

Appendix 6

Background to with-profits policies and the CGNU Life and CULAC insurance companies

A report for the policyholder advocate in connection with the reattribution of the inherited estates of the CGNU Life and CULAC with-profits funds

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1.00 Introduction

The purpose of this appendix is to assist in putting the reattribution in context by explaining the nature of with-profits business and, in particular, to describe the business of the two life insurance companies where a reattribution is proposed, namely CGNU Life and CULAC.

Section 2.00 refers to with-profits business in general. Section 3.00 briefly describes the history of CGNU Life and CULAC, summarises the business CGNU Life and CULAC have in force, and their new business.

2.00 The nature of with-profits business

2.01 General description

Insurance, by its nature, covers uncertain conditions, while providing security for policyholders against, for example, adverse movements in investment conditions, and adverse events, such as sickness or death. Insurance companies do this by establishing a fund into which the premiums from policyholders are paid and from which claims are paid; this is the ‘pooling’ principle. The fund also benefits from investment returns, and is charged with expenses and tax (this is a simplified explanation of insurance, but it can be used to help explain how with-profits business operates).

There are particular uncertainties in life insurance business due to the long-term nature of the contracts. It can be difficult for an insurer to determine the rates of premium to charge on these contracts. For example an insurer needs to take into account the possibility that investment returns may be poor and mortality trends may be adverse. It may therefore have to set the premium rates very high in order to guarantee the benefits payable. The contracts may therefore appear unattractive to policyholders.

One solution to this is for policyholders and the insurer to share the risks. For a given level of premium, the insurer guarantees what may appear to be a modest amount to the policyholder.

However, if the fund does well (e.g. investment returns are good), then the profits will be shared with policyholders. This is a “with-profits policy”. Insurance companies may be mutual or proprietary; the former are essentially owned by their policyholders as they have no external shareholders; the latter do have external shareholders. In a proprietary insurer carrying on with-profits business, profits are split between policyholders and shareholders, generally on a 90:10 basis (as is the case with CGNU Life and CULAC)¹.

As described above, the amount paid to the with-profits policyholder above the guaranteed benefit depends on the profits earned by the fund. In contrast, in non-profit policies the total amount paid to the policyholder is defined and guaranteed. In unit-linked policies the payment depends on the price of the units in the fund that the policyholder has chosen for their investment: there are typically no investment guarantees in the policies, and the insurer’s profits depend on the charges it makes in accordance with the policy conditions.

2.02 Typical with-profits policies

Life insurance policies usually have a term of many years. It is common for policies to be either a single premium policy (i.e. one premium paid at the outset) or regular premium policies (typically, a premium paid each month or year over the term of the policy).

Policyholders may have options to increase the premium they pay. In return, the life insurer pays an amount in specified circumstances (claims).

A number of typical with-profits policies are:

- An endowment assurance policy: premiums are paid regularly; the claim is paid on the earlier of the death of the person whose life is insured and the maturity date of the policy (i.e. the end of the term of the policy);
- A traditional whole life policy: premiums are paid regularly, up to some specified age (e.g. 85); the claim is paid on the death of the person insured, whenever that occurs;

¹ Where a 90:10 basis applies, the proportion of distributed surplus is allocated to policyholders is not less than 90%; it is usually 90.0% or slightly more than 90.0%.

- A single premium bond: a single premium is payable; the claim is paid on the death of the insured person, whenever that occurs;
- A personal pension policy: premiums may be paid either as a single premium or regularly; if the person whose life is insured dies before the maturity date of the policy (chosen to be the life insured's retirement date) the amount paid is a return of the premium(s) paid with interest at a specified rate; if the person insured is alive at the maturity date, then the amount of claim reflects the profits that have been allocated. Some policies have a guaranteed annuity option (GAO), i.e. they guarantee the rate at which, at the maturity date, the policyholder can exchange the sum then payable for an annuity.
- An annuity: a single premium is paid; the insurer makes a payment each month during the insured person's lifetime.

In practice, insurance companies design products that involve variations on the above general themes.

2.03 Bonuses

The special features of with-profits relate to how the amount of payment under the policy is determined.

For example, a traditional with-profits endowment assurance policy could involve the policyholder paying a premium of £1,000 a year, and with a policy term of 25 years. The insurer offers a guaranteed sum assured, say £25,000 (lower than it would offer under a non-profit policy). However, the accumulation of premiums paid by policyholders is likely to produce a profit compared to that (modest) sum assured; and the insurer commits to sharing with the policyholder the profits it earns on a 90:10 basis. In particular, if generally mortality rates turn out to be low and investment returns are high, there should be substantial profits.

The insurance company pays these profits to policyholders by adding “bonuses” to the initial amount guaranteed under the policy. These bonuses are typically of two types: regular and final bonuses (also called reversionary and terminal bonuses – see below).

