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Topical issues facing With Profits firms: Challenges and Opportunities

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11 October 2017

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Introduction and context

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Introduction

- This presentation considers strategies that With Profits (WP) firms are using to deal with the market context
- We will set the scene then provide context and for each of
  - Run-off
  - Transformation
  - Growth
  - Sale
- We also provide some observations on recent market activity

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Introduction

A caveat

The views expressed in this presentation are entirely my own and not necessarily representative of the views of my employer, the Institute or other parties

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Context

- Wide range of firms writing WP business
  - proprietary & mutual
  - International v UK-focused
  - Large v small
  - Single fund v multiple funds

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Context

- Some common challenges faced
  - Return on assets and sustained low yield environment
  - Market uncertainty (Brexit, Trump, medium/longer term impacts of QE etc)
  - Sustainability of new business volumes
  - Long-term viability (e.g. Chrysallis for mutual firms)
  - Operational challenges – e.g. differing business mix over time

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Context

- Some differing dynamics for each too – e.g.
  - need for short-term return on equity for shareholders v longer-term investment time horizon for mutual
  - possibly different frictional cost of capital (given differing tax status)
  - governance

Context

- Increasing Regulatory scrutiny & focus
  - pensions freedoms
  - Auto-enrolment
  - charge caps (Stakeholder DWP)
- FCA thematic reviews
  - Legacy business
  - value for money
  - and now a thematic on With Profits

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Context

- A word on FCA Thematic on WP
  - Data request – deadline 11 August
  - Will likely select 5 or 6 firms for a deep dive
  - Firms preparing / considering
- Likely areas of focus
  - Governance
  - Fairness and best interests
  - Planned actions / historic actions
  - Assets – strategic assets, hedging
  - Policyholder communications
  - New business terms

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Run-off

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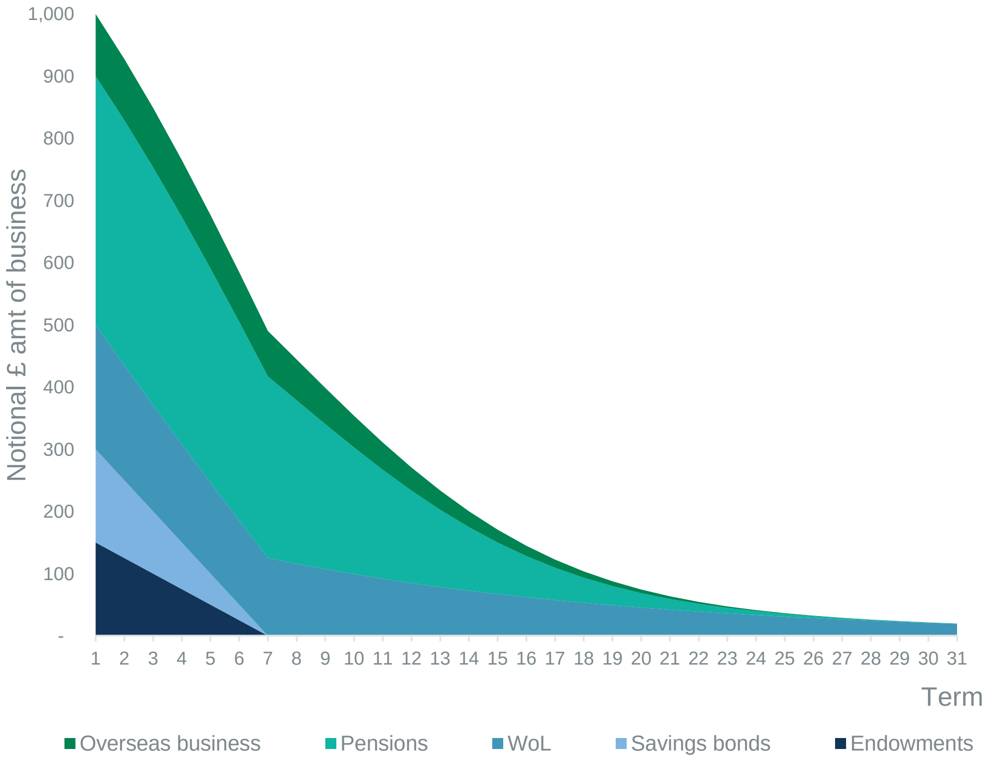
Run-off



- Many funds closed
  - Rapidly contracting – loss of scale
  - Low yields – guarantees bite!
  - Change in business mix
  - Possible inefficiencies from capital and operational perspective

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Run-off

- Challenge for closed book to meet business requirements e.g.
  - ROCE hurdles
  - limited upside prospects
  - But lots of downside potential
    - Charges no longer support expenses?
    - balance of value v capital support no longer attractive
    - Burn-through
    - Risk of retrospective redress
- So possibly not great from business perspective…..

