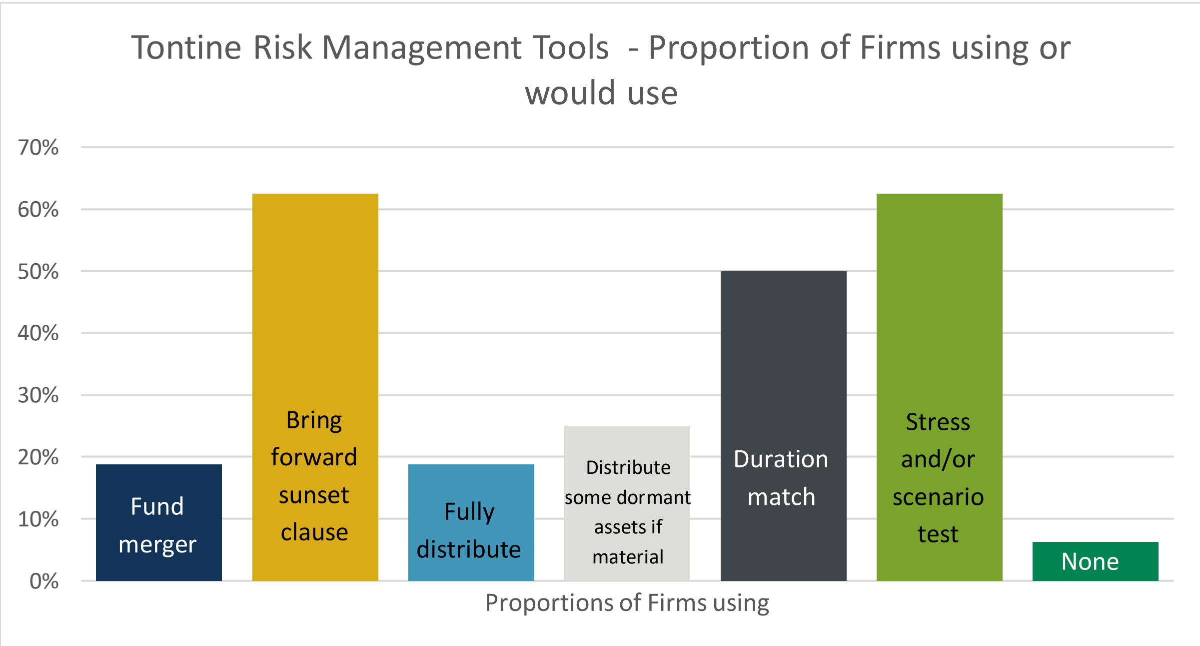
One firm used a dynamic measure of risk appetite expressed as a specified likelihood of Solvency Capital Requirement (SCR) coverage that can be maintained over the lifetime of the fund. This is an example of a clear and measurable risk appetite that can be articulated in terms of a risk metric appropriate to the fund over time, which the working party encourages firms to have. It is also important to appreciate the interaction between the need for capital and the impact on a fund's excess surplus that could otherwise be distributed to policyholders. Firms may find that defining their risk appetite in these terms simplifies the ongoing management of the fund.

The sustainability of an EBR over time may depend on the fund's end-game solution. This was seen in the responses from two of the firms that did not foresee a change in risk appetite before a Scheme of Arrangement[4] or fund merger would be required.

### 1.7.2 Tontine risk management

Tontine risk refers to the potential for a material portion of the fund to be distributed to a small number of policyholders as it runs off and for this distribution to be disproportionate to any additional level of risk these policyholders will be exposed.

Of the 16 firms that responded to the survey, the following approaches to managing tontine risk were used.




Each firm employs between zero and five of these tools, averaging two each, with duration matching and stress and/or scenario testing being the most common combination. Responses also provided the following insight:

- Three of the 16 firms would consider a fund merger to manage tontine risk.
- 10 firms would consider accelerating the sunset clause, where this would be in policyholders' best interests (section 1.10.4).
- Three firms are currently fully distributing the estate of at least some of their funds, with declared final bonuses set so that excess surplus is small. Each of these three firms have access to capital support, without which they may have been unable to fully distribute, and two of them

[4] A Scheme of Arrangement is a formal procedure under Part 26 of the Companies Act 2006 under which a company may enter into a compromise or arrangement with its with-profits policyholders as creditors to the fund.

can withdraw or claw back estate distributions in adverse circumstances. Two firms mentioned the need for prudent contingency as a limiting factor on the pace of distribution.

- Two of the eight firms with material goneaways were distributing a portion of the fund's dormant assets that are unlikely to ever be found. This is one of the tools (besides tracing etc. as outlined in the goneaways Section 1.9) for managing the risk that a large portion of dormant assets will be distributed to a small number of policyholders at the end of the fund's life. The working party encourages other firms as a matter of fairness to do the same, particularly if dormant assets are projected to become material over the remaining lifetime of the fund - as can often be the case for Industrial Branch business.
- Half of the firms match the duration of the assets to at least some of the with-profits liabilities, despite most firms having material guarantees.
- 10 firms perform stress and/or scenario testing to help manage tontine risk.
- One firm did not specifically mention managing tontine risk using any of these tools in relation to their small fund which has immaterial goneaways.

Firms need to determine for themselves, what an appropriate level of compensation is for the additional risk incurred by longer standing customers. Funds that are too prudent in their distribution philosophy risk disadvantaging exiting policyholders, while funds that are too optimistic with their distributions may risk the benefit security for the policyholders who remain.

