

life insurance matters

Focusing on with-profits business

With-profit governance

The independent judgement
of With-Profits Committees

Breathing life into
with-profit funds

Open, closed or what the
FSA decides?

New with-profits products
for the new century

Effective communication

watsonwyatt.com



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Welcome to life insurance matters

Commentators have long been predicting the end of the road for with-profits business, though it resolutely refuses to end. With-profits funds still amount to hundreds of billions of pounds, and their continued management is going to be a feature of the industry for years to come. Moreover, as these funds mature and decline in an environment of increasing scrutiny on management actions, it is imperative that management acts fairly to all concerned and is seen to be doing so.

In this publication we look at a number of issues which impact upon insurers who have with-profits funds, ranging quite widely over the landscape. We look both at the opportunities for with-profit products in the future, both familiar and less familiar ideas, as well as looking at the issues that arise when a company decides to stop offering with-profits products. The governance issues are also never far from the mind of practitioners in this field – the structure of governance and the role of independence, for example – and we share some of the findings of a survey Watson Wyatt conducted last year.

The diverse histories of different funds, whether by origin, by structure or just by the development they have seen, make it essential for every management and Board to consider their fund on its own merits. At Watson Wyatt we believe we have a deep understanding of with-profits as it is today, how it might develop, and an appreciation of the issues and challenges faced by those with regular management responsibility and those with governance oversight, whether from the perspective of proprietors or of policyholders.

We hope you will enjoy reading what follows, and would be delighted to explore any of the contents with you in more detail.

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Governance practices

In the summer of 2008, Watson Wyatt undertook a survey to gather information on the governance practices of with-profit firms. This survey was split into two parts; the first was concerned with what governance models firms apply and how these operate in practice. The second section asked for opinions of firms on how effectively their governance arrangements worked in practice. Nineteen firms responded to this survey. Some of the key results from section 1 are highlighted in **Figures 1–6**. Further insights from our survey are outlined in the article on page 6 of this brochure.

Figure 1 | How often does the committee meet?

| | |
|----------------------------|---|
| Twice a year | 1 |
| Three or four times a year | 7 |
| Five to six times a year | 6 |
| More often | 4 |
| Not answered | 1 |

Figure 2 | Does the Chairman of the WPC attend Board meetings?

| | |
|---|---|
| Not at all | 3 |
| Attends all meetings (as a director) | 5 |
| As the agenda dictates but more than annually | 3 |
| Annually | 1 |
| Other | 6 |
| Not answered | 1 |

Figure 3 | Which model for independent judgment in the terms of COBS 20.3.2 is used for the With-Profit Fund of your company?

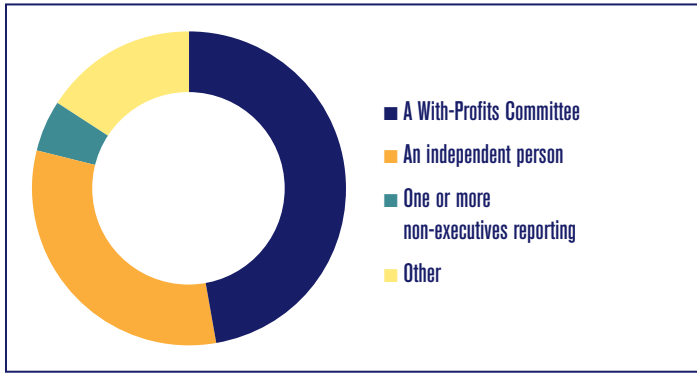


Figure 4 | How often does the Committee review compliance with PPFM?

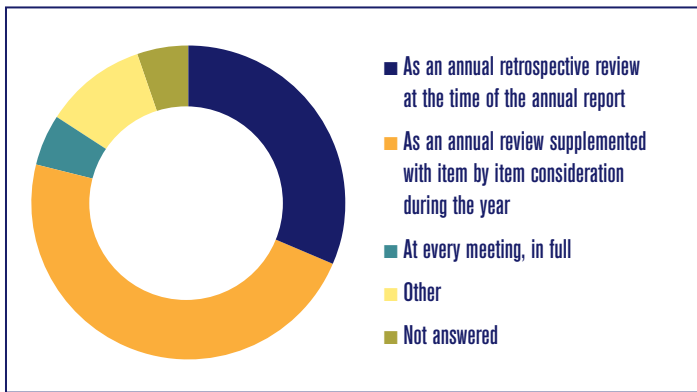


Figure 5 | In respect of bonus declarations, does the Committee:

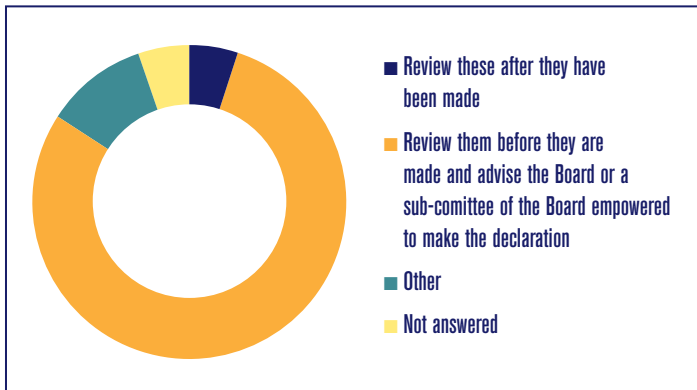
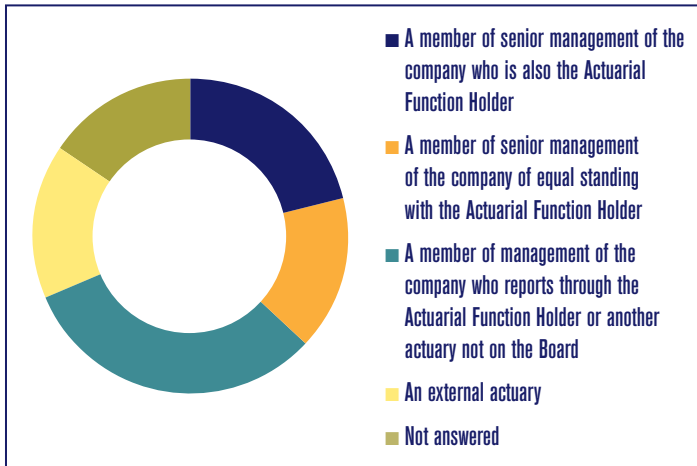


Figure 6 | The With-Profits Actuary is:



Life insurance matters in the numbers

1/3

Our survey found that less than one-third of respondents strongly agreed that their [With-Profits] Committee regularly reviewed risk appetites, and even fewer seemed to receive any risk management information.

See page 7

2007

Following a thematic review of the governance arrangements of with-profits business in 2007, the FSA generally found that... the independent judgement that had been applied was restricted to monitoring compliance with the PPFM.

See page 11

3 months

or less to submit a run-off plan to the FSA following closure of a with-profits fund.

See page 18

£319 billion

Total assets in UK with-profits funds as at 31 December 2008.

Source information Nottingham University Business School – the financial position of UK's top 20 with-profits life insurers.

85 per cent

of the life insurance industry are committed to providing products and services that meet customer needs.

See page 25



With-profit governance

Anisha Shah reflects on the recent return
of the FSA's focus.

The FSA carried out a review of the governance surrounding with-profit funds in the early 2000s. As a result, Principles and Practices of Financial Management (PPFMs) were introduced and all firms were expected to have adopted them by 30 April 2004. In addition, the role of the With-Profits Actuary (WPA) was introduced for all with-profit funds. Since then, firms have been operating in a relatively stable governance regime. Recently, however a focus on with-profits governance has returned.

On 19 September 2007, the FSA issued a 'Dear CEO' letter to insurers questioning practices it observed as part of two reviews carried out: one on the governance arrangements of with-profit funds and the other on the management of closed funds. Some of the governance related issues discussed were:

- some providers' arrangements for independent output not involving a wider consideration for Treating Customers Fairly (TCF) issues
- lack of timely information to the With-Profits Committee (WPC)
- conflicts of interest in the way that firms use independent reviewers for the management of their with-profit funds
- insufficient communication of with-profits governance to policyholders.

The letter expected senior management "to review how they have implemented the Principles for Business in their governance arrangements."

In early 2008, the Treasury Select Committee announced that it would undertake an inquiry into inherited estates. This also involved looking into the role of the WPC. The report released on the conclusion of this investigation was accomplished by a press notice which stated: "The report expresses concern that WPCs lack adequate resources, remit and visibility for them to protect policyholders' interests in with-profits funds. It recommends that the FSA consider granting WPCs an explicit role to ensure that a fund is run in accordance with the FSA's principle of treating customers fairly, rather than merely considering the firm's compliance with its own internal rulebook."

