

## **Appendix 9**

### **Investment Policy, Smoothing and Bonus Policy**

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

**June 2009**

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## **1.00 Introduction**

Section 2.00 explains the investment strategy of with-profits life insurers, which is geared to providing a good return for policyholders (and shareholders in proprietary companies). This traditionally involves a strong element of investment in equities and property, while also providing a minimum benefit that is guaranteed. Funds have faced a number of challenges from changing conditions in recent years. This has led them to examine their investment strategy more closely than before to ensure that it is robust in the event of changing circumstances.

With-profits business is also characterized by the way in which payouts depend on asset shares that are subject to smoothing. Section 3.00 describes the calculation of asset shares, which play a central role in the management of with-profits business. Section 4.00 explains what is meant by the smoothing policy of an insurer, which affects the bonuses that policyholders receive.

## **2.00 Investment strategy**

With-profits business is traditionally marketed and operated on the basis that it offers an investment with guaranteed benefits for policyholders, but also a significant equity component in the investment return.

This section outlines the main points involved, but is necessarily a simplification of what is, in practice, more complex.

One approach to investment choice is to adopt a “matching” strategy. This would mean the insurer investing in relatively risk free investments, for example government bonds (“gilts”) to provide a secure return, to the extent that it has liabilities arising from its guaranteed benefits to policyholders which the insurer is contractually obliged to fund. The insurer can then invest the remainder of its investments in equities and properties, which involves

somewhat greater risk but also an expectation of a higher return. The return on these other assets can be used to provide bonuses.

However, insurers have typically invested less in gilts and more in equities and properties than a matched investment strategy strictly implies, in order to increase expected overall risk-adjusted returns. One justification for this is that it has been common for the assets of with-profits insurers to be significantly higher than the value of their guaranteed liabilities. In these circumstances, if the value of equities declines, insurers can – before the value of equities has declined to the point that the insurer’s assets are only just equal to the value of their guaranteed liabilities - sell some of their remaining equities, using the proceeds to buy gilts of an amount equal to the guaranteed liabilities.

This holding of fewer gilts and more equities (and properties) than correspond to a matched strategy is sometimes called ‘mismatching’. In proprietary firms the mismatch may also be supported by assets in the shareholders’ fund, or by the availability of assets elsewhere in the group, or by the ability of the company to raise equity capital if required.

The backing of policyholders’ guaranteed benefits with potentially higher return but less liquid assets carries risks. To mitigate this risk firms take account of the extent of the guarantees when devising investment policy, and the fact that surrender values are not guaranteed. Furthermore, there may be renewal premiums and investment income available to pay claims without the need to liquidate investments. Firms’ procedures for managing risks can include modeling their business, in some cases using stochastic techniques<sup>1</sup>, to test the robustness of their chosen investment strategy.

Some with-profits insurers hold assets which would not typically form part of the with-profits funds portfolio, but which have strategic importance to the group as a whole. The FSA requires the justification for holding such strategic assets to be explained in the insurer’s

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<sup>1</sup> Stochastic techniques involve assumptions that result from a model that projects future cash flows using a random process. See Appendix 14, Approaches to Modelling: Stress Testing, Scenario Analysis and Stochastic Modelling

Principles and Practices of Financial Management document. Most with-profits firms also have non-profit policies.<sup>2</sup> In most cases these are backed by bonds. The investment return to be credited to with-profits policies asset shares would take account of some investments being allocated to non-profit policies.

There are differences between firms in the way they choose their investment strategy and a firm's chosen investment strategy needs to be consistent with its policyholder literature. Some have an investment mix that varies according to outstanding term of the policies. For example, for policies near to maturity, it may be considered appropriate to ensure that the guaranteed benefits are covered by bonds, on the basis that even if there is a substantial terminal bonus content, policyholders may not wish to see great volatility in their prospective payout. A move towards a higher proportion of bonds as policies approach maturity would therefore be appropriate.

It was common in the 1980s and 1990s for firms to define an investment strategy as comprising, for example, 50% UK equities; 15% overseas equities; 10% property; 22% bonds; 3% cash. Investment managers would choose investments with specified tolerances around these limits. The investment return was calculated overall, and credited to all asset shares. The bond content would typically include some corporate bonds, which increased the overall return compared with gilts, albeit at some extra risk.

In the late 1990s many firms saw their solvency levels decline, as interest rates fell. This was especially the case for insurers which had guaranteed annuity option (GAO) liabilities. Most such firms took action to match these liabilities. Some did this by reinsurance. Others bought a special type of asset that investment banks began to market in the late 1990s: these were a type of derivative called 'swaptions', and they enabled insurers to match more closely their GAO liabilities than had been possible before. However, while swaptions helped insurers cope with the effect of low interest rates on their GAO liabilities (swaptions increased in

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<sup>2</sup> Non-profit policies are those where the amount of benefit payable to policyholders is guaranteed, and not dependent on future bonuses

value similar to the increase in the value of their liabilities), they did not cover the effect of lower mortality rates on GAO liabilities.

The investment risk in with-profits funds was much more closely scrutinised as a result of the falls in interest rates, followed by the decline in share prices in 2000-03. Many firms closed to new business, and some of those sold all or nearly all of their shares and property. All firms had to review their investment strategy in the newly demanding investment conditions. Some decided to have a higher bond proportion of their assets to back those policies with relatively high guarantees. Some adopted a different investment strategy for their inherited estate compared to asset shares. Firms studied their investment risk more closely, and many chose to use specially designed financial assets such as derivatives in order to protect themselves against adverse outcomes. The duration of their liabilities was also studied more closely in order to ensure that bonds of suitable term could be included in the assets.