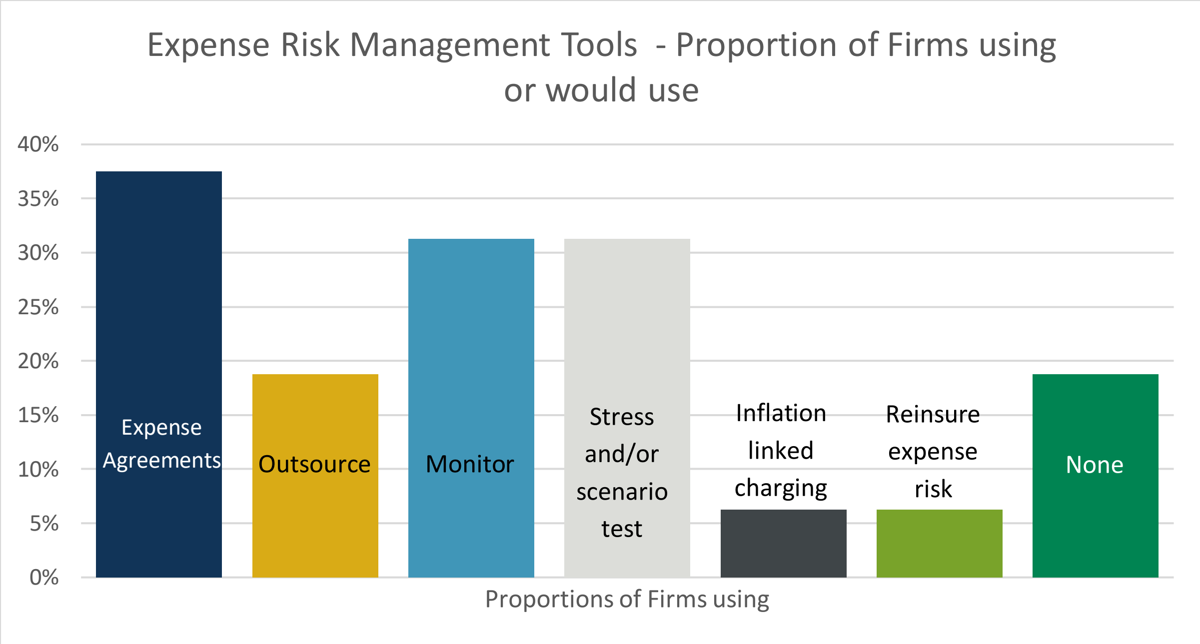
Firms should consider how their distribution strategy affects different generations of policyholders and how estate distributions are expected to compare between policyholders exiting now and those exiting with the same durations at a later date.

Most of the firms use stress and scenario testing, and most would consider bringing forward the sunset clause, to manage tontine risk.

### **1.7.3** Expense risk management

Expense risk refers to the tendency for expenses to be a larger proportion of the fund as it runs off. The simplest tool is to minimise expenses as much as possible by simplifying the fund management structure as the fund runs off. A case study for such an exercise was presented at the 2018 IFoA Life Conference in the presentation "There is More to With-Profits Life than Non-Profit Conversion" ((Jenkins J, 2018) summarised in the sixth slide).

Of the 16 firms that responded to the survey, the following tools are used to manage expense risk, with expense agreements being the most common. (Note that in the 1.6 non-investment expense section above, responses were broken down by fund rather than by firm.)




Each firm employs between 0 and 4 of these tools, averaging 1 each.

It may become more difficult for firms to negotiate expense agreements as the fund(s) become smaller. Of the six firms that have expense agreements, 2 had only small fund(s), 1 had medium fund(s), and 3 had large fund(s). Of the five firms that volunteer that they monitor expenses, 3 included only small fund(s), 1 included at least one medium fund, and 1 included at least one large fund.

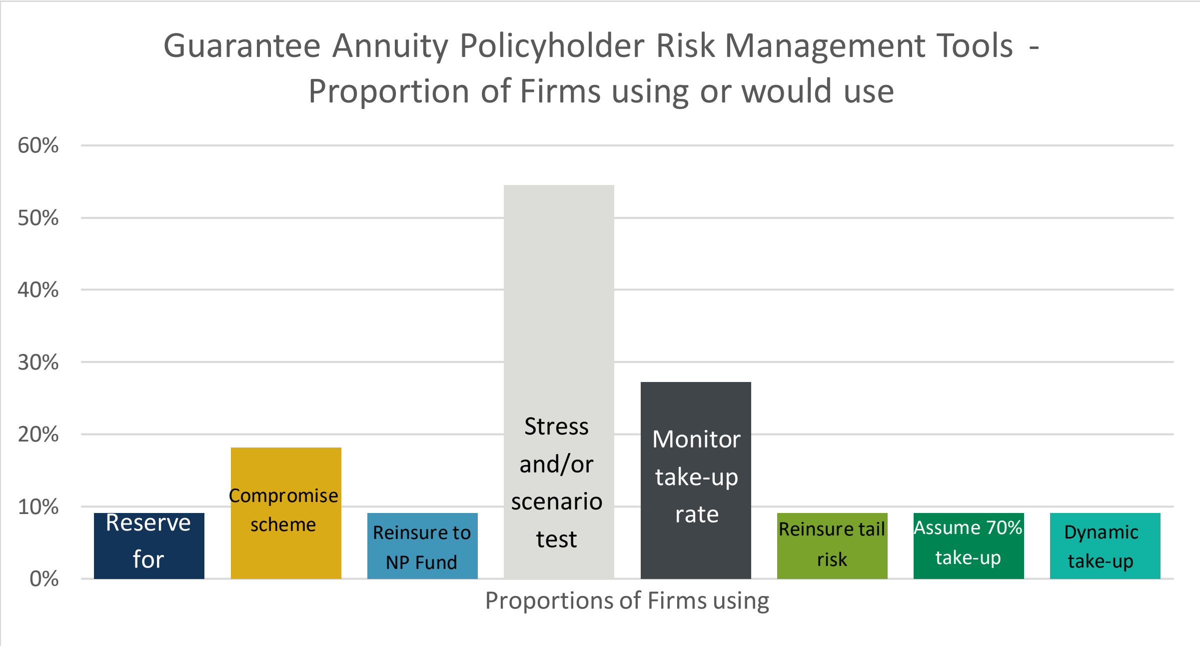
Three firms are currently using outsourcing at least some of their functions, for example actuarial or policy administration. It can be a balancing act deciding when to enter into an outsourcing agreement in time to avoid diseconomies of scale - not too soon when the fund is still large enough to support the overhead expenses in-house, and not too late in order to be in a commercially strong negotiating position.

