Office of the Policyholder Advocate

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Association of Consulting Actuaries

With-Profits – an outsider's perspective

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With-Profits – an outsider's perspective

- Introduction to With Profits
- and to Reattributions
- With-Profits: the reality
- What does this all mean for the policyholder advocate?
- The Financial Services Authority – what should it have done?
- What I expected and what I found

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The scale of our exercise

- total NU and Pru estates £14bn (NU £5bn fund, Pru £9bn)
- outcome will affect 1 in 5 households (NU 1m policies, Pru 4.4m policies)
- enough money to affect the UK economy in 2009/10
- AXA precedent: policyholders 31% of estate (21% of reattributed estate)
  - shareholders received ~ 70% of estate, not 10%
- many of you will have an interest through your pension work

Typical Norwich Union products

- Pension plan
- Lump sum investment
- Regular savings into a savings policy
- Mortgage endowment
- Receiving pension payments from Norwich Union
- Unitised
- Bond

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Norwich Union

- **Norwich Union Life** is the life insurance division within the **Aviva plc** group of companies.

- **Aviva plc** is the world's sixth-largest insurance group and the biggest in the UK and is one of the leading providers of life and pensions products in Europe.

- The following companies form part of **Norwich Union Life:**

  - **Commercial Union Life Assurance Company Ltd** (CULAC);
  - **CGNU Life Assurance Limited** (CGNU Life);
  - Norwich Union International Limited (NUIL);
  - Norwich Union Life (RBS) Limited (NUL(RBS));
  - Norwich Union Life & Pensions Limited (NULAP)

Norwich Union (cont.)

- CGNU Life
  - formed in 2000 by a merger of CGU with Norwich Union
  - known previously as CGU Life Assurance Limited, General Accident Life Assurance Limited and Yorkshire General Life Assurance Limited.
- CULAC
  - Previously known as the North British & Mercantile Insurance Company Limited and Ocean Marine

With-Profits policies: key features

- Premiums:
    - policyholders pay single or regular premiums into a with-profits fund.
- Investments:
    - premiums are invested in assets such as bonds, gilts, shares and property
- Share in profits / risks
    - policyholders have a right to share in profits if the investments do well
    - 90% of profits are paid to policyholders, 10% to the shareholder
- Regular Bonuses
    - paid yearly - **reversionary** (guaranteed) or on maturity - **terminal bonuses**
- Guarantees
    - minimum returns can be guaranteed providing an underpin to the investment
- Smoothing
    - profit can be kept back in good years, so bonuses in poorer years can be topped up. Policyholders do not know whether they will be a beneficiary or not.

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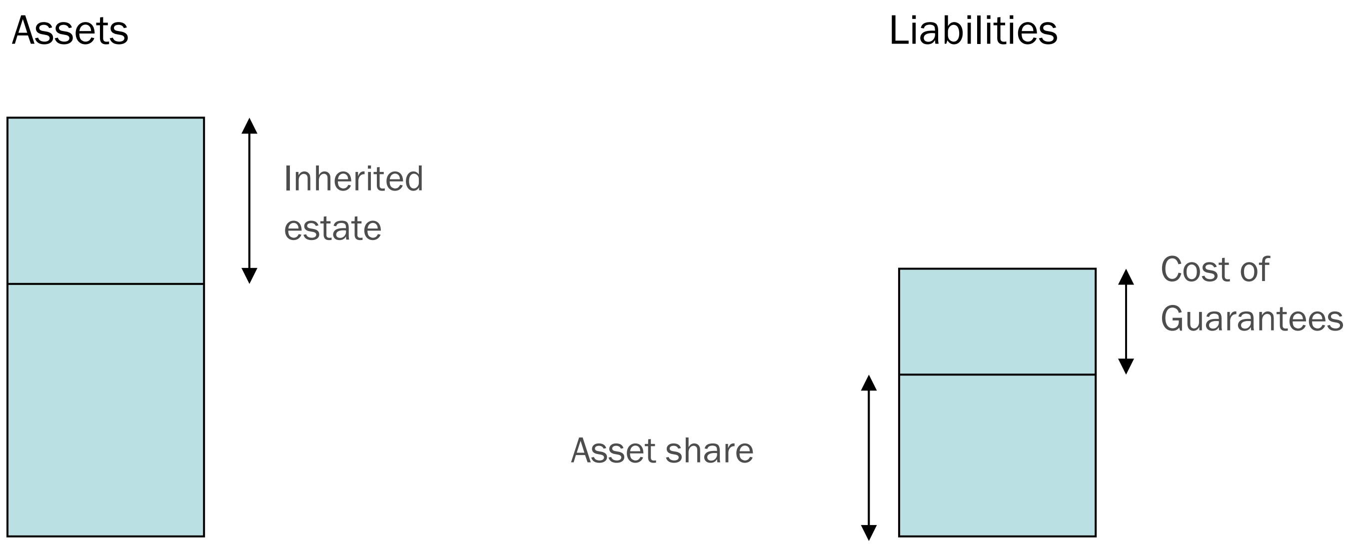
With-Profits policies (cont.)