The FSA plans to follow up individual firms' behaviour both to ensure that firms' management is such that with-profits policyholders are treated fairly and also through specific follow-up on governance issues raised in the 'Dear CEO' letter.

Against this background, Watson Wyatt carried out a focused survey of WPAs and members of WPCs in the summer of 2008. Responses were received from 19 firms and some of the findings are discussed above. Figure 7 below suggests that the FSA had not engaged with most firms by the time of our survey.

The FSA has stated (in its memorandum to the Treasury Select Committee inquiry) that it expects senior management of firms to ensure that their with-profits governance arrangements are consulted on any significant issues that affect with-profit policyholders' interests.

Figure 7 | The FSA have questioned the adequacy of the arrangements in some respects

| | |
|----------------------------|----|
| Disagree strongly | 15 |
| Disagree slightly | 3 |
| Neither agree nor disagree | 3 |
| Agree slightly | 5 |
| Agree strongly | 2 |
| Not answered | 10 |



Figure 8 | The WPC regularly reviews the risk appetites set by the company for the with-profits funds it is responsible for relative to the financial strength and past statements to policyholders

| | |
|----------------------------|----|
| Disagree strongly | 1 |
| Disagree slightly | 3 |
| Neither agree nor disagree | 3 |
| Agree slightly | 14 |
| Agree strongly | 8 |
| Not answered | 9 |

Figure 9 | The terms of reference go beyond assessing compliance with PPFM and include wider 'Treating Customers Fairly' issues

| | |
|----------------------------|----|
| Disagree strongly | 0 |
| Disagree slightly | 3 |
| Neither agree nor disagree | 1 |
| Agree slightly | 3 |
| Agree strongly | 24 |
| Not answered | 7 |

In relation to this, our survey found that less than one-third of respondents strongly agreed that their committee regularly reviewed risk appetites, and even fewer seemed to receive any risk management information (see Figure 8).

Also there was little evidence that WPCs (or equivalent) were made aware of any supporting management information on TCF in relation to the funds they look after (however, as Figure 9 shows, the vast majority of WPCs were aware that their remit included wider TCF issues).

Under FSA rules, with-profits providers must seek independent input, whether from a WPC or alternative arrangement in a number of situations, and in particular where there may be a conflict of interest between policyholders and shareholders. As noted earlier in this article, the FSA has found evidence of conflicts of interest, where either the independent reviewers are also involved in some other work with the firm or where some or all of the members of the WPC are executives of the firm.

“ [The FSA] will take supervisory or enforcement action, where appropriate, in cases where [they] find that customers are not being treated fairly. ”

More generally, the level of independence applied within with-profits governance arrangements may be a concern. None of the companies we surveyed had a consumer representative on the WPC. Also, there were examples of disconnect between committee member and management views on whether external actuarial advice was needed. This may be because some members of committees are assuming that the presence of actuaries who are independent of the firm can be considered as external actuarial advisors. However, this then poses the question: “what role are these actuaries playing?”

We also found that there were instance where committee members thought that some members contribute much less than others in the discussions. If a subset of the membership becomes dominant, the system is not really performing the role of a committee as intended. In addition, the preference of the majority to receive papers that contain firm recommendations may be challenged for discouraging independent thinking and input to management decision-making.

Plans for the future evolution of with-profits governance arrangements may need to be clarified or strengthened. Our survey revealed that there was limited evidence in firms of mechanisms for measuring the performance of the WPC (or equivalent), and some respondents strongly disagreed with the suggestion that there was a planned and progressive refresh of the WPC membership.

There seems to be mounting pressure for the Actuarial Function Holder (AFH) and WPA roles to be performed by different people so as to increase the independence of the WPA. The Financial Services Consumers Panel has also commented on the viability of a Board member of a company also being a member of the WPC. In conjunction with the earlier comments by the Treasury Select Committee, this may prompt the FSA to revise its current rulebook, which at present contains little in the way of specific rules around governance. There seems to be scope for a number of improvements to the present governance regime. This may include:

- preventing the same individual from holding both the AFH and WPA roles, at least in proprietary companies
- requiring a majority of clearly independent non-directors on the WPC
- externalising the WPA role, or insisting on an external peer review if this role is held internally
- extending the WPC remit to require it to protect policyholders' interests in with-profit funds more explicitly and ensure that the management of the fund adheres to the FSA's TCF principles
- requiring any independent persons (as described in COBS 20.3.2) to be subject to the Approved Persons regime.