### **1.7.4** Policyholder behaviour risk management

The survey asked firms about policyholder behaviour risk, specifically around annuity guarantees and market value reductions (MVRs). One firm responded that they assume all policyholders exit at the MVR-free date but otherwise MVR was not mentioned in the responses.

#### 1.7.5 Annuity guarantees

Eight of the firms that responded have very material (> 15% of BEL) and 3 have material (>5% of BEL) annuity guarantees in at least one fund. Of these 11 firms, most use stress and/or scenario testing as a risk management tool. They consider the following tools in managing policyholder risk.




One of the firms is investigating the use of reinsurance to cover their tail risk and 1 of the firms models dynamic annuity guarantee take-up rates that vary depending on the risk-free yields.

Two of the firms have completed compromise schemes. This may be a consideration for other firms depending on:

- The offer they could feasibly afford to make
- Costs of a Scheme of Arrangement
- If it is a reattribution (which requires a policyholder advocate)
- If there will be an opt-out, and if so, what the compromise take-up rate will be, and how that interacts with the offered uplift

As an example, Royal London (Valentine, et al., 2018) carried out a GAR compromise in 2018 for one of its closed funds. Policyholder experience indicated a typical take-up of GARs around 60%. Capital was held to cover the risk of this increasing to 95% in a 1-in-200-year stress. This combination allowed an offer to be made that was equivalent to uplifting asset shares by the value of the GARs, assuming a 75% take up. This mirrored a common situation where customers took 25% tax-free cash and used the remaining fund to buy an annuity.

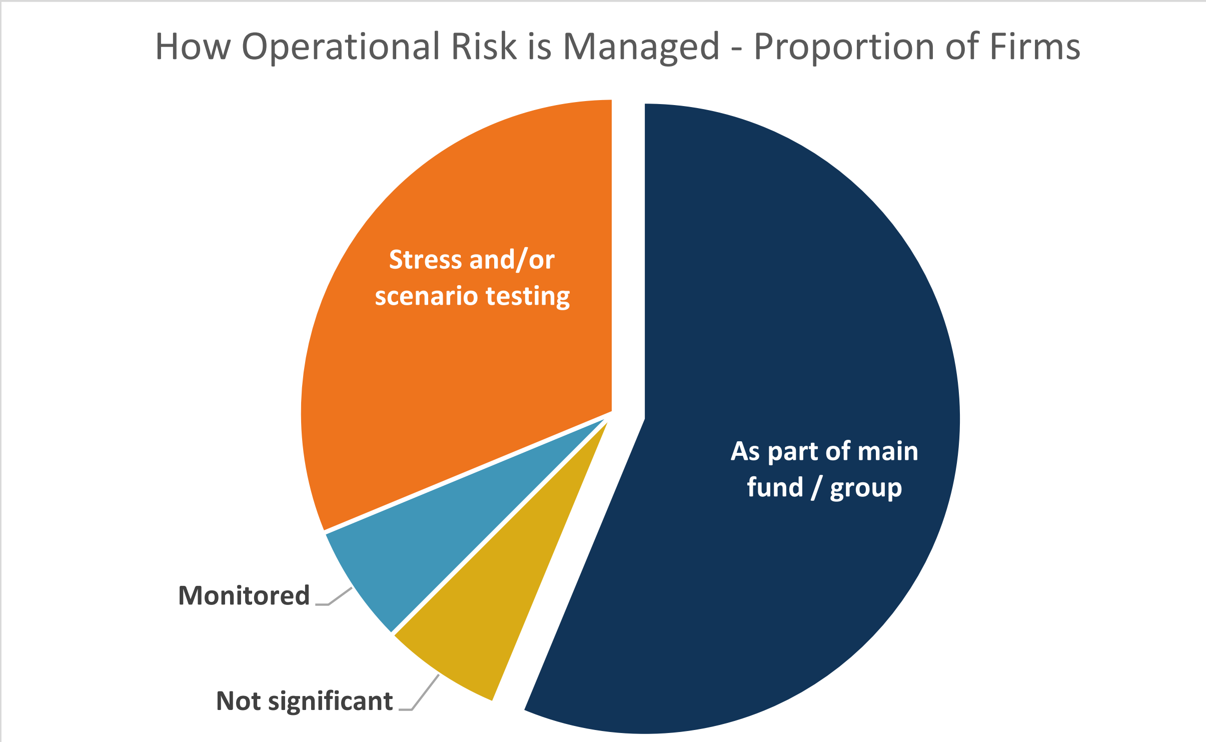
Royal London chose to offer an opt-out, so that those who wanted to keep their GAR benefit could, while those who wanted the flexibility received an uplift to their asset share of between 55% and 75% (depending on age and product type). Around 70% of the GARs were exchanged, leaving the fund with less risk overall and enabling an acceleration of the estate distribution and a material reduction in the tontine risk.

The success of such a compromise for other funds will depend critically on their individual experience, and the moneyness of the GARs. The practical difficulties should not be underestimated either and clear communications with affected policyholders are vital to success.

In addition to mitigating the GAR take-up risk, longevity risk and interest-rate risk, such an exercise can mitigate regulatory risk, for example from the establishment of a secondary annuity market, compulsory annuitisation for guaranteed benefits or the abolition of tax-free cash.

### 1.7.6 Operational risk management

Only one firm stated that scenarios specific to the with-profits fund, such as the loss of business knowledge, are considered as a tool in managing operational risk. Four firms said they use stress and/or scenario testing to manage operational risks and one other said they monitor operational risk. However, nine firms said that operation risk was managed as part of the larger group or main fund. They consider the following tools in managing operational risk.




It is important that operational risks specific to the closed with-profits fund are fully explored, and to consider what plausible scenarios would result in material operational losses, how likely these are, and how these would be managed. Risks particular to the fund could be key person, counterparty risks with third-party providers, reputational, legal and regulatory risks.