The “inherited estate”: Assets not required to meet the liabilities of the fund.



Inherited estates

- sources of the inherited estate:
    - usually arises from the retention of profits within the with-profits fund
    - built up over many years
    - shareholders not contributed to either of CGNU or CULAC estates
- inherited estate can only be used for a limited number of purposes including:
    - to provide extra security against unexpected liabilities
    - to provide investment flexibility;
    - to smooth bonuses
    - to support the sale of new business
  - as described in customer literature and CFPPFM

Special distributions from the estate

- funds which hold the money are usually **90/10 funds**
- money distributed from the inherited estate is shared between policyholders (90 per cent) and shareholders (10 per cent)
- directors of insurance companies have a lot of discretion about when distributions might happen
- new rules from the FSA mean that:
  - the company has to consider each year whether it has more assets than it needs to support the fund and if so it must distribute excess surplus capital – subject to TCF
  - over time estates no longer supposed to be created as distributions should equal 100% of asset shares

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Special distributions – pre-reattribution distribution from CGNU/CULAC estates

- £2.4bn distribution of surplus excess capital announced Jan ’08
- £2.1bn to policyholders, 90:10
- credited in three tranches to those policies in force on
    - 1/1/08; 1/1/09; 1/1/10 at end of each year
- good news – would not have been paid if this role did not exist
    - estate derisked as part of reattribution exercise
    - releasing surplus capital
    - around 40-45% of estate

- even if no offer made, eligible policyholders already benefited from policyholder advocate process

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Reattributions

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Reattributions

- policyholders made cash offer in exchange for rights to future estate 90% distributions
  - cash offer called a PIP - policyholder incentive payment
- each policyholder will have to vote ‘yes’ to get the offer
- if policyholders say ‘no’ or don’t vote their policy will be transferred to the OWPSF
  - policyholders keep existing rights
  - same position as if no reattribution had occurred
  - personal expectations maintained $\neq 0$
- shareholders will get 100% control of the inherited estate
- but will continue to honour existing guarantees
- other parties:
  - FSA sets rules for with-profits and reattributions and
    - – gives a ‘fairness’ opinion to the Court
  - independent expert reports on the scheme and its impact on policyholders
  - High Court examines scheme – agrees, or throws out

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Some choices for allocation of Policyholder Incentive Payment

- what is the minimum policyholders will accept?
- should it be a flat payment per policy or depend on the value of the policy
- should people with failing mortgage endowments get more?
- should someone who has been in the fund for a long time and only has a short time until the policy finishes get more than a newcomer
- or should the newcomer with more chance of a distribution get more?
- resounding response – treat us all the same, do not prefer one group over another, we are all essentially in the same boat
- our approach:
  - 90:10 special distribution of excess surplus on asset shares – history
  - reattribution only looks forward
    - future distributions based on asset shares at that time
    - PIP is compensation for giving up future special distributions

