Topical issues facing With Profits firms: Challenges and Opportunities

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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
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
Context

• Wide range of firms writing WP business
  – proprietary & mutual
  – International v UK-focused
  – Large v small
  – Single fund v multiple funds
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
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
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
Run-off
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
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
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?
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
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
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
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)
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
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!
Transformation
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?
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
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
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
Balancing stakeholders’ needs

- Fair
- Alternatives considered
- Communications
- Design

- Clear and certain
- Fair
- Independent review
- Communications

- No contractual changes
- Communications

- Sufficient benefits

Voting Policyholders (With-profits)

Regulators (PRA and FCA) / Court / Independent Actuary

Non-voting Policyholders (others e.g. non-profit contracts, etc)

Firm

Policyholders (With-profits)

Institute and Faculty of Actuaries
Transformation

- Non-trivial undertaking
  
  Design & Feasibility 3 to 6 months
  
  Implementation 6 to 18 months

  PMO
  Actuarial design
  Actuarial modelling
  Legal
  Communications
  Governance
  Operations

  Go? or no-go?

- But rewards are potentially significant
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”)
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
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
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
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
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
Growth

• 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?

Insert graph showing smoothed returns
Sale

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

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