The Joint Forum on Actuarial Regulation (JFAR) observed in its 2016 risk perspective (JFAR, 2016) update that there was a shortage of new actuaries entering the field of with-profits. Firms may find it challenging to replace a departing With-Profits Actuary, or to find senior actuaries with with-profits experience, at short notice. Succession planning can provide an affordable longer-term alternative to outsourcing actuarial functions for firms that expect to have significant with-profits scale. Alternatively, firms whose with-profits business may no longer be a focus may wish to consider alternative ways to remove these operational risks, with conversion, simplification, sale or outsourcing as potential options.

### 1.7.7 Other risk management

The survey also asked firms to share other risks they managed, with a few offering responses. Where there are material annuity guarantees, longevity stress and scenario testing was used. This considered the impact on estate distribution, as well as interest rate and equity risk hedging.

It is often said “no two with-profits funds are the same” and while many risks can be categorised into the broad categories included within this paper, we might expect funds to have one or more risks which are unique to them. The working party encourages readers to consider not only whether the risks discussed are relevant to their fund, but also whether there are alternative better or more proportionate ways in which they might choose to manage those risks.

## 1.8 Run-off plans

The regular maintenance and embeddedness of run-off plans in the management of with-profits funds is key to ensuring an equitable distribution of the estate and helps to minimise tontine risk or the risk that policyholders' reasonable expectations are not met. This section of the report focuses on the factors considered in the maintenance of run-off plans, the non-market risks that have been considered and the methods employed to manage the risks inherent in with-profits funds.

### **1.8.1** Factors considered in run-off plans

Firms were asked to indicate the factors that they had considered in their run-off plans. The results indicated that a range of factors had been considered by firms, including bonus setting, estate distribution, PPFM compliance, regular WPC meetings and regular Board meetings.

Some firms indicated that other factors were considered in their run-off plans, including holding longevity swaps to give greater certainty over annuity pay-outs, refreshing run-off plans and ORSA projections and surrender value calculations.

### **1.8.2** Non-market risks

Firms were asked to indicate the key non-market risks that are considered in their with-profits fund run-off plans. Unsurprisingly, the most common non-market risk which has been considered by most participants is tontine risk, including the risk of asset and liability duration mismatch and dormant assets. Four firms did not indicate that this was a key risk that had been considered in their run-off plans, although one of these indicated that whilst this risk was not explicitly covered in their run-off plans the aim of their run-off plans, and sensitivities was to avoid tontine risk.

Just over half of the firms indicated that policyholder behaviour was a risk that had been considered in their run-off plans. Policyholder behaviours that are commonly allowed for (from most common to least common) include:

- Persistency or lapse risk, and the corresponding impact of these on GAO costs;
- Early guaranteed surrender values;
- Contracts assumed to leave at MVR free date but where no MVR currently applies;
- GAO take up rates;
- GAO take up assumed at current rates.

Of those firms who have not considered this in their run-off plans, one indicated that they are building capability to stress these, and another noted that their historical experience shows that behaviour has been relatively stable over time and that their fund is relatively insensitive to such risks.

Interestingly, about half of the firms in the survey indicated that they had not considered operational risk monitoring in their run-off plans. One firm who responded indicated that operational risk was not significant for their with-profits funds, and another noted that the cost of operational risk is borne by the shareholder. Despite these reasons, this could still be a potential area for further consideration for with-profits funds in the ongoing maintenance and embeddedness of their run-off plans. A key challenge for with-profits providers is in the assessment of whether operational risk is a significant risk for their with-profits funds, and if not, why this assessment is appropriate, i.e., why it is not considered to be significant.

In addition to operational risk, about half of the survey participants indicated that they had not considered expense risk a key risk as the fund runs off. Participants who did not consider this to be a key risk noted that this was due to low materiality, the existence of expense arrangements that reduce the risk, or that the expense risk is being borne by the shareholder fund.

Firms noted additional risks that had been taken into consideration in the run-off plans, including longevity risk, market risk, goneaways, mortality, key person risk and hedging.

## 1.9 Goneaways

The long-term duration of life and pensions products inevitably leads to firms losing contact with a proportion of their policyholders. We refer to such policies, where no known contact details are held, as 'goneaways'.

Many with-profits funds have closed to new business and these closed funds represent an estimated £200bn of consumer investments. A similar amount is also held in funds which are still open to new business where they face similar, albeit less urgent, challenges in tracing policyholders. Many closed with-profits funds expect to run-off quickly over the coming years, which makes timely intervention necessary to prevent poor consumer outcomes.

### 1.9.1 Size of goneaways

Several firms were unable to readily provide goneaway rates for each fund, instead providing a combined rate across multiple funds. Where reported, goneaways accounted for between 1% to 68% by policy count, averaging 13% and from 0.2% to 25% by asset share, averaging 8%.

A broad range of goneaway rates were reported by firms, which are not only representative of the lengths a firm may take to stay in contact with consumers, but also the heritage of the book; how many times the business may have changed hands and/or trading name, and perhaps most important, how policies were marketed. Industrial Branch business was sold in high volumes up until the 1990s, with a local sales representative walking door-to-door to collect regular premiums in cash. In many cases the records kept were not sufficient to be able to track down the policyholder (or their beneficiaries) today, perhaps listing "Sarah from Churchill Place" or "John, who drank in the Taxpayer on Fridays" as the name on the policy. Dates of birth were not always recorded, as policies only depended upon an age at entry. Without an accurate name, address or date of birth, it is easy to see how policyholders can become difficult to trace. Similar difficulties are encountered where data has been lost on migration of systems.

### 1.9.2 Tracing activities performed

A number of firms are reviewing their approach to tracing and there is a general lack of maturity in plans to distribute proceeds, probably reflecting the view that more attempts to re-engage with goneaways are required.