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Policyholder Advocate's job – best possible offer for Policyholders

- understand numbers and value of offer to shareholders
  - negotiate to ensure offer at least covers what policyholders expect to receive
- ensure that allocation of PIP reflects what policyholders are giving up
- ensure those who don't vote in favour are in same position as would have been if there was no reattribution – real choice to vote yes, or no
- deal in practice only goes ahead only if FSA says the offer is fair
- company makes the offer
  - PA describes and interprets
- report to policyholders
  - help policyholders work out if offer is good for them personally
  - quantify items to consider (e.g. likely termination date, key sensitivities)
- lay out case to High Court

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With-Profits – the Reality

What policyholders should be able to expect

- fund is run with a ‘duty of care’
- 90:10 fund: interests aligned
  - run for max. risk adjusted returns
  - gate can’t be bypassed
  - discretion used in policyholders’ interests
- all major uses of estate flagged by ‘red hand’
  - no need to read small print (PPFM)
- expectations secure because:
  - major brand
  - regulated by FSA
- deal: buy out policyholders 90% of estate
  - protected by FSA and PA so expect a fair price for that 90%

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With-Profits: the reality

- FSA Conduct of Business Sourcebook (COBS) allow the 90:10 fund to be used for shareholder interests beyond the 10%:
  - shareholder tax – shareholders would pay this tax if there was no estate
  - strategic assets – conflict of interest
  - misselling – moral hazard ∵ 90% of cost paid by policyholders
  - new business – companies use estate to subsidise operational costs
    - FSA says it no longer permits the estate to be eroded to subsidise new business
- FSA allows estate to be eroded
  - reduces policyholders expected distributions below 90% on an ongoing basis
  - ∴ COBS discriminate against policyholders and in favour of shareholders
  - why?

With-Profits: the reality cont.

- estate created with policyholders' money
  - shareholders not contributed
- companies write PPFM to take full advantage of COB rules
  - duty to do so
- With-profits Committee (WPC) duty to Policyholders
  - but also to adherence to PPFM
- customers are unaware
  - no red hand
  - not in CFPPFM
  - not in policyholder literature
- COBS rules allow companies to 'gift' policyholder's estate capital to future generations

New business

- today's generation received estate capital for free, and pass it on for free
- economic analysis says:
  - history is irrelevant – does not matter what was paid or how capital arose
  - money put to work going forward to earn max. risk adjusted return
  - new policies would pay fully for any capital requirements
  - investment in new business like any other investment
    - is risk reward best investment opportunity for fund capital?
- economic analysis identical to how companies will run the fund post a reattribution
  - shareholders will only write new business that is expected to be profitable
  - capital backing new policies owned 100% by shareholders, and will be rewarded
  - shareholders take guarantee risk, not fund, and will be rewarded for that risk
  - capital will not be gifted to new policyholders

New business

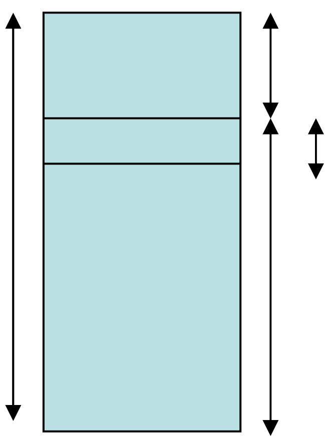
- economic analysis equivalent to a closed fund run off for policyholders
  - but new business would continue to be written
    - and would pay for all the capital required to back that new policy
  - fund guarantees put policyholder returns at risk: nature of 90:10
- economic analysis says 90% of estate should go to today's policyholders:
  - shareholder capital treated the same as policyholder capital
  - new business only written if returns commensurate with risks and capital costs
  - policyholder capital fully compensated for backing guarantees
  - capital would not be 'gifted', but paid for (e.g. 98% asset share)
  - policyholders would receive 'shadow' share as mature
  - fund would bear guarantee risks, and outturn would affect policyholder returns
  - policyholders need to be aware of risk they are taking in fund writing guarantees
  - some may wish to opt for lower risk options
  - shareholders may prefer risk reward profile required