The FSA explicitly states the following in their 'Dear CEO' letter: “We will take supervisory or enforcement action,

where appropriate, in cases where we find that customers are not being treated fairly.” As with other issues, the FSA can wield the regulatory stick if it is not happy with how firms are behaving.

Conclusion

This gives an insight into the issues that firms face in the current governance regime. Greater prescription and strengthening of the requirements around demonstrable independence would be obvious ways for the FSA to respond to the concerns of others. However, this goes against the FSA's decision to have principles-based regulation, so a balance will have to be struck.

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The independent judgement of With-Profits Committees

Gavin Lock considers whether
the judgement exercised is
truly independent.

“ It is obviously difficult to assess whether the judgement exercised by WPCs is truly independent. ”

FSA rules require, somewhat prosaically, that a firm should maintain governance arrangements designed to ensure that it complies with, maintains and records any applicable PPFM. These arrangements should involve some independent judgement in assessing compliance with its PPFM and addressing conflicting rights and interests of policyholders and, if applicable, shareholders.

In practice, the intention of these rules is that with-profits governance is an important and powerful input to the running of the firm and to securing the fair treatment of policyholders. For most larger with-profits firms, these duties are performed by a With-Profits Committee (WPC), although smaller firms often rely on a single independent person for this input.

Following a thematic review of the governance arrangements of with-profits business in 2007, the FSA generally found that, notwithstanding the actual phrasing of its rules, the independent judgement that had been applied was restricted to monitoring compliance with the PPFM. This was in contrast to the FSA's aim, namely that thought be given to the broader outcome that the governance arrangements are intended to achieve (and in particular when considered in relation to FSA Principle 6 – Treating Customers

Fairly, and Principle 8 – Managing Conflicts of Interest).

The FSA also found examples of potential conflicts of interest, where either the independent reviewers were also involved in other work with the firm or where some (or all) WPC members were executives of the firm. The FSA has recently emphasised that any firm that continues to have a material outstanding issue in any area where the FSA has previously highlighted poor practice is particularly likely to be deemed at significant risk of not treating its customers fairly overall. A further review of with-profits is being conducted by the FSA and governance arrangements will be under the microscope again.

A question of perception

As noted in the previous article on page 7, Watson Wyatt recently conducted a review of with-profits governance arrangements which found that the WPCs of the larger with-profits firms tended to comprise individuals that are more independent (having a higher representation of non-executive directors or other individuals that are independent of the firm) than those of smaller firms.

Whether wholly independent of the firm or not, the WPC members themselves generally felt strongly that their committee composition was appropriate to allow the exercise of independent judgement and that there was sufficient independent challenge from the arrangements set in place. Responses from firms where the governance model involves

a single independent person also indicated a belief that their approach was appropriate.

It would perhaps have been surprising were these opinions not to have been voiced whatever the approach taken. Be that as it may, it must be the case that from an external perspective the models operated by larger firms would appear to offer greater independence.

Obviously, it is difficult to assess whether the judgement exercised by WPCs is truly independent. At one extreme, for WPCs that are wholly independent, this would appear self evident. However, there is almost certainly still reliance on the information and advice provided from within the firm and it is possible that this may not always be completely aligned with what the WPC would have wanted. This reliance on the firm for information is also true for members of WPCs more generally. On the other hand, there may still be limited independent input via recourse to the practices and deliberations of others facing similar issues in different organisations.

We should not forget that the With-Profits Actuary, whether internal or external, is obviously also part of the independence, given that the role involves advising the firm's management on key aspects of discretion and fair treatment for with-profits policyholders.

The real issue would seem to be whether the model of independence adopted really is independent enough. Independence can exist within the



governance model in different ways and all the approaches currently being taken can rightfully claim to be independent. However, at the same time many of them remain exposed to potential conflicts of interest as well as suggestions that they could be more independent. Firms, and indeed individual WPC members, should be asking themselves whether the structure in place facilitates the delivery of independent judgement and challenge, and whether the potential for conflicts of interest can be managed, or seen to be managed, satisfactorily.

Using external advice helps to demonstrate greater independence. We all know that external advice comes at a cost, but it can provide a valuable contribution to the independent judgement as well as useful insights and perspectives from outside the company. It also strengthens the external perception of independence and may reduce the potential for conflicts of interest arising from WPC members that may otherwise have essentially shareholder-focused roles.