Only one firm referred to the ABI Framework for the Management of 'Gone-Away' Customers (ABI, 2018) in the Life and Pensions Market' which would appear to be a good starting point for defining a tracing strategy and framework. Firms should also consider the goneaway guidance provided by the FCA in their 2016 report 'Fair treatment of long-standing customers in the life insurance sector' (FG16/8). (FCA, 2016)

Most firms actively attempt to trace new goneaways, using alternative contact information already held and address checking services. A fund restructure or the introduction of a compromise agreement often triggers renewed tracing activity. Most firms will also increase their tracing efforts as policies approach their scheduled maturity dates.

### 1.9.3 Value of tracing exercises to date

Firms reported differing levels of success with their tracing exercises. The most success is found for recent goneaways, where success rates of 60% to 75% are reported by a number of firms. Later tracing exercises had mixed success rates, this is in part due to the more easily traced policies being tracked down first time around, but also because it can be difficult for a long-lost policyholder to trust in and engage with the tracing firm. Policyholders may ignore communications either due to them not recognising the brand following take-overs or mergers, or having a suspicion of being scammed when receiving ‘out of the blue’ letters.

### **1.9.4** External parties used for tracing

Firms use a combination of internal teams and external providers to perform their tracing and may use different external parties at different stages of the tracing cycle. Several tracing firms were listed by more than one respondent. A number of firms also use the letter forwarding service provided by the DWP if they have details of National Insurance numbers.

### **1.9.5** How industry could help resolve particular tracing difficulties

Consumers invested in with-profits funds can hope to share in the business profits that emerge within the fund through distributions of surplus. These with-profits investments are explicitly excluded from the government’s dormant asset scheme, with the expectation that firms managing the fund seek to distribute assets amongst surviving policyholders. This makes the challenge of tracing policyholders pertinent to the timely identification and distribution of these dormant assets amongst other policyholders in the fund. Improving firms’ ability to trace policyholders, or otherwise conclude that future tracing is unlikely, will help accelerate the distribution of these assets between living policyholders or their beneficiaries.

There is no central source of information and no access to government data is permitted. An industry wide solution is needed. In November 2021 we, as part of the IFoA, provided feedback to the consultation paper “Data: a new direction” (Department for Digital, Culture, Media and Sport, 2021). We outlined that if the DCMS were to:

- Create a central source of information and raise awareness with the public that insurance firms are trying to reunite customers with their money; and

- Allow financial institutions to work together and to access central information for the purposes of reuniting customers with their money.

Then the corresponding benefits would be:

- Financial institutions could trace more successfully the owners of dormant assets, where the customer or their beneficiary is owed money but where they have moved, and their current address is unknown. This is particularly relevant for life insurance with-profits funds which are not covered by the Dormant Assets Scheme. The results of our survey indicate that dormant assets are a material and growing concern for with-profits funds that are no longer selling new business, and which need to distribute the fund to its existing customers equitably and fairly;
- When tracing efforts are successful and a current address is found, the insurer could more easily engage with the customer to reunite them with their money. Our survey indicates that customers tend either not to recognise the brand following takeovers/ mergers, have suspicions of being scammed, or ignore 'out of the blue' letters; and
- When the customer is paying premiums via auto transfer from bank accounts, banks could disclose information regarding the source of the payments. Currently banks do not do this due to GDPR regulation, even though this may be beneficial to the account holder.

Policyholders with overseas addresses are particularly difficult to trace. Tracing activity abroad can be particularly costly as firms typically lack the scale to negotiate bulk-tracing rates. Tracing activity may also be less successful as the insurer may hold details limited to a period of the policyholder being UK domiciled without any significant overlap with the period of expatriation.

### 1.9.6 De minimis limits for tracing activities

There is no consistency on the application of de minimis limits either in terms of size or approach or between proprietary and mutual firms. Some firms responded that they include all policies in tracing exercises irrespective of the size of the policy, other firms apply a de minimis policy value before tracing; typical limits were £25 to £30 while some firms cited a still modest de minimis of £100. These limits are typically reviewed as the cost of tracing reduces over time with new technology available.

### 1.9.7 Charges to asset shares for goneaway exercises

There is no clear pattern or distinction between proprietary and mutual firms in respect of charging tracing costs to asset shares. Where the costs are charged to asset shares, no firms expected this cost to become disproportionate on other policyholders as the funds run off further.

### 1.9.8 Portion of goneaways eligible for distribution

Firms may classify a portion of their goneaway policies as dormant assets, these are assets where the firm no longer has any expectation that the policyholder will ever be traced. While a firm retains the contractual obligation to meet the claim of a policyholder that does re-establish contact, an actuarial distribution of some or all assets that meet a firms' definition of 'dormant' is typically considered to be in the best interest of policyholders. Although, there are clear challenges associated with over-distribution and, unlike non-profit insurance, there is no government scheme that covers dormant with-profits assets.

There are a range of different approaches to the defining and distributing of dormant assets. Some firms have delayed defining a process, with their current focus on tracing exercises and determine the extent of their remaining unclaimed assets. Other firms apply an age-based approach to writing off unclaimed assets typically for policyholders aged over 105. Similarly for policies which are past their maturity dates, some firms wait for up to 15 years before writing-off assets, while others write-off a fixed proportion of all post maturity unclaimed assets.

The working party encourage firms to consider which approach is most suitable for their fund(s), noting that this may differ by fund. Establishing a tracing process to improve the confidence in transitioning policies from goneaway to dormant should not prevent firms from beginning to distribute a prudent proportion of goneaway assets. For some funds, dormant assets present a material component of their tontine risk.

## 1.10 Sunset Clauses

For most closed funds, the long term "end state" of the fund will be set out in a sunset clause included within the funds' governing documentation.