Firms have also advanced the way they model their business, improving their process of making financial projections, using stochastic modeling in a more sophisticated way than previously. This has enabled firms to analyse their investment portfolio better and to incorporate management actions.

### 3.00 Asset shares

Life insurers typically use asset shares as a guide when determining payouts.

The asset share of a policy can be calculated as:

$$AS_{t+1} = AS_t + P_t - G_t + I_t - E_t - C_t - T_t + M_t - H_t$$

Where  $AS_t$  = asset share at time t,  $AS_0 = 0$

$P$  = premium

$G$  = charge for guarantees etc deducted from asset share

$I$  = investment return

$E$  = expenses

$C$  = cost of life cover

$T$  = tax (including increase in provision for tax payable in the future)

$M$  = miscellaneous profits credited (and losses charged to) asset share\*

$H$  = transfer of surplus to shareholders†.

$G$  and  $H$  are zero for some companies.

\*Examples of miscellaneous profits are profits made when policies are surrendered (if the surrender value is less than asset share, as will commonly be the case); or profits on non-profit business (if, say, mortality experience is more favourable than assumed in setting the premium rates). However, where there are adverse circumstances, those miscellaneous profits may be losses

†This is generally the 10% share of distributed surplus that is deducted from the asset share and transferred to shareholders.

In principle, the accumulation of an asset share is continuous though, in practice, it will be calculated at monthly or annual intervals, with due allowance for the timing of items in the periods being used and for investment return.

The term “raw asset share” may be used for a calculation that excludes the charge for guarantees ( $G$ ); the miscellaneous profits credited, and losses charged ( $M$ ); and the transfer of surplus to shareholders ( $H$ ).

The use of asset shares as a guide for determining payouts became more widespread in the late 1970s and 1980s. The calculations often involve a number of approximations. For example, when calculating asset shares for policies effected some years ago, the historical experience of expense rates and investment rates might not be available.

Asset share calculations have not always been robust. However, most firms now use asset shares in calculating their liabilities in the returns they make to the Financial Services Authority and in their accounts, and so are subject to audit. Therefore firms have had to

review their asset share systems and upgrade as necessary. This could make firms less likely to implement retrospective changes to accrued asset shares, as had been common in the past. Some issues surrounding asset share calculations may remain: for example, miscellaneous surplus may be difficult to estimate.

Asset shares are not always calculated separately for individual policies. Calculating aggregate asset shares may be done by calculating asset shares for specimen policies (model points) and then scaling up to give a figure for the with-profits business as a whole. When asset shares are calculated for the purpose of determining bonus rates and payouts, they are calculated at model points and the bonus rates derived are then applied to similar policies.

Asset shares may not be calculated for some cases, e.g. paid-up policies and whole life policies. Insurers therefore have to take steps to ensure that the payout is fair in relation to what has been earned for the policy.

#### **4.00 Bonuses and smoothing**

The insurer's 'desired payout' under a with-profits policy is usually the smoothed asset share. The smoothing provides valuable protection to policyholders so that (unlike on unit-linked policies) they are not subject to daily fluctuations of asset values in the calculation of their payout.

Smoothing usually operates to limit the change in payout from one year to the next, on comparable policies, to for example, 15%. However, the payout should still be fair in relation to asset share.

Each insurer has a smoothing policy which will be referred to in its Principles and Practices of Financial Management (PPFM) document. The pre-retribution PPFM of CGNU Life and CULAC stated:

*“Bonus rates are smoothed so that the full extent of changes in the market value of assets in the Fund is not always immediately reflected in claim payments. The aim of the current smoothing policy is such that changes in maturity payouts on comparable conventional with-profits policies from year-to-year are normally limited to no more than 15%. The aim for unitised with-profits policies is that policy payout changes are compared between consecutive years and normally limited to no more than 15% on the same policy. The aim is that in normal circumstances the cost of smoothing will be broadly neutral over the long term. There is no specific overall limit to the accumulated cost or surplus of smoothing beyond the principle of maintaining regulatory solvency at an acceptable level.”*

In exceptional circumstances, such as a sharp decline in share prices, some companies may reduce the amount of smoothing they do, in order to maintain the solvency of the fund. However, it may lead to disappointment for policyholders, who would place most value on smoothing in such circumstances.

Reversionary bonuses are usually added once a year, following the annual valuation of assets and liabilities. Terminal bonuses are the means whereby insurers ensure that payouts are at the desired level. Before 2000 it was common for insurers to change terminal bonus rates once a year (although some changed more often). The stock market decline of 2000-03 led many insurers to review terminal bonus rates more frequently.

The smoothing process produces a pattern of payouts that while unchanged for some months, then has a change of say up to 15% at one point in time. Where changes in terminal bonus rates occur more frequently than annually, the ‘one point in time’ change is likely to be a lower figure than otherwise.

Smoothing should occur so that the payout is fair in relation to the asset share. For example, CGNU Life and CULAC said in their pre-retribution PPFM:

*“Maturity and surrender payouts for a group of policies should normally fall in the range 80% to 140% for conventional with-profits policies and 80% to 120% for unitised with-profits policies of asset shares. Payouts may however lie outside of this range following exceptional stock market conditions. In these circumstances the Company would aim to bring the average payout back in line with 100% of asset share over a maximum five-year period subject to meeting guarantees already built up.”*

The payout is subject to the minimum amount guaranteed. This is the initially guaranteed benefit plus the increases arising from reversionary bonuses. Insurers would normally plan on the expectation that the guaranteed amount at maturity will be less than asset share. This would be taken into account in setting reversionary bonus rates.