….but is default for many firms

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Run-off

- Arguably not great for policyholders either
  - Fixed interest investment strategy so not getting real return which may have been expected at Point of Sale
  - Some pay-outs can be highly leveraged
  - Scantiness of data in bonus-setting cells leads to volatile pay-outs from one time period to another
  - Plans to distribute the estate welcome particularly since not getting real return (but always too late if self-supporting given need to meet CRRs)

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Run-off

- What management actions to change things?

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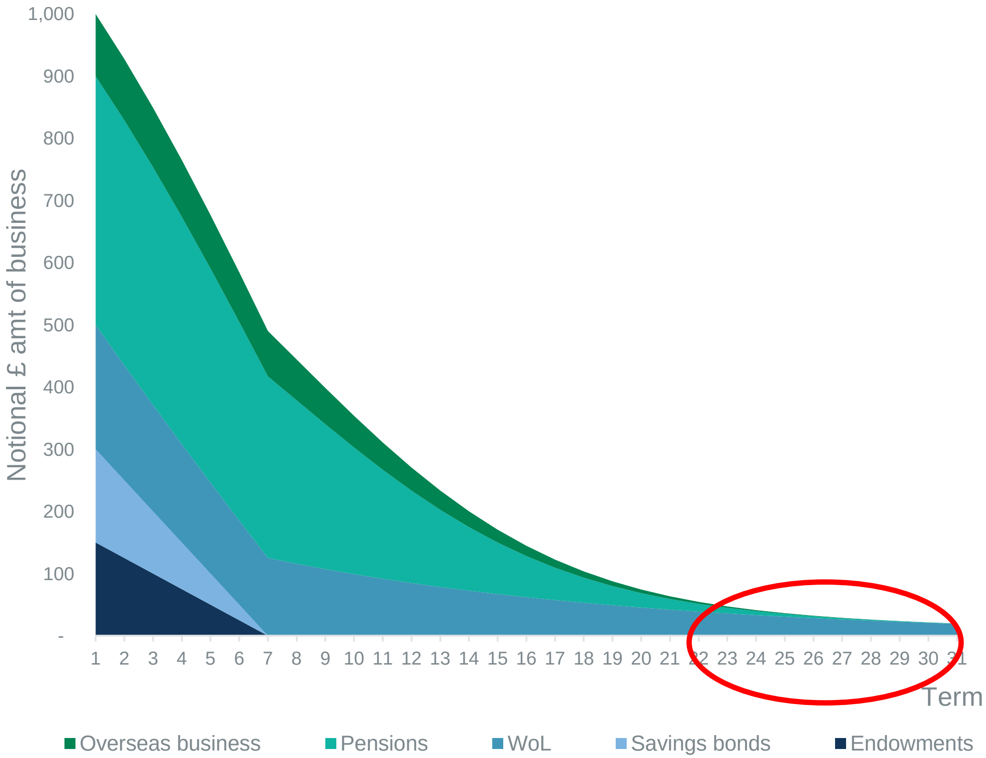
Run-off

Manage the 'tail'



Why?

- Address concerns about long-term costs to support long-term-to-go contracts. E.g. Some WoL contracts sold many years ago
- Many are very small but have many years left to go
- Challenge to extract sufficient charge to meet ongoing costs – which will only get worse
- Large expense reserve and disproportionate capital