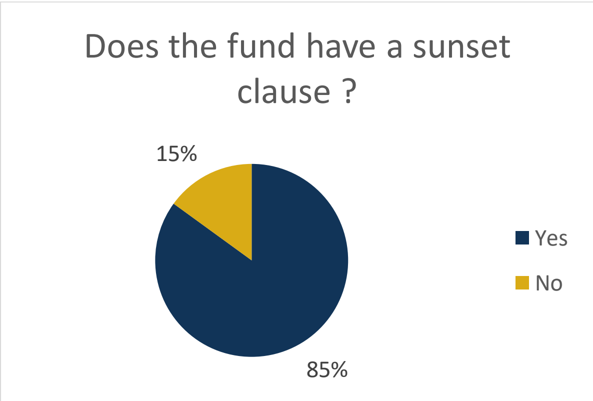
Many sunset clauses were written several decades ago, in vastly different macroeconomic and regulatory conditions. It can therefore be difficult to interpret existing sunset clauses in a way that is consistent with the current regulatory regime and concepts of fairness; there can be a challenging balancing act between acting in accordance with these legal clauses vs. potentially changing them if they do not lead to optimal solutions for customers. Some firms (Royal London, 2021)[5] have gone to court to change sunset clauses so that they have clarity on how they will be implemented, however this can be a timely and costly exercise.

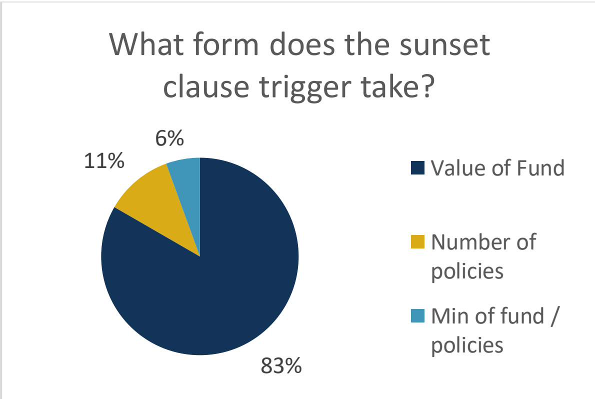
In terms of timing (i.e. the point at which the sunset clause states that the fund is "too small" and action should be taken), it should be noted that sunset clauses would typically have been written prior to reinsurance arrangements (including expense agreements) and pooling of assets being as prevalent as they are currently. In practice, with this type of support arrangement in place, closed funds may be able to operate for several years beyond the triggering of the sunset clauses.

The effective management of closed funds should consider the nature of the sunset clauses, whether this is likely to lead to good customer outcomes and whether the timing of the sunset clause is appropriate.

### 1.10.1 Existence and trigger level of sunset clauses

In the first instance we consider the existence and form of sunset clauses.




The majority of closed funds have a sunset clause.

Of the nine funds with no sunset clause:

- Two plan to add a clause as part of wider Scheme change,
- One has a sunset clause tied to another fund,
- Three have assessed the long-term end state within the Run-off Plan (noting that this is non-binding), and
- Three did not specify how the expected end-point for the fund is considered.

The trigger point for the sunset clause in all responses received is based on a measure of the size of the fund, either in terms of value or in terms of number of policies. Size measured by value is most

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[5] Changes we've made to Refuge Assurance Industrial Branch With-Profits Policies - Royal London

common, although there is variation in how “value” is defined, with definitions including: asset shares, technical provisions, total assets, and with-profits liabilities.

In a small number of funds, the sunset clause is triggered by a breaching a minimum number of policies.

There is a wide range of trigger points in terms of the size set:

- In terms of value, the sunset clauses range from £5m up to £500m.
- For those funds with a value-based trigger, 27% of funds specifically mentioned in their response that this trigger increases in line with a specified index each year. In most cases, the relevant index is RPI, but for a small number of funds the indexation is in line with National Average Earnings.
- In terms of number of policies, the trigger point ranges from 1,000 up to 12,000, with all but one fund in the range of 1,000 to 5,000 policies.
- A small number of funds have more than one limit, with different rules applying according to which limit is breached. For example, the sunset clause being optional at a certain level, but then mandatory if the level falls below the next threshold.

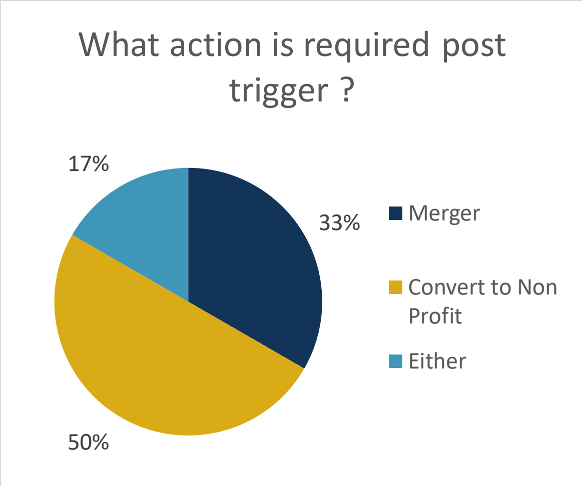
Firms should review their clauses and recognise that different forms of trigger have different issues to manage. For example, triggers based on a value of assets / liabilities could be triggered by a market fall. The timing of inflation linked triggers will be sensitive to periods of higher than anticipated inflation, if assets do not keep pace. For triggers based on numbers of policies, many life policies were traditionally sold in tranches, therefore large tranches of policies could exit at specific points in the future. For pensions business, whereas this business may have originally been written with a stated planned retirement date, this was prior to changes to pension regulations allowing greater freedom in when and how pension funds can be drawn down. One firm commented that the expected point of triggering the sunset clause has been delayed by several years due to changes to policyholder behaviour following the introduction of greater pension freedoms.

