Open, closed or what the FSA decides?

Nick Rose analyses the options available to with-profits management teams.

If a company decides to close its with-profits fund, there is a significant task to undertake in notifying the FSA and affected policyholders and preparing run-off plans in accordance with COBS 20.2.58 and Appendix 2.15 to the Supervision manual. Furthermore, the timelines for doing this are tight and the FSA expects firms to have clarity over how the fund will be run off. This creates a risk that decisions made at the point of closure could prove difficult to reverse as the fund declines. So the management team need to understand what is involved in closing the fund, and what they would have to do if they want to avoid doing so.

According to the rulebook, none of this applies if the fund had effectively closed before 1 November 2007, when the current rules took effect. That is not effective in all circumstances – if the fund were to re-commence writing some new business, then it is deemed to be open and any subsequent decision to stop writing business means these rules would apply just as if the fund had always been open. In addition, the FSA is pressing for equivalent plans to be provided by already closed funds.

The COBS rules in 20.2.53 and later are largely saying that closure of a fund is not just about a conscious Board decision, but more a practical matter of if it is writing any new business or not. The FSA could therefore deem a with-profits fund closed simply because it is no longer writing enough new business. If the fund is to be closed (or treated as such) then there really is a major management effort required to set the strategy for its run-off. In addition to providing the detailed plans to the FSA, there will also be policyholder and potentially media queries to answer — which by their nature tend to be time-consuming. Plus, the more attention received from external parties, the greater the pressure will be to ensure all communications are consistent, clear and not misleading with regards to what the future holds.

Suppose for a moment that the Board decided tomorrow that it would close the company's with-profits fund from the first of next month. What would the firm then have to do? Answer: an awful lot of work within very tight timescales, starting with writing to the FSA and all their with profits policyholders within 28 days – that is by the end of the same month. The firm probably will not have all the information needed for policyholders within that time limit, so they will have to plan to write to them again when they do have that information, telling them in the first letter when the second letter will drop through their letterbox.

Alongside that is the need to start work on the detailed run-off plan to be approved by the Board and submitted to the FSA within three months. FSA rules require the plan to contain details of how the investment strategy will change, the plans to ensure the inherited estate will be distributed fairly, and projected revenue accounts and balance sheets for the next three years. Of course, decisions about how to manage the fund as it runs off require much more information than this, for example knowing how the solvency of the fund may vary over its remaining lifetime under a range of future scenarios.

However, closure could be advantageous to management, shareholders and policyholders by giving a degree of certainty to the future. Where the fund is already beginning to shrink,

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it will make management confront a number of issues that they are probably beginning to think about anyway, for example having to judge how much of the estate could or should be distributed, how and when in order to maintain a reasonable balance between different groups of policyholders and shareholders (where appropriate). In effect, closure can lead to the development of a much more robust framework for the future management of the fund.

Maintaining satisfactory solvency levels and keeping the estate proportionate to the size of the remaining business is a balancing act that requires careful and frequent monitoring. The firm will need to ensure that the models they are using remain adequate to do this. As the fund starts to shrink, they will need to work out what types and levels of risk are acceptable to both policyholders and shareholders, how the risk profile can be managed down over time, and how the fund can protect itself by changing its investment strategy and/or using derivatives to protect its position.

Developing a formal run-off plan would also provide a good opportunity to re-think the PPFM so it defines more clearly how the firm will manage the fund in future. The current PPFM was most likely not drafted with the run-off of the fund particularly in mind, so this is a chance to set out explicitly how the fund is to be managed as it decreases in size. The communications with policyholders that closure requires and a re-write of the customer-friendly version of the PPFM provide an excellent chance to re-base their expectations. Policyholders should then have a better understanding of what they are likely to get from their policies in future, taking account of the current and likely future economic and demographic trends.

Agreeing a detailed formal plan with the FSA puts the firm in a stronger position with them too, as they are effectively signing up to the plan as well. It might even be worth considering going for a formal court-approved scheme which would set down in detail how the fund is to be managed. Although it introduces additional cost, it could be very useful in some circumstances, for example to give clarity where previously it was vague or ambiguous. A PPFM backed by a clear scheme would be more difficult for anybody to subsequently re-interpret. Ultimately, a scheme may be necessary in any event to deal with the fund when it gets below a size which can be sensibly managed by itself.

If the company is doing more than just writing with-profits and wants to continue its other business, then it will need to consider the effect closure or staying open will have on those other aspects of the business, and what they may be able to do to mitigate any negative impacts. For instance, will closure be seen as a positive management step to deal with a business unit that is not delivering, or maybe just as a step towards closure of the whole business?

Even if the company does not really want to write new with-profits business, they might consider writing a small volume just so they do not have to do all this. This must be a high-risk strategy because there can be no guarantees they will write enough new business and the FSA could deem the fund to be closed in any case. Similarly, transferring all of the new business on via reinsurance does not avoid closure in the eyes of the rulebook. If firms would still like to keep their with-profits fund open, then maybe a better strategy would be to think differently, and develop new products that meet customer needs and fit within the regulatory definition of with-profits. The following article (starting on page 20) considers this in more detail.

Conclusion

There are some real positives that could emerge from a formal closure of the with-profits fund for all parties, but the closure process involves a lot of hard work in a short timescale. If the with-profits fund is getting very little new business then it might be forced to go down this route whether the firm wants to or not. Either way the firm needs to face the issues that a declining fund will bring. The alternative is that it finds other sources of new business that make the with-profits fund a positive contributor to the business again.

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