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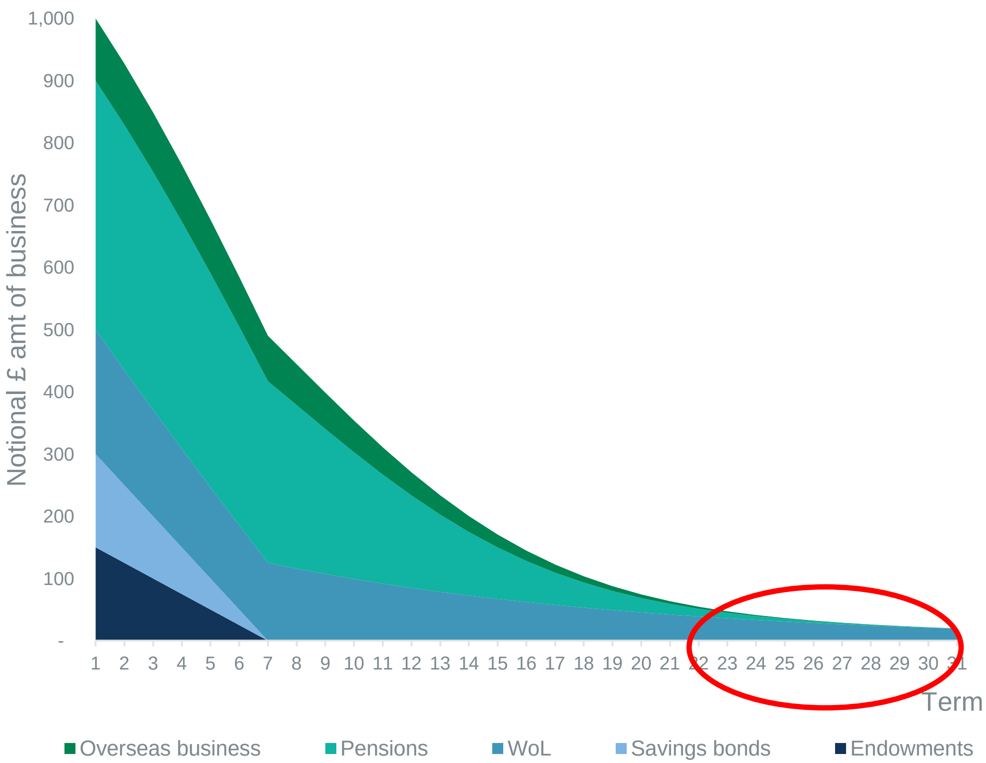
Run-off

Manage the 'tail'



How?

- Offer early pay-outs
- Buy-out? or enhanced surrender?
- Targeted approach? or offers for all?

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Run-off

Manage the 'tail'

- Potential benefits
  - ✓ Can cauterise cost of loss-making contracts without adverse impact on policyholder
  - ✓ Most effective for small contracts
  - ✓ Release expense reserve
  - ✓ Reduces NHR => reduce risk margin
  - ✓ Reduces capital

- Challenges
  - ✓ Does early payment trigger tax charge?
  - ✓ Is it what policyholders need?
  - ✓ Policyholder appetite?
  - ✓ Regulatory challenge

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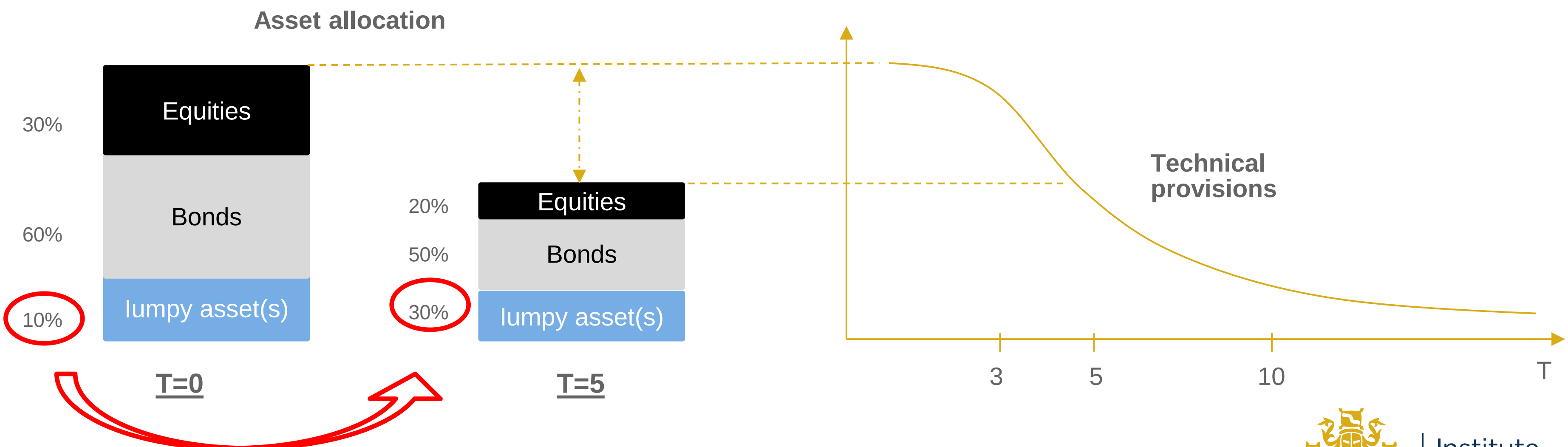
Run-off