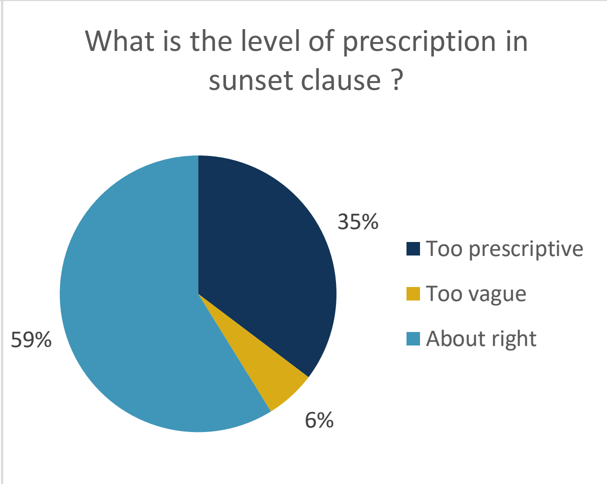
For firms that have trigger points that are indexed, it is noted that RPI will change to be aligned to the Consumer Price Index including Housing costs (CPIH) with effect from 2030. CPIH is expected to be lower and less volatile than RPI.

Firms should regularly review the appropriateness of the trigger point for their closed with-profits fund(s), and should consider sensitivities to market movements (asset-based triggers) and changes to policyholder behaviour (policy-count triggers). Given changes to RPI, firms with index linked trigger points may wish to revisit the expected future time of the trigger.

**1.10.2** What actions are required by the sunset clause?

Upon triggering the sunset clause, the action that can then be taken falls firmly into two areas: merger or conversion to non-profit, with a small number of fund clauses allowing the flexibility to do either.




There were no issues raised by survey participants relating to the option to merge into another fund, suggesting support remains in place and this remains a viable option for the funds concerned.

Whilst merger allows policies to remain in with- profits form for longer and potentially benefit from economies of scale; there can be issues of fairness relating to the receiving fund. In particular, does the merger introduce new risks (or heighten existing risks) for the policyholders in the receiving fund? If so, then what is a fair level of compensation for the risk being taken on?

In practice there will be a broad range of possibilities within the definition of "merger". At one end of the scale, the funds could be "fully merged" so that risks (and rewards / distributions) relating to all policies are shared equally across the newly merged fund. This is the cleanest in terms of operation and shares risk across the wider pool.

At the other end of the scale, certain risks and rights to distribution could be notionally ring-fenced post-merger with a view to keeping the risk-reward exposure of policyholders as close as possible to pre-merger position. However, ring-fencing and merging of funds appear to be opposite in meaning and effect.

In practice a merger of funds will need to balance the requirement to reduce risk for the closed with-profits fund as it runs-off with the fair treatment of policies in the receiving fund which will require close consideration of the risks (and rewards) that will be shared across the fund vs. those what will remain ring-fenced. These decisions need to be taken in the context of wording of the sunset clause. Firms should consider these issues as early as possible in advance of a (potential) merger.

In terms of conversion, the key question is how to fairly balance loss of future upside with reduced risk of downside. A key challenge here for many firms is how to fairly share potential future goneaway profits between (groups of) policyholders and/or shareholders at the point of conversion (see section 1.9).

There was a broadly even split between those who felt the clauses were now "too prescriptive" vs. those who felt they are "about right". Many participants wished to reduce prescriptiveness to allow for flexibility in timing or form of post-wind-up benefits. Many of those who said the level of prescriptiveness was about right still had a desire to make changes, such as changing the trigger level and/or form.

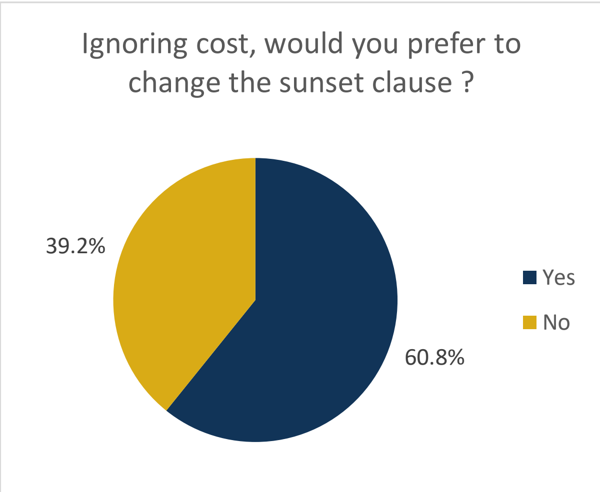
An element of vagueness was seen as a both a positive and negative. A permissive clause can offer flexibility which may improve customer outcomes. However, the application of subjective judgement is also likely to be subject to higher scrutiny and hence costs (for example Independent Expert fees, regulatory review / approval). More prescriptive, mandatory clauses have less subjectivity and must be acted upon, giving them clear business prioritisation. The working party notes that if acting on a mandatory clause would not be in the “best” interests of members, or if the timing were not appropriate, then the firm would need to consider seeking an amendment from the courts. The associated costs would need to be considered when assessing alternatives to the existing clause, which may remain the fairest alternative following a cost-benefit analysis.

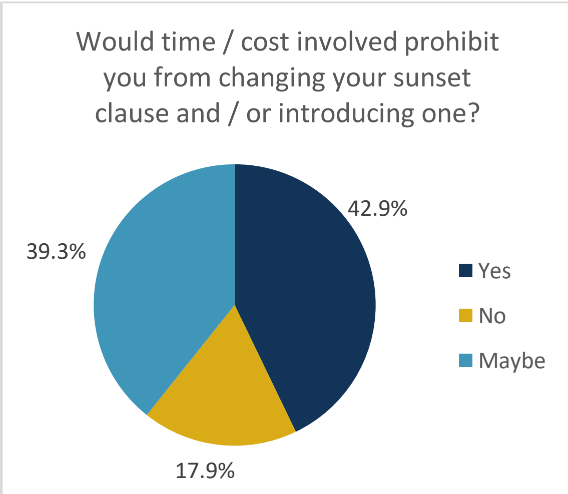
It is noted that the required involvement of regulators as defined in the clauses varies, with some requiring “agreement” and other requiring “notification”.

Finally, some clauses may be expected to trigger a long time in the future so it is difficult to anticipate what options will be available at that point in time. That seems to be an issue for those wanting to reduce prescriptiveness, as actions expected to be taken when written decades ago are not what firms may feel is in the best interest of customers now.