Each year the insurance company values assets in its fund, and liabilities from the policies issued. The liabilities valued are the guaranteed benefits only, but since these guaranteed benefits were set on a conservative basis, we would ordinarily expect this valuation to demonstrate a surplus. The insurer can use some of that surplus to declare a rate of regular (annual) bonus. For example, the firm may declare a 2% bonus. This means that the guaranteed benefit under the policy increases from £25,000 to £25,500 (25000×1.02). This is also known as a ‘reversionary bonus’, meaning that the bonus is not payable in the form of cash: it reverts to the policyholder whenever a claim is made (on death before maturity or on the maturity date). Over the term of the policy the guaranteed sum assured increases as a result of the addition of annual bonuses. In deciding what annual bonus rate to declare, the insurer has to ensure that the resulting guaranteed benefits are not too high in relation to the resources of the fund. Insurers tend not to make substantial changes in annual bonus rates from year to year.

At the maturity date, the insurance company usually adds a final, or terminal, bonus in order that the payout to the policyholder is at the desired level. The starting point for this is the ‘asset share’, i.e. the share of the assets in the fund that are attributable to this policy.

Briefly, the asset share is the sum of the premiums paid plus investment returns, minus: a charge that may be made for the guarantees that the policy provides; the insurance company’s expenses; the cost of life cover; tax; and the share of profits allocated to shareholders.

Companies’ practice in calculating asset shares varies; for example, on some policies, the asset share is calculated using not the actual expenses but a charge that has been set in place of expenses.

It is usual for the assets in the insurance company's fund to consist of equities, property, bonds (government and corporate) and cash. With-profits policies have typically been considered as a convenient way for individuals to save in a manner that enables them to access stock market returns. The insurance company must maintain a mix of assets that represents a prudent investment strategy.

As an illustration of a terminal bonus calculation we can consider a hypothetical policy where the guaranteed benefit has, by the maturity date, increased to £36,000 as a result of the addition of annual bonuses. Say the asset share at maturity is £40,000. This can be used as the basis for calculating the amount to be paid to the policyholder. For example, assets of £40,000 represent a profit of £4,000 compared to the guaranteed benefit of £36,000. This £4,000 profit could be allocated 10% to the shareholders (£400), 90% (£3,600) to the policyholder. That £3,600 is the terminal bonus, added to the guaranteed benefit of £36,000 to create a payout of £39,600. (In this example, the payout is equal to the asset share).

However, the insurer may pay more or less than asset share. One reason for this is that with-profits business involves 'smoothing', typically meaning that the insurer looks to avoid changes in the payout on a given type of policy of more than say 10% or 15% from one year to the next. We may therefore find that, when asset prices are relatively high, the payout may be less than asset share. Conversely, when asset prices are relatively low, the payout may be more than asset share. The policyholder is thus protected from low asset prices in exchange for forgoing some benefit when asset prices are relatively high. Smoothing would ideally tend to even out payments over time.

Also, asset share calculations are not typically made policy-by-policy. Calculation of asset shares and bonuses involves some approximations, usually based on calculations for specimen policies, and with similar policies (e.g. policies on male and female lives) being treated similarly for bonus purposes (see Appendix 9 'Investment policy, smoothing and bonus policy').

2.04 New with-profits business

The above description relates to how with-profits policies were traditionally structured. New with-profits business is now almost exclusively “unitised” with-profits business. The guaranteed sum assured relates to the premiums actually paid, increasing as further premiums are paid. The annual bonus rate will be nearer to the rate of investment rate earned. However, the principles are the same as a traditional with-profits policy: the guarantees are more conservative than on a non-profit policy, with annual and terminal bonuses being determined so that the policyholder’s payout usually reflects the asset share subject to smoothing.

Insurance companies have typically determined guaranteed benefits (and annual bonus rates) on a conservative basis, but there are cases where the guaranteed benefit under a policy turns out to exceed the asset share. In such cases the guarantee is valuable and normally in such circumstances the company would not add a terminal bonus.

A number of policyholders do not want to keep their policy in force until the maturity date and they surrender their policy. Insurers calculate and pay surrender values, broadly in line with the asset share as accumulated to the date of surrender.