- The concern about lumpy assets
  - Rapidly contracting with e.g. tranches of endowments & bonds exiting
  - Asset may continue to be attractive for yield but not of such scale
  - Transaction to divest may take too long or not be possible at an attractive price
  - Unintended increase in concentration of lumpy assets over time



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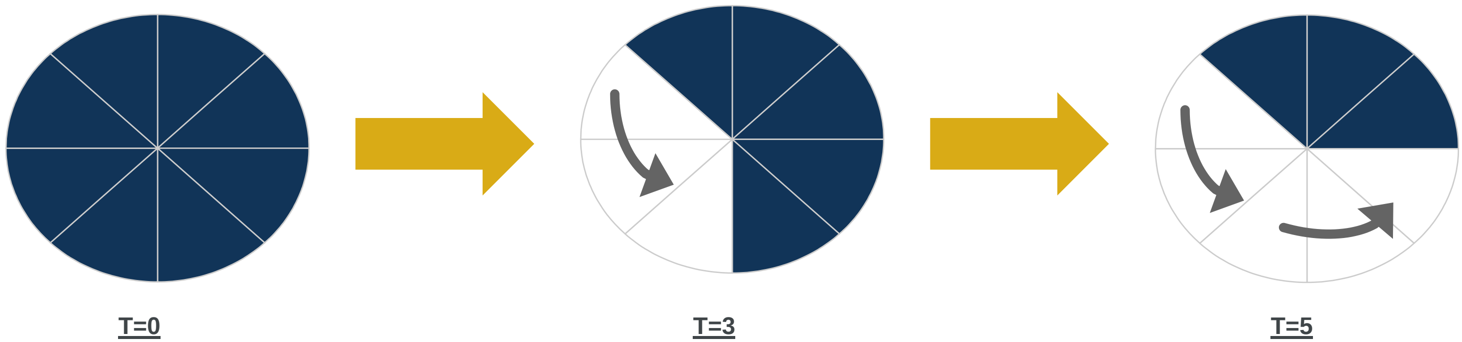
Run-off

- Unitisation of lumpy assets



How

- ‘Drop’ the illiquid asset into a separate investment fund (eg JPUT, APUT, PAIF etc)
- Use investment fund as a vehicle to sell exposure to the illiquid asset to other wholesale or retail investors.
- Tax-Transparent Funds (limited partnership or legal entity)

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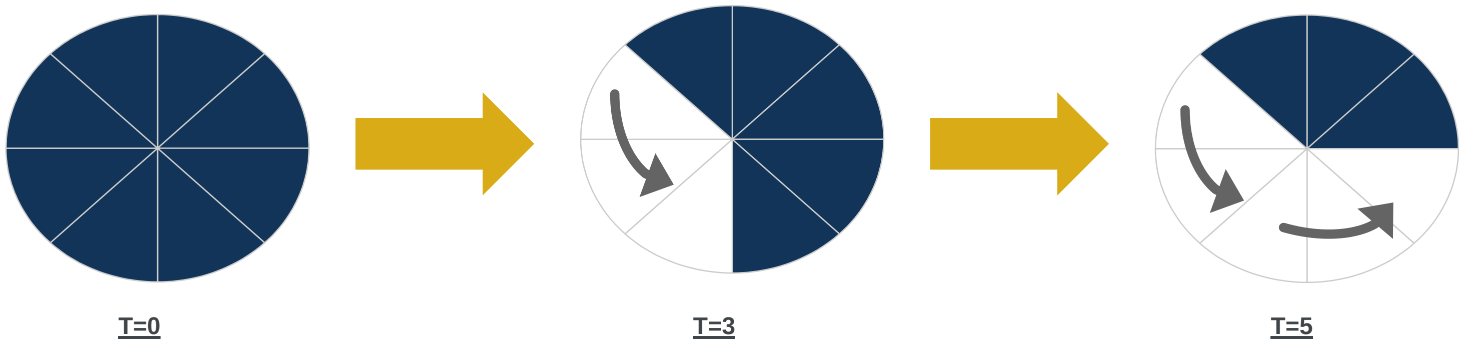
Run-off

