New with-profits products for the new century

Andrew Chamberlain contemplates the scope for new product development.

For the working lives of many in the industry today, with-profits has been seen as a pure investment vehicle. Indeed from the mid-1980s more and more 'investment profits only' products were invented. However, with-profits products began as a response to some deep uncertainties as to the level of mortality that might be expected amongst the buyers of life assurance.

Today we think little of differentiating mortality between those who have been underwritten and those who have not, and with increasing sophistication between different groups, by occupation, income, residence and other rating factors; but much of this was new and unheard of over 200 years ago. Other uncertainties also abounded and the growth of the mutual insurer called for a product which could share the profits which arose from the cautious pricing of all of the risks taken.

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Over the last two centuries, with-profits business has evolved from its roots in mortality to become a product perceived as being a route to equity investment with guarantees and smoothing. This is a fair way from its origins, and perhaps the time has come to reappraise the role of with-profits products and the approach to risk pooling. Whilst investment related products still have a place, other risks can also be hard to predict and sharing these can be beneficial to the capital provider (usually the shareholder) and customer (policyholder). In recent times, firms have enhanced their risk monitoring and management frameworks, creating greater visibility of risk exposures. This provides an opportunity and a potential platform for greater risk pooling between capital provider and customer.

The problem of uncertain longevity is so close to that which applied to early life companies that it almost feels like we have come full circle. This time, the improvements in mortality are more an issue for annuities than for life assurance, but the problem is essentially the same – an insurer needs to be cautious and in doing so will be overcharging (hopefully!). If there is a stronger reason than this for a profit sharing mechanism, it is not easy to spot. The prospect for an annuity which rose gently with longevity improvements 'on target', but which did not rise at all if longevity improved faster than a certain level, and rose faster if longevity was to rise more slowly, is an attractive solution for capital providers and policyholders capable of taking some risk with their in-retirement income.

Similar issues of unpredictability can apply to health insurance policies, especially products like critical illness insurance. Although term products are not normally associated with profit-sharing by bonus, there is nothing to prevent a product which pays a fixed sum insured carrying a variable bonus on top (or variable premium underneath) according to experience.

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You do not have to look too far back to find a time when expense risk was a major issue. Furthermore, in the current economic climate, with the unprecedented levels of government deficit and contingent liabilities at the same time as the use of 'quantitative easing' (which in consumer-friendly plain English is essentially printing money), this must create a risk of high inflation later. However, as inflation measures wax and wane in usefulness (now we have the CPI, on top of our old friends the RPI and NAEI, but who remembers TPI?), sharing the expense risks with policyholders might be desirable.

Mutuals have particular issues if with-profits business declines, though building societies existed for many years without problems finding mechanisms to distribute profits. Many mutual insurers have of course demutualised, but for those that remain mutual, surviving in this state while their traditional with-profits business declines is a fundamental issue. It is likely that any method used to give variability to the charges on products issued by a mutual will fall into the definition of with-profits – which given the words used in the term is perhaps unsurprising. Just as there was the move to restrict with-profits to investment-related elements, is there any reason why 'except investment profits' products might not become more common in the coming years?

Notwithstanding these potential uses of the with-profits concept, is it really the time for the smoothed investment vehicle to die? Consider this suggestion. People have a need to accumulate historically unheard of funds to support increasingly long lives after working age. They can work longer, but whenever they retire they will need large sums of money to finance their remaining lifetime. The decline and fall of the defined benefit pension scheme forces people to rely upon themselves for this financial planning, yet the majority of investment vehicles are not designed for their concerns. In particular, most ordinary people may accept the variability of assets, but have some limitations to that acceptance. First, they do want some sort of underpin, a guarantee, but cannot afford to pay a lot of money for this. Secondly, they are distressed if rapid market movements, day to day especially, but even week to week, significantly alter their fund. They expect some stability to support the decisions they have to make about their lives. They do not want to have to select the day to switch investments on their own, nor do they want an arbitrary formula to apply on a particular day which might be a 'good' day or a 'bad' day.

With-profits can deliver these needs, though I would suggest that we need to go back to the original ideas of the product:

- flexibility has a price, and those who want it must pay it, and not expect others to meet the cost
- lump sums which may be needed at short notice or on uncertain dates do not work well in the with-profits world; people do need to make some sort of plans, and cannot have guarantees applying continuously, as the pooling of risk relies upon the fund exits being known and managed
- regular premium policies held to maturity can enjoy the benefits only if those who do not use the policies this way meet the costs, and, indeed, pay a risk premium for the right to withdraw their funds early.

Conclusion

The insurance regulatory environment has made it tremendously difficult to deliver the product people actually need, in the name of fairness. Surely the time has come to reverse this trend, in particular with 'except investment profits' products becoming more common in future. This does not have to mean a radical regulatory overhaul either – the rules over how open funds are managed could be directed to the mutual model instead, with shareholders restricted in their freedoms to use the fund to suit themselves.

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