Conclusion

The current rules provide significant flexibility regarding how to achieve the independence required for the management of with-profits funds. Since they were introduced, there seems to have been a gradual trend, both as a result of regulatory pressure and emerging market best practice, for with-profits governance arrangements to be more self-evidently independent. It is possible that a 'gold standard' may yet emerge, with a WPC of wholly independent members supported by external advice.

Despite the above, it could be argued that the effectiveness of the exercise of independent judgement has nothing to do with the governance model: it merely depends upon the skills, experience and integrity of the individuals themselves. With this in mind, it will be interesting to see how the forthcoming FSA review looks upon this area.

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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'



“ Some practices may no longer be in the policyholder’s best interest... but changes can often be implemented relatively easily. ”

- 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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A portrait of Nick Rose, a middle-aged man with grey hair, wearing a light-colored striped shirt. He is looking slightly to the right of the camera with a neutral expression. The background is a plain, light-colored wall.

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,

“ **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.** ”

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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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.

“ ... perhaps the time has come to reappraise the role of with-profits products and the approach to risk pooling. ”

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

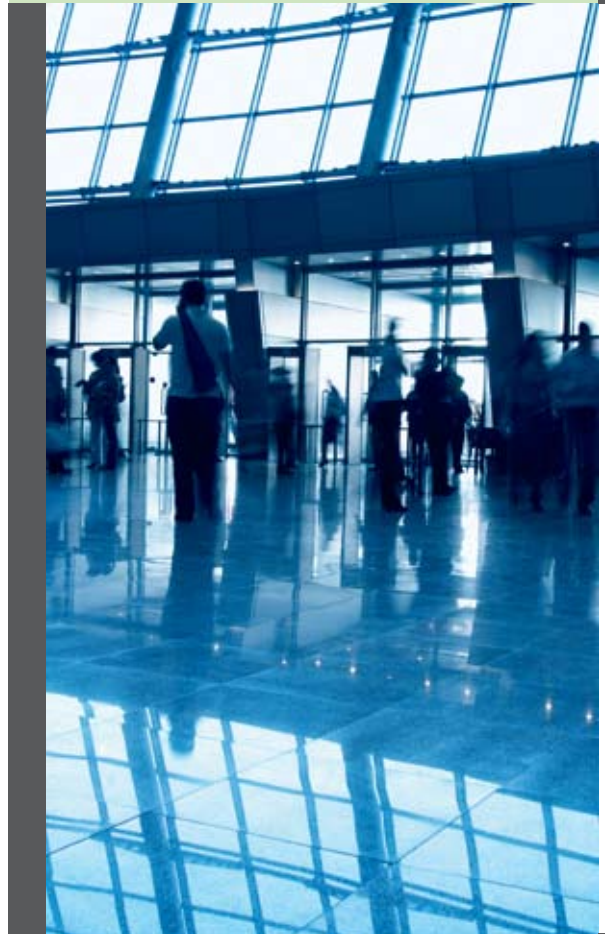
The insurance regulatory environment has made it tremendously difficult to deliver the product people actually need, in the name of fairness. Surely the time has come to reverse this trend, in particular with 'except investment profits' products becoming more common in future. This does not have to mean 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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Richard Waller draws insight from recent research into policyholder communications.

Effective communication

Providing a good quality service to with-profits policyholders is a regulatory requirement. FSA Principle for Business number 7 requires firms to pay due regard to the information needs of their clients, and communicate information to them in a way which is clear, fair and not misleading. This is reinforced by the six TCF consumer outcomes established by FSA during 2006. There are also additional requirements for with-profits business in COBS 16.6.

Setting the rulebook aside, it is approaching 10 years since the insurance industry launched the Raising Standards initiative to improve customer communications. Major brands quickly jumped on the bandwagon and when Raising Standards faded and was replaced by the Customer Impact Scheme it was again strongly supported by the industry. In fact, its latest annual report disclosed that 85 per cent of the life insurance industry are signed up to this scheme, and hence are committed to:

- developing and promoting products and services that meet customer needs
- providing clear information and a good service at the point of sale
- maintaining effective relationships and a good service post-sale.

With this apparently substantial effort going into customer servicing you could be forgiven for thinking that with-profits customers are highly satisfied policyholders enjoying the benefits of

their chosen investments. Sadly, this is commonly not the case. The reason for this is simply that people do not generally understand financial services, and probably never will.