2.05 FSA rules – transparency and governance

Insurers have considerable discretion in operating this form of business. The Financial Services Authority (FSA), which regulates insurers, requires insurers that have with-profits policies to issue a ‘Principles and Practices of Financial Management’ document (PPFM). This explains, in outline, how they run their business, for example how their mix of investments is chosen, and how they determine bonuses. However, some customers find it difficult to understand PPFMs, and the FSA also requires firms to produce a separate consumer friendly PPFM (CFPPFM). The insurer also has to establish governance mechanisms consistent with the regulatory requirements of the FSA. The FSA has a number of governance rules applicable specifically to with-profits business. This is in addition to its more general rules, including the principles that customers should be treated fairly and conflicts of interest should be managed fairly (see Appendix 30 ‘With-profits governance arrangements’ and Appendix 31 ‘Principles and Practices of Financial Management’)

3.00 CGNU Life and CULAC²

3.01 History of CGNU Life and CULAC

Each of CGNU Life and CULAC is a company in the Aviva plc group, which is the result of several mergers. CGNU Life was originally the main UK life insurance company in the General Accident group, which merged with the Commercial Union group in 1998 to form CGU. CULAC was the main UK life insurance company in the Commercial Union Group. It was 2000 when the Norwich Union Group merged with CGU to form the CGNU Life group, which name was changed to Aviva in 2002.

CGNU Life was originally the life company of Yorkshire Insurance, which was acquired by General Accident. It has been previously known as CGU Life Assurance Limited (1.10.1998 to 1.10.2000), General Accident Life Assurance Limited (1.1.1985 to 30.9.1998) and Yorkshire-General Life Assurance Company Limited (to 31.12.1984).

3.02 Business in force

Liabilities

Each of CGNU Life and CULAC writes almost all of its business in the UK and, net of reinsurance³, the business is largely with-profits. The figures below relate to 31 December 2008.

Most of the net liabilities were with-profits: 91% in the case of CGNU Life and 83% for CULAC. Of the with-profits liabilities, most were unitised business (76% CGNU Life, 81% CULAC) as distinct from traditional with-profits. Almost all other types of non-profit business were non-linked.

² The data in this section relates to 31 December 2008, which is the date of the latest comprehensive publicly available information.

³ A reinsurance contract is one where an insurer pays a premium to a reinsurance company, which pays claims to the insurer in defined circumstances, typically matching the obligations of the insurer under its contracts with policyholders. The reinsurance company may be another insurance company that is part of Aviva plc.

The long-term insurance funds of CGNU Life and CULAC each contain two sub-funds: a stakeholder sub-fund and a main sub-fund. Each of the two stakeholder sub-funds had £0.4bn of pension liabilities. Policyholders in these sub-funds do not have rights to future distributions from the inherited estate. In the main sub-fund of CGNU Life, the largest class of business, measured by UK liabilities (net of reinsurance), and using classes in the FSA returns, was £4.9bn on single premium unitised with-profits life business (i.e. with-profits bonds). £1.6bn was on “conventional with-profits target cash” (e.g. mortgage endowments). £0.7bn related to individual unitised with-profits pensions business. There was also an important class of non-profit compulsory purchase pension annuities, of £0.6bn liabilities. In the main sub-fund of CULAC, the largest class of business was also single premium unitised with-profits life business, with £5.2bn liabilities. Second was £1.2bn of non-profit compulsory purchase pension annuities, then £1.1bn of individual unitised with-profits pensions business, and £0.9bn of conventional with-profits target cash. Therefore, of the £22.8bn total net liabilities across the two companies, £10.1bn related to UK single premium unitised with-profits life business.

Assets

As at 31 December 2008 the assets of the long-term insurance funds of CGNU Life and CULAC were largely in fixed-interest securities, equities, land and property. The figures in this section refer to assets excluding those held to match linked liabilities (which are relatively small). In CGNU Life, the assets were £14.7bn, comprising £1.1bn backing non-profit liabilities and capital requirement, and £13.7bn backing with-profits liabilities and capital requirement. All of the £1.1bn were in fixed-interest securities. Of the £13.7bn, 39% were in fixed-interest securities, 25% in equities and 16% in land and buildings. In CULAC, the assets were £15.2bn, comprising £2.1bn backing non-profit liabilities and capital requirement, and £13.1bn backing with-profits liabilities and capital requirement. All of the £2.1bn were in fixed-interest securities. Of the £13.1bn, 46% were in fixed-interest securities, 25% in equities

and 12% were in land and buildings,. The figures in this section have been based on the FSA statutory solvency valuation (and the economic exposure of assets⁴).

In addition to the long-term insurance funds, each of CGNU Life and CULAC has a shareholders' fund, where the capital and reserves at 31 December 2008 were £101m and £94m in CGNU Life and CULAC respectively.

3.03 New business

UK new business in 2008 in CGNU Life was £453m regular premium and £4393m single premium, both before (inwards and outwards) reinsurance. Most new business was unit-linked business reinsured elsewhere in the Group⁵. The new with-profits business was £16m regular and £1704m single premium. The main class of with-profits business was life unitised with-profits single premium business: £1608m, a large part of which was reinsured to CULAC.

UK new business in CULAC in 2008 was £5m regular premium and £58m single premium. This included £1m regular and £11m single premium with-profits business. Inwards reinsurance of new business included £723m of life unitised with-profits single premium business.