Fund writes new business

Assets = Liabilities

fund

invested traditionally



expected cost of guarantees

high risk of capital being called to back guarantees, high return

‘asset shares’

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New Business

- economic analysis for mutuals (now tiny share of market)
  - invest in new business if best use of fund capital
  - ensures new business is profitable and expected to enhance performance of mutual
  - as new policyholders arrive, value their shadow ‘shares’
  - as mature, value shadow ‘shares’ (conservatively)
  - pay out or deduct difference from terminal bonus – nature of 90:10
- intergenerational transfer is:
  - a subsidy
  - distorts markets and is anti-competitive
  - discriminates against today’s policyholders
- if the FSA acted as an economic regulator it would not allow intergenerational transfers

Effect of intergenerational transfers in a reattribution

- FSA rules allow estate to be gifted to new policyholders who have no rights
- where does this 'un-owned' estate go to in a reattribution?
- FSA rules enable the company to take this 'un-owned' estate without paying for it
    - main driver for AXA transforming shareholder 10% into 70%
- un-owned estate projected to go to future policyholders
    - likely to be transferred to shareholders
    - unless FSA says 'unfair'
    - reduces price company expects to pay for estate

What are the rules for reattribution?

- FSA rules allow more than 10% of estate to be taken by shareholders
  - shareholders compensated for value of uses
  - deduct NPV from value of estate
  - reduces share of estate for policyholders below 90%

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What are the rules for reattribution?

- company writes scheme rules
- ∴ expect scheme to be designed along AXA lines to:
  - project as small a share of estate as possible going to current policyholders
  - reduce and delay future distributions e.g.:
    - » excessive capital standards (risk appetite)
- ∴ expect company to:
  - project high levels of new business
  - ∵ new business transfers estate to future policyholders (dilutes and defers)
- less projected to go to current policyholders, less the company likely to pay for estate
  - does not reflect value of estate to shareholders
  - takes expected policyholder share down from 90%
- FSA has to give a view of ‘fairness’