There have been many reports into policyholder communications during recent years that have highlighted areas of poor quality. These failings can be broadly summarised as follows:

- weak explanations of risk – the literature does not always make it clear what risks the customer is taking, and/or how their outcome may vary under different circumstances
- weak disclosure of charges – leaving open the possibility that customers will get an unwelcome surprise
- poor explanation of options and guarantees – this has been a common criticism of firms seemingly wanting to keep hidden from the customer valuable aspects of the product

- weak explanations of discretionary aspects – failing to explain how the actions of the insurer may affect the policyholder
- overuse of jargon – too much complex terminology without adequate explanation
- poor layout – customers have not always found it easy to follow the information provided to them
- insufficient relevance – the information provided does not always enable customers to distinguish between the key messages and points of technical detail
- weak flagging of advice – not helping customers with what to do next
- lack of consumer testing – not checking whether customers understand what they are being given.



Addressing these failings is of particular importance for with-profits business given it is one of the least understood products available.

The sentiment of the points above is consistent with some of the consumer research carried out recently. For example, research for the Financial Services Consumer Panel in 2007 found that most consumers did not have a clear idea what investment risks actually are. Another of its findings was that there was a consensus across most consumer groups that you just have to trust the advice that you were given. For with-profits customers this last message does not sit well with the research by Ipsos MORI, also in 2007, that found that advisors were reluctant to advise on with-profits products, possibly because of a lack

of understanding on their part, insufficient support from product providers or fears they will be accused of mis-selling.

Whilst there has been a lot of focus on the quality of communications from insurers, less attention has been paid to the customers themselves and their engagement with financial services. A few examples here that offer a different insight are outlined below.

In July 2008, a report for the FSA by the London School of Economics concluded that financial capability initiatives which are designed to inform and educate should be expected to have a positive but modest impact. This is because there is evidence that psychological factors rather than informational differences may explain much of the

variation in financial capability. In other words people's financial behaviour may primarily depend on their intrinsic psychological attributes rather than information or skills they have, and how they choose to deploy them.

Previous to that, the Personal Finance Research Centre at the University of Bristol found that levels of financial capability vary significantly by type of person with almost two-thirds of the population having a weakness in one or more of the five aspects of financial capability defined in their research. Significantly, even the most financially capable people were still relatively weak at choosing the right products and might struggle to understand the terms and conditions in the small print of the products they buy.

“ Addressing these failings is of particular importance for with-profits business given it is one of the least understood products available. ”

Lastly, research carried out by the University of Warwick for The Actuarial Profession found that although greater financial literacy is beneficial, it alone cannot be relied on in seeking to improve financial decision-making. This same research also found that people choosing from a range of options tend to select the middle option whether the overall range is low in value or high.

When the above factors are taken into account, it is easier to see why with-profits policyholders struggle to understand their products, no matter how good the quality of the communications is. However, it would be wrong to conclude from this that there is no point trying to improve the effectiveness of communications. It is surely better to have happy customers than unhappy customers (or no customers) after all.

Treating with-profits policyholders as long-term partners and viewing the communications with them as part of a strategy for preserving their value (or goodwill) may help to make each communication more effective. With this mindset, firms can plan each communication from pre-sale marketing to post-sale servicing to be a positive experience making people feel valued as a customer. Differing strategies could be adopted for different segments of the customer base, perhaps tailored to their level of sophistication or, in the case of post-sale servicing, to ensure greater focus on the customers that contribute most value. Plus, with sufficient data, multifactorial analyses

could be employed to develop more predictive models of customer behaviour in support of a more tailored communications strategy.

The FSA TCF regime is driven by outcomes, which means that the test of the firm's communication will be in the effect it has on policyholder actions and satisfaction. Without a coherent communication strategy, the achievement of a successful outcome is, at the very best, being left to luck – a business risk that could have serious financial consequences were things to go wrong.

Conclusion

For organisations that view their with-profits fund as a legacy business, it may be more challenging to devote the resources needed to improve their customer communications strategy away from their focus on growing the franchise around the current new business lines. However, combining a more strategic approach to communicating with with-profits policyholders with ongoing development in the quality of the communications themselves is perhaps a better way to increase the overall effectiveness of those communications. And as we move through recessionary times, with greater pressure on cost-control and an increased risk of adverse policyholder behaviour, this might be quite timely.

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