Unitisation of lumpy assets



Potential benefits

- ✓ Run down asset in line with fund
- ✓ Can satisfy TCF, regulatory etc
- ✓ Could be used to bring together pools of illiquid assets so these can be managed centrally
- ✓ Greater flexibility

Challenges

- ? Nature and structure of the funds
- ? Do other buyers exist?
- ? Operational aspects
- ? Valuation
- ? Tax implications

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Run-off

- Lots of other actions and issues not mentioned
- E.g. Out-sourcing
  - More variable cost-base – but is it more expensive overall?
  - What risks being transferred? And what cost?
  - Best price typically achieved on largest books
  - So out-sourcing is least attractive when you need it most!

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Transformation

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Transformation

- Significant level of activity and interest currently
- What if could change the nature of benefits / liabilities?
- Opportunity to
  - solve legacy issues
  - share benefits between s/h and p/h

Transformation

Inefficient legacy systems and complex product features

Radical overhaul
Standardise, streamline simplify -
Significant cost reduction
More capital efficient?

Unfair estate distribution
Tontine

More equitable distribution

Solvency distress

Improved solvency position

Possibly make the business more attractive?

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Transformation

How to do it?

- Part VII schemes
  - Precedent set - courts ancillary powers used to change contractual terms
  - Conversion to unit-linked /reduction in guaranteed benefits
- Governance
  - Independent Expert required
- No policyholder vote

- But focus on another way

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Transformation

How to do it?

- Scheme of arrangement
  - Legal instrument is the Company's Act
  - Different legal instrument to that used for Part VII transfers
- Governance
  - No Independent Expert required by law
  - Question over policyholder Advocate (required for reattribution)
- Positive vote required
  - Scheme accepted if majority vote in favour with at least 75% of value in favour
  - Need positive vote for each voting class

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Transformation

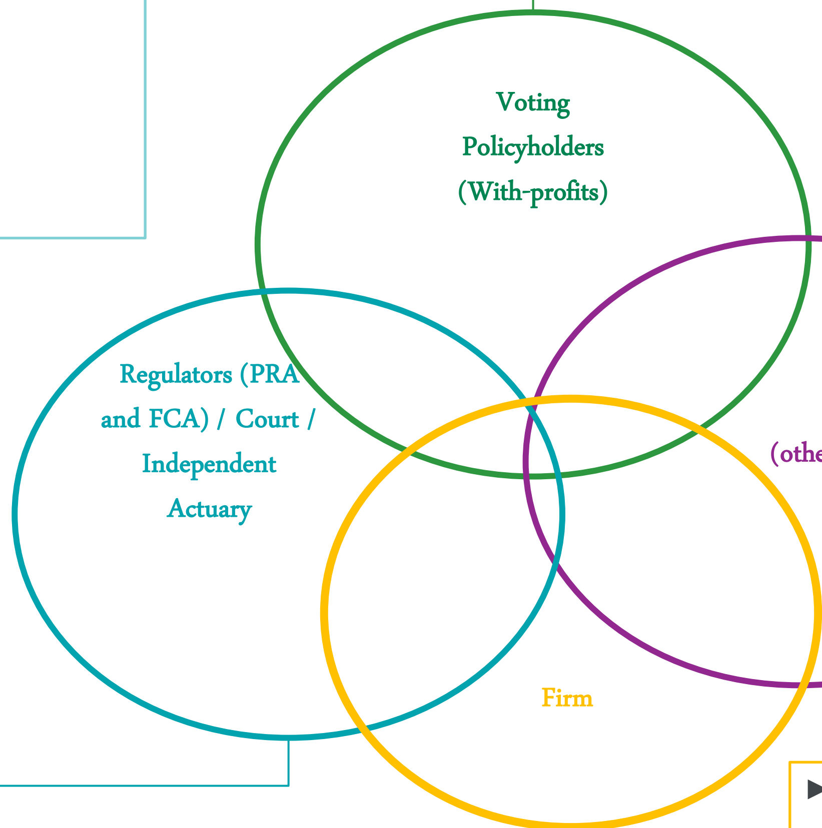
- Creditors given vote
  - Who are the creditors? Who gets the vote?
  - Who gets the vote for group schemes?
- Voting classes of creditors
  - Need identified
  - Typically aim for single voting class to avoid veto by small cohort
- Actuarial modelling used to compare results for scheme with alternative reality
- Fairness criteria applied to results