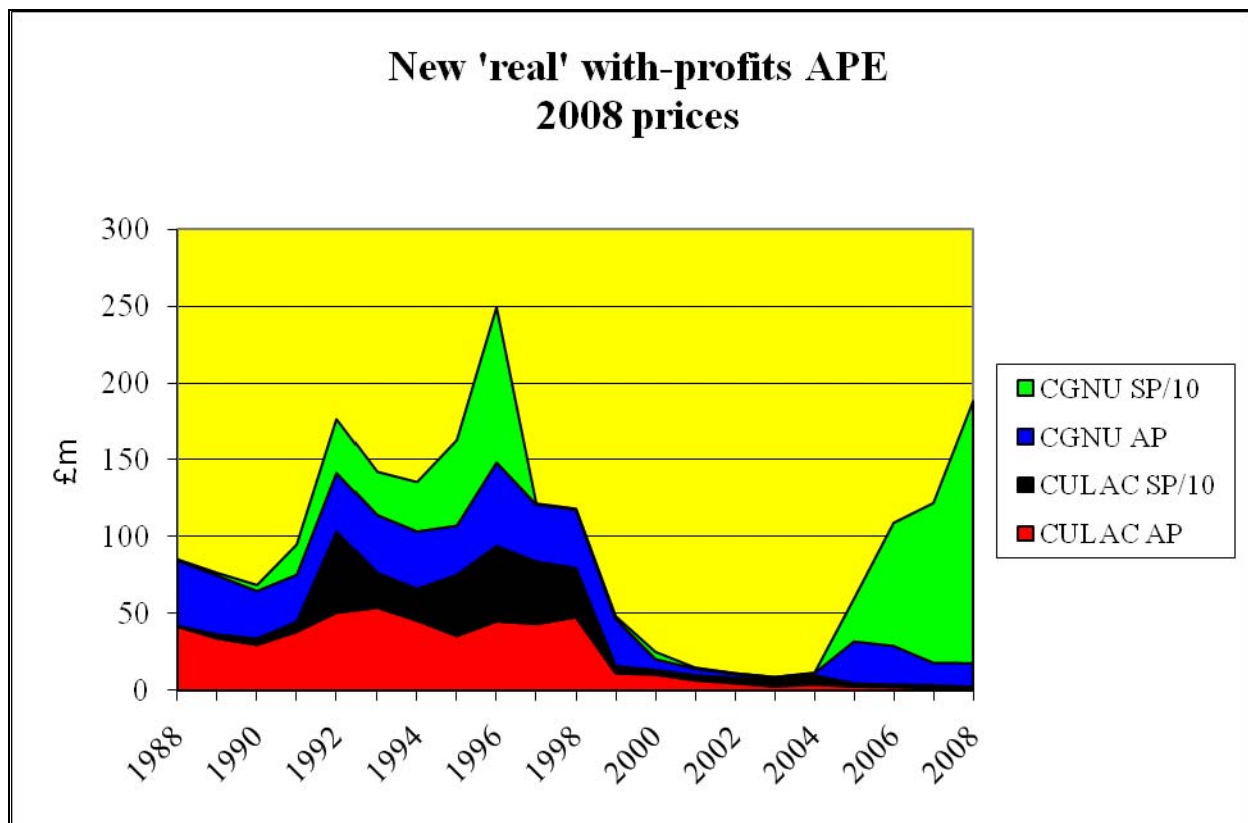
The chart below shows the new UK with-profits business over 1988-2008 in each of the two companies, in real (i.e. inflation-adjusted) terms at 2008 prices (this counts direct business only, i.e. excluding reinsurance, to avoid double-counting; it excludes any business reinsured from other group companies).

The elements of the chart are the new annual premium or 10% of the single premium new business in each of the two companies. The top line shows the total annual premium

⁴ We use the term 'economic exposure', because this takes into account, when considering equities (for example), not only equities that are owned directly, but also derivatives the value of which depends on equity values.

⁵ Reinsurance to a company in Aviva plc that does not write with-profits policies can mean that the shareholders receive 100% of the profits from that business, as opposed to only 10% of the profits if the business is retained in a with-profits company.

equivalent (APE) for the two companies, where APE is new annual premium plus 10% of single premium business. In 2008 the APE was 143% of the average in the 1990s in real terms; some new with-profits business was being written with a subsidy from the inherited estate.



3.04 Summary of CGNU Life and CULAC business

Most of the business in force in the two companies, net of reinsurance, is with-profits (CGNU also has substantial unit-linked liabilities that are reinsured). A large part of the liabilities arise

from single premium with-profits bonds. The assets in the funds are in a range of investments, with 42% of the assets being in fixed-interest investments (for the two companies combined). New with-profits business reduced significantly in the late 1990s. It has grown significantly in 2005-08, primarily as a result of single premium life bonds.