



Breathing life into with-profit funds

Peter Kettlewell examines a number of techniques that might be employed to improve the management of with-profits funds.



This article was first produced for our Winter 2008 'Risk and value matters' publication, focused on risk management and value management issues relevant to the life insurance industry. Many of the topics and techniques discussed in that publication are relevant to with-profits business and readers may find it useful to refer to that publication as well.

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Most with-profits funds are decades old, and over that time each fund will have developed its own specific practices in the way it is run. However, some of these practices may no longer be as appropriate as they once were and, in particular, some of these practices may no longer be in the policyholders' best interests. Changing these practices may feel like radical surgery – but changes can often be implemented relatively easily.

In this article we examine a number of techniques that might be employed to improve the management of with-profits funds. We illustrate each technique with a case study.

Investment strategy

A number of with-profits funds invest their estate in the same way as the asset shares. However, in some cases this is simply because it has always been done this way, not because it is in policyholders' interests to do so. Investing the estate and the asset shares in the same way is not always optimal as:

- it tends to increase risks (via a gearing effect)
- it can restrict the opportunities for simple, yet effective, risk reduction techniques.

Case study A – internal hedging

An insurer wanted to reduce its

exposure to interest rate risk in its with-profits fund. It invested in bonds which broadly matched the expected cashflows of the fund and yet – despite this – it was still vulnerable to movements in the yield curve.

While in aggregate the bonds matched the expected cashflows, the bonds in the estate were shorter than the guarantees (which tended to be longer than the aggregate cashflows).

The solution in this case was to invest the estate in longer bonds and the asset shares in shorter bonds. In practice, this was achieved without incurring any dealing costs by setting up notional interest rate derivatives between the estate and the asset shares. This made sure that, while the fund as a whole held the same bonds, they were effectively divided up differently, substantially reducing the interest rate risk in the fund.

Case study B – hedging with derivatives

Another insurer had a relatively high equity backing ratio (EBR) in its asset shares. However, it also invested its estate using the same EBR. This had the effect of 'gearing up' the equity risk. As a result, the fund's Individual Capital Assessment (ICA) was relatively large and this prevented it from distributing any of its estate to policyholders.

The solution in this case was to disinvest all the equities in the estate and purchase a portfolio of equity put options designed to hedge the guarantees. This reduced the ICA significantly and also stabilised the working capital. This diminished the

risk that the shareholder would have to inject additional capital into the fund, and also meant that the firm could begin to distribute some of its estate to policyholders.

Case study C – allocating notional investment returns to asset shares

In this case, an insurer had a separate sub-fund containing a group of policies with very high guarantees. In this particular fund, policyholders were not entitled to any of the estate; their interest in the fund being limited to their asset share plus any guarantees.

Because of the high value of the guarantees, the investment returns on asset shares were largely irrelevant for most policies. The investment manager of this firm believed that higher investment returns could be earned by investing in alternative assets. However, it was questionable whether these particular investments were the sorts of investment in which policyholders expected their money to be invested.

To overcome this, the investment return credited to asset shares was divorced from the actual investment return earned on the assets. Policyholders' asset shares were instead credited with the notional return from an index which closely resembled their original investment mix. Shareholders would receive any excess returns (over and above the return on the index) but would also incur any shortfalls.

While this might seem a radical course of action and certainly needs to be tested against the PPFM, it is

not that dissimilar to the way that asset shares were calculated a number of years ago. In the days before the 'managed fund' approach to asset shares was common, asset shares were often credited with the return on a notional equity or bond index – despite the fact that the actual performance of the fund might have been quite different.

Risk management

Altering investment strategies is not the only way of mitigating risk. Management actions can play a key role too. Typical management actions for with-profits business include:

- varying the asset share EBR as solvency changes
- charging guarantee costs to asset shares.

Case study D – different ways of charging for guarantees

An insurer recently reviewed the way that it charged guarantee costs to asset shares. Various alternatives were proposed, which included:

- charging some/all guarantee costs to asset shares as soon as they have been incurred – the 'Charge As You Go Method'
- charging an amount to asset shares to cover some/all of the expected future guarantee costs – the 'Expected Guarantees Method'



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- making a charge to asset shares, but only to the extent that there is expected to be a deficit in the fund – the ‘Expected Shortfall Method’.

The criteria used to judge the merits of each approach included:

- impact on the different generations of policyholders
- volatility of the charge
- the effectiveness of the charge in mitigating risk
- practicality of implementation.

Ultimately the firm decided to adopt the ‘Expected Shortfall Method’ on the basis that:

- they were uncomfortable routinely charging for guarantee costs as this had not been communicated to policyholders at the point of sale
- they were, however, comfortable charging policyholders in more adverse scenarios, but only in order to enhance the security of guarantee benefits.

Capital management

While capital management is obviously important in its own right, it can also be one of the limiting factors for the investment strategy of the fund. For example, in adverse scenarios the fund could become a forced seller of equities in order to protect solvency.

Case study E – restructure

An insurer with a weakly capitalised with-profits fund was forced to invest cautiously given its low peak 1 solvency level.

However, the fund had one particular product line which differed markedly from other products in the fund. This block of business was moved to its better-capitalised parent via a part VII transfer. The transfer released reserves in the (subsidiary) company, as the peak 1 liabilities released exceeded the value of the assets transferred.

The solvency of the parent was largely unaffected by the transfer as it was a peak 2 company and the assets that were transferred equalled the peak 2 liabilities. Also, as the solvency of its subsidiary improved (as a result of the transfer) this flowed through to the peak 1 position of the parent.

Due to the improved solvency position of the subsidiary company, it was then able to re-risk through (hedged) equity purchases – giving the remaining policyholders more potential upside in the event of strong equity performance.

Conclusion

Because of the age of most with-profits funds, the way that they are managed and their structure can sometimes be seen as a ‘historical accident’. Changing some of the historical practices built up over time can often benefit policyholders and, where this is the case, regulators are often receptive to innovative proposals – although they will naturally judge each case on its own merits.

The case studies outlined in this article highlight just some of the ways that with-profits funds can be managed. While these techniques will not be appropriate for all funds, they demonstrate the potential benefits that can be obtained by revisiting some of the existing practices and that any change can be implemented without the need for major surgery.

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