Transformation

Balancing stakeholders’ needs

- Fair
- Alternatives considered
- Communications
- Design

- Clear and certain
- Fair
- Independent review
- Communications



- No contractual changes
- Communications

- Sufficient benefits

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Transformation

- Non-trivial undertaking

Design & Feasibility 3 to 6 months

- PMO
- Actuarial design
- Actuarial modelling
- Legal
- Communications
- Governance
- Operations

Go? or no-go?

Implementation 6 to 18 months

- PMO
- Actuarial design
- Actuarial modelling
- Legal
- Communications
- Governance
- Operations

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- But rewards are potentially significant

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Growth

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Growth

Some statistics – the population is aging

- The number of people aged 60 or over is expected to pass the 20 million mark by 2030
- There are now 11.8 million people aged 65 or over in the UK - this number projected to rise by over 40 per cent in the next 17 years to over 16 million.
- 1.6 million people are aged 85 or over - predicted to more than double in the next 23 years to over 3.4 million.
- There are over half a million people aged 90 and over in the UK. 70% of these are women.

(Source: AGE UK “Later Life in the United Kingdom, August 2017”)

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Growth

Opportunity

- Provide retirement products
- WP could provide fantastic platform for drawdown and/or securing retirement pot
- So WP could be a good vehicle for providing guaranteed minimum income, withdrawals, investment return
- Research tells us that policyholders like certain features that WP business offers – e.g. Smoothing & Guarantees

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Growth

Challenges

- WP brand irreversibly damaged ?
- Daily Mirror effect – bad press
  - Perceived as providing poor value in times of market buoyancy because of smoothing
  - Opacity / not well understood
  - Do policyholders trust the concept of management discretion?
- FCA comment re paucity of options available in the market

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Growth

- p/h like guarantees – but let's look at cost/implications providing them
- If long-term return on assets typically based on sovereign & corporates is 350bps
  - Less costs for admin (say 75bps)
  - Less Investment costs (say 25bps)
  - May charge cross-subsidy for guarantees (say 50bps)
  - So only just meet price inflation or less. Attractive proposition?
- Implications for providing any sort of guarantee – even save initial investment has a cost

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Growth

- Comparison to GEBs
  - when introduced was say 6% gilt yield
  - so from principal of 100 invest 94 in gilt and leave 6% in equity index call
  - then if equity price increases significantly – get some equity upside
  - if equity doesn't grow or falls – get money back from gilt yield
  - However yields fallen – so now closer to 99 in gilt and 1 in call – doesn't work
  - Even when gilt yields were better – lost yield from dividend income

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Growth

- So really hard to provide guarantees cheaply
- Only real advantage WPFs may have is management actions
- But then compare to CPPI investment strategies – not hard guarantee but softer floor (possibly at lower cost?)
- Or even iCPPI which growing in popularity especially among variable annuity providers

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Growth

Insert graph showing smoothed returns

- Turning to look at smoothing
- Less cost & capital strain than guarantees
- Challenges with controlling smoothing strain
- What is impact on in-force book and ability to distribute?

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Sale

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Sale

- Many firms view WP as non-core
- Low NB sales
- Little no growth prospects

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Sale

- Challenges with sale
- Cost allocation
- Fixed v variable cost base - extent to which run-off feasible for long-term dependent on how variable cost base is
- Contribution to overheads
- Perimeter of sale
- What optimises value? turning off legacy admin systems? What metrics?

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Sale

- Overview of potential buyers
- Who buys? And what is the rationale?
- Overview of recent acquirers

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Questions

Comments

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