### **1.10.3** Changes to sunset clauses

Any changes to sunset clauses are likely to require a balance between the time and cost of implementing the change compared with the benefit this will deliver for policyholders.




More than half (61%) of funds included within the survey had a preference for changing the sunset clause if cost were not an issue; of these, 33% viewed the time and cost involved as being prohibitive to making required changes, with a further 43% being unsure. When including all funds, including those that did not have a preference for changing the sunset clause, 43% viewed the time and cost involved as being prohibitive to making required changes, with a further 39% being unsure.

Of those wanting to make changes to sunset clauses, the most common reasons were:

- Many wished to reduce prescriptiveness to allow for flexibility in timing or form of post-wind up benefits
- For some funds, there was a desire to introduce new features, such as indexation or some reference to unclaimed assets
- In some cases, the required changes were more “housekeeping” in nature, e.g. to update/give more precision to definitions, for example references to previous regulatory regimes.

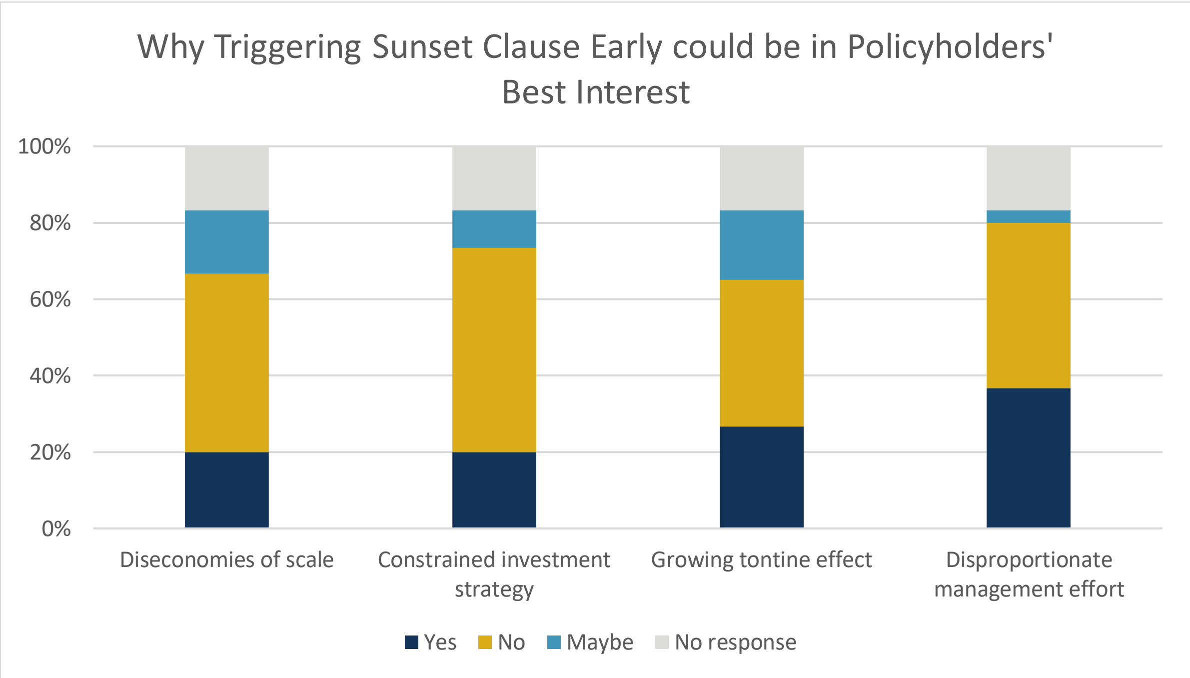
Many firms are looking at cost effective ways to manage a fund to the existing sunset clause, or to amend timing of the sunset clause, including:

- Efficiencies and simplifications, de-risking activity, expense agreements, etc. to ensure the fund remains viable until reaching its existing clause.
- Amending the clause as part of a wider programme of planned changes (although some noted these would not be done if it put the wider programme at risk).
- Use of allowable amendments to the scheme (under the existing scheme's modification provisions) or Schemes of Arrangement to terminate the fund immediately / in the very near term.

The data and feedback from firms highlights significant barriers to changing sunset clauses. For smaller funds in particular, the cost of amending legal documentation can outweigh the benefit of the change.

### 1.10.4 Activating the sunset clause early?

If advancing the sunset clause was demonstrably in the best interest of policyholders within a closed fund, then this should be considered. There are a range of reasons why triggering the sunset clause early could be in policyholders' best interests:




The most common issues that would be likely to prompt early trigger of the sunset clause was a growing tontine effect or disproportionate management effort.

For some funds the reverse is true, where firms would consider running funds beyond the sunset trigger. Where funds have expense agreements to manage the cost base and collectivised investments to maintain diversification, there may not be a pressing need to wind up the fund earlier and an ideal sunset clause allows the firm to determine the most appropriate time to wind up the fund.

### 1.10.5 Sunset Clauses - Conclusions

The FCA's TR19/3 (FCA, 2019) noted that good practice is to assess whether sunset clauses remain appropriate.

We believe the majority of firms are monitoring this but there does appear to be a disconnect as the costs are likely to be too high to amend the clause and therefore work tends to be focused on how to best manage funds within the existing sunset clauses, rather than changing the clauses.

For this reason, some firms have gone back to court to redefine what the sunset clause intended to do, or / how it was intended to be interpreted, so that they have clarity on implementation. However, this process takes time - so it is important to consider options and commence the process early.

The take-away is to start early to give yourself time to consider the wrinkles and foibles associated with implementing a sunset clause.

## Conclusions

The conclusions and recommendations of the working party have been provided in sections 1.1 and 1.2 of this paper.

The working party would also like to highlight the prospect of an industry led approach to tracking down goneaway policyholders as a possible area for further research from the IFoA, given the wider relevance, beyond closed with-profits funds alone.

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