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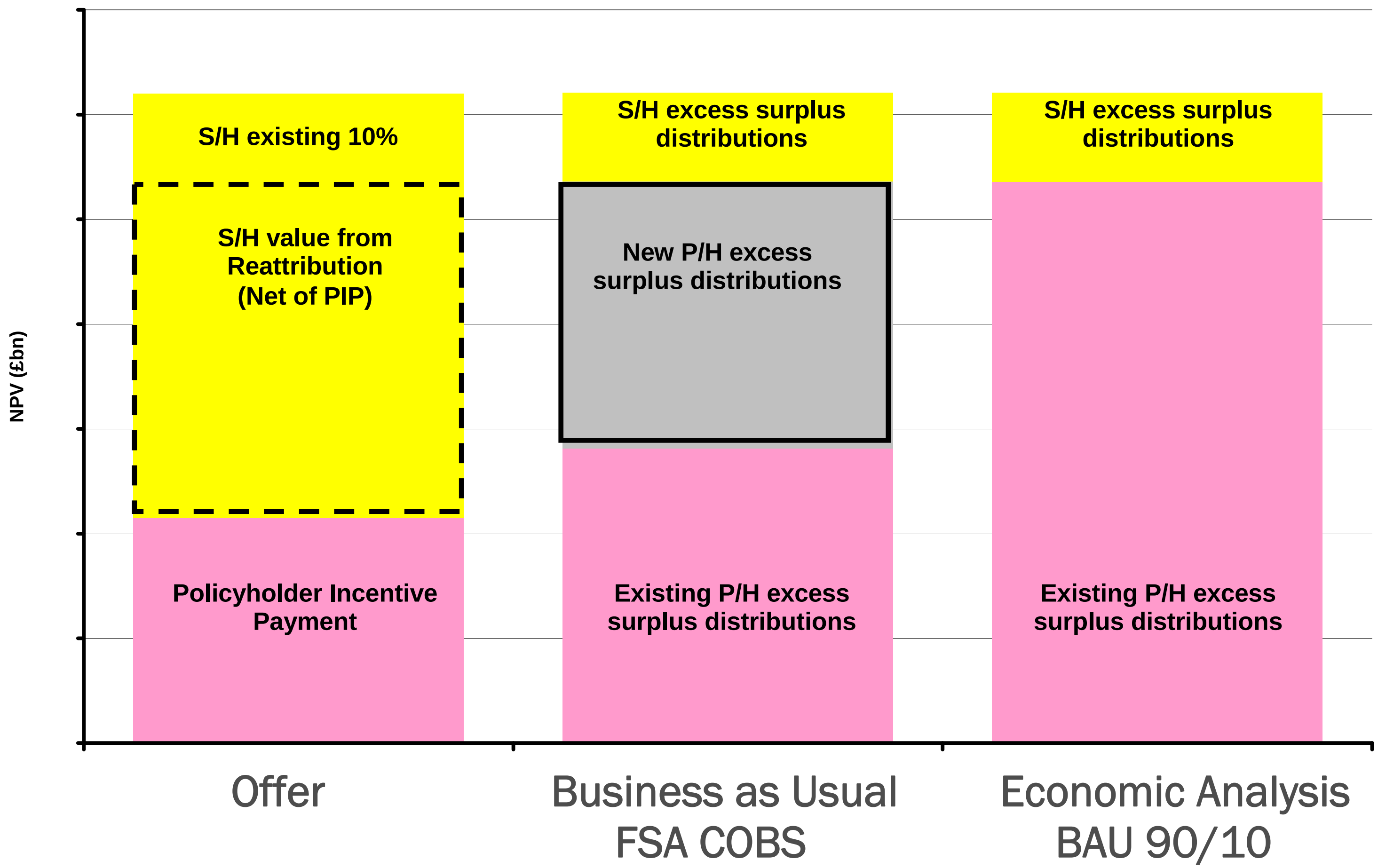
Example – division of estate (excluding costs and 'uses')



Consequences of current rules

- company makes the offer
- any offer will be better than no offer for many (off books before likely special distribution)
- reattribution could be no better than AXA
  - FSA not changed any of key rules despite lengthy with-profits review
  - COBS discriminates on uses of estate, discriminates on new business capital ‘gift’
  - means company can offer well below 90% to gain 90% of the estate
- reasons why not 90:10
  - FSA concessions:
    - » allowance for anything outside shareholders normal 10%
    - » capital that would have gone to future policyholders ‘ownerless’
  - shareholders will take on some tail and non-market risks
  - deal costs high (incl. tax)
  - but return to shareholders likely to be excessive unless FSA says ‘unfair’

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What does the law say?

- pretty much a ‘law free zone’
- FSA made clear that old arguments that PRE=0 are dead
- FSA made clear that excess capital surplus must be distributed
    - unless TCF not to do so
    - i.e. new business continues to be subsidised from estate
- is there an implied term of the contract which would not allow discrimination?
    - if so, FSA ‘concessions’ to shareholders would be illegal
    - estate could not be used differently from rest of fund
    - intergenerational discriminatory ‘gift’ of capital would not be permitted
    - would go to House of Lords

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The Financial Services Authority

What should it do?

What is an economic regulator?

- an organisation which is designed to bring the greatest wealth to the economy
  - through effective competition to secure consumer benefits
  - regulatory rules which mimic this outcome where competition ineffective
    - e.g. price controls, licences, COBS

- Government is elected and has the mandate to redistribute wealth
  - although regulators may have the power
  - they do not necessarily have the mandate

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What would an economic approach mean for customers?

- competitive outcome is one which creates greatest wealth
  - it ensures efficient allocation of resources
- no discrimination between customers
  - charged according to cost of service
  - no cross subsidies; everyone pays their own costs
  - £ is a £ is a £
- no discrimination between customers and shareholders
  - shareholders don’t get excessive returns
- competition is not effective for many financial products
  - long term, complex, cross-subsidies persist: overdrafts, PPI, insurance
  - FSA role to protect customers by ensuring regulation prevents discrimination and excessive shareholder returns

Is the FSA an Economic Regulator?

- Financial Services and Markets Act
  - follows Utility Acts concepts and structure
  - utility regulators are described as economic regulators - duties
  - FSA duties / objectives are broadly identical
- FSA does not have specific duty to promote competition and has no powers to set price controls, but does oversee rules, e.g. COBS
- Acts enable / encourage regulators to ‘do the right thing’ by:
  - not bound by precedent (unlike courts)
  - keeping regulator out of expensive litigation
  - due process check and balance via Judicial Review

How an economic regulator would treat With Profits

- economic regulator would not allow discrimination
- estate: FSA would treat £'s in inherited estate same as £'s in fund
  - no different rules for treatment of estate capital vs. fund capital
  - ∴ no discrimination against policyholders and in favour of shareholders
  - misselling costs would not be allowed to be charged to customers
- new business: FSA would ensure no capital subsidies for new business
  - estate capital treated same as shareholder capital
  - no 'intergenerational transfer' of capital (capital gift)
  - no anti-competitive bias towards companies with estates
- cost to policyholders of discrimination by the FSA is not trivial
  - cost of allowing estate to be used for shareholder gain = many £100's/policyholder
  - cost of allowing new business capital subsidy = £1000's/policyholder
  - in a reattribution policyholder discrimination = shareholder gain
  - ......unless FSA says 'unfair'

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What I expected and what I found

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What I expected and what I found

- expected to negotiate a deal where:
  - Policyholders gave up rights to 90% of whole estate
  - in return for cash and certainty up front
- instead:
  - FSA discriminates against policyholders by
    - –allowing shareholders to take money from estate outside 90:10 gate
    - –allows companies to use estate capital to subsidise new business
- result:
  - policyholders' expectations lower than 90% of estate
    - today's policyholder expectations much lower again because of estate transfer
  - company broadly sets the rules of how much less
  - offer may have little bearing on shareholder returns from deal
  - deal likely to well below that of a competitive auction for assets
  - company takes chance of how many policyholders vote 'Yes' to any offer
  - FSA has fairness remit and Court will not proceed if FSA says deal is unfair
    - this makes FSA effectively the deal maker, not policyholder advocate

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Not all negative

- have got £2.4bn out to policyholders 90:10 via special distribution
- policyholders not fully aware of value of future distributions from estate
  - industry downplayed likely distributions
  - any offer likely to be pleasant surprise
- FSA tightened up regulation so that:
  - distributions of excess capital must be made
  - estate derisked so special distribution possible
  - made clear that PRE $\neq$ 0: policyholders can expect future distributions from estate
  - most erosion of the estate now stopped
    - »subsidies of operational new business costs stopped (still some erosion)
    - »consulting on misselling
    - »shareholder tax remains worst offender ('concession to industry')
- worked out what numbers and rules mean and cost, so there will be transparency
- beginning to get public understanding about what the 'black box' of with-profits consists of
  - e.g. press and Treasury Select Committee

Still to go

- will FSA ensure that?
  - offer is ‘fair’
  - reasonable share of what would have gone to future policyholders gets paid out in PIP
  - shareholder return is not excessive

- will the FSA review its COBS rules so that they are no longer discriminatory
  - against policyholders, giving preference to shareholders (uses of estate)
  - against today’s policyholders (intergenerational transfer)

- we will continue the public and private pressure