

Appendix 10

Equity between policyholder groups

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 set out how equity between policyholder groups can operate in a with-profits business, with specific reference to a reattribution of an inherited estate in accordance with Financial Services Authority's (FSA) rules.

By way of background, Section 2 explains the usual practice of allocating bonuses between policyholders when fund surpluses arise. Section 3 considers equity in the context of a reattribution, when policyholders are being offered a one-off payment in return for giving up their rights to any future special bonuses from an inherited estate. Section 3.1 describes possible ways of allocating between policyholders the total sum being offered by the insurer. Section 3.2 discusses the position of policyholders in a reattribution who choose not to elect to accept the insurers offer. Section 4 describes the way in which these issues were dealt with in the context of the AXA reattribution.

2.00 Background

2.01 Asset shares and bonus policy

Equity is not a fully defined concept in with-profits life insurance. Firms use their discretion, within the boundaries of the FSA's Conduct of Business rules (COBS) to allocate bonuses, which means that there is no single set of rules to guide us, especially in the context of a reattribution.

However, COBS 20.2.3-16¹ indicate that the FSA expects asset shares to be used as a firm guide in the determination of bonuses in most circumstances. The asset share of a policy can be thought of as the share of the assets of the fund that are attributable to the policy. While firms' practices in calculating asset shares vary, they can be regarded as the accumulation of premiums paid by the policyholders, with the investment return that has been earned, minus

¹ FSA Conduct of Business rules, as implemented November 2007

various outgoings. These outgoings are: expenses; the charges made for guarantees, options and smoothing; claims, taxes and transfers of surplus to shareholders.

The use of asset shares is now standard for most with-profits policies. The use of asset shares means that before smoothing of investment returns is applied (as explained below) a policyholder receives about as much as their premiums have earned, net of charges. This is often regarded as a major step forward in ensuring equitable treatment of policyholders. However, with-profits policies have a minimum payout, which is the guaranteed benefit under the policy as increased by any additional reversionary bonuses (also called regular or annual bonuses). If the guaranteed minimum payment under the policy is greater than the asset share, the insurer must pay out the guaranteed payment.

In practice, payouts are typically based on smoothed asset shares, involving transfers between policyholders over time, since with-profits business is intended to provide smoothing of investment returns. This can mean that policyholders whose policies mature when stock markets have just risen strongly receive less than (what is a relatively high) asset share; others whose policies mature when stock markets have fallen sharply receive more than (what is a relatively low) asset share. Insurers would be expected to check that decisions they make on smoothing are consistent with what policyholders have been led to believe will apply and have accepted as part of their contract, although contract documentation may well not refer to this in detail. Firms will also need to check that their practice is consistent with what their Principles and Practices of Financial Management (PPFM) document describes and with the provisions of FSA rules.

2.02 Determining policyholder groups

Policies are grouped for the purpose of setting bonus rates. This can be done in several ways. It is common, if not universal, for bonuses to be different on life and pension policies. This is largely because a major factor determining the surplus arising is the investment return earned in comparison with what was assumed in setting the guaranteed benefit under the policy. The investment return on a pension policy accumulates free of tax, while in a life policy, the

investment return is taxed. This can mean a strong investment performance can have a greater effect on the way the asset share of a pension policy grows, compared with that of a life policy, and so can justify a higher bonus to the pension policy.

As an example of pooling, consider three policies with identical benefits but where the policyholder is 25 years old in two cases, 35 years in the other. The policies on 25-year-olds will receive the same bonus rates, as the experience of the class of 25-year-olds is pooled together. The firm charges a higher premium for the 35-year-old, reflecting the expected higher mortality. The actual excess mortality will be different, but probably not by much, so that if bonus rates were calculated separately for the policies they would be very close. In practice, firms declare the same bonus rate for policies for 25- and 35-year-olds. This is because, having already made the differentiation between the ages in the premium rates according to expected mortality, they are content that the differentials that arise in practice can be pooled across ages, with the same bonus rate being applied. Indeed, there is also a point of equity. It can be argued that if premium rates have already been set to allow for the (expected) difference in mortality by age, then it is unfair to have a further differentiation by age when bonus rates are set. Another example is that bonus rates are typically the same for policies whether premiums are paid monthly or annually: this is because different premiums have already been charged (to reflect loss of income) and a further differentiation when bonus rates are set is arguably unfair. Indeed, while the assumptions underlying the premium differentials may not be borne out in practice, the differences can be pooled across both annual and monthly premium classes. However, following the *Equitable Life v Hyman*² ruling in the House of Lords, some life insurers had to review their practices on the identification of groups of policyholders for the purpose of setting bonuses, to avoid policies with different options being given different bonus rates in a way inconsistent with the court's ruling .

² *Equitable Life Assurance Society v. Hyman*, House of Lords, 2000

3.00 Reattribution of an inherited estate

3.01 Introduction

Although a reattribution is intended to be fair to groups of policyholders, while maintaining equity between classes and generations, a number of approaches to maintaining equity are possible. Indeed, a firm proposing a reattribution may wish to use a combination of approaches.

3.02 Allocation of the total incentive payment between policyholders

Allocation of aggregate incentive payment on a retrospective basis

In order to ensure equity between policyholders over time in a reattribution some might claim that the benefit offered to policyholders should have a large retrospective element, i.e. it should reflect past events and experience: those policyholders who have been in the fund for longest should benefit most. This might be argued, for example, if the inherited estate reflects investment earnings or other sources of surplus held back for various reasons and which may perhaps have been distributed earlier if circumstances had been different. But there are arguments against such a retrospective approach. For example, the source and precise timing of the growth of an inherited estate may well be difficult to determine precisely and older policies may have already benefited from the investment flexibility (and hence potentially higher returns) that the inherited estate has provided.

Allocation of aggregate incentive payment on a prospective basis

An alternative approach is for reattribution payments to policyholders to be determined on a prospective basis, whereby the offer to policyholders in a reattribution would reflect the value of what they were giving up from expected future distributions from the inherited estate.

It is possible to carry out calculations to assess the present value of possible future payments to current with-profits policyholders on such a basis. This is inevitably subject to uncertainty, since it involves a number of assumptions about the factors that affect future excess surplus

distributions, such as the amount of new business, investment conditions, and the FSA regulations in force.

A prospective approach would tend to lead to policyholders with longer maturity dates gaining more from the reattribution, as it is more likely that during the lifetime of their policy distributions of an excess surplus, in the form of special bonuses, would arise. This would generally benefit policyholders who joined the fund recently.

Equity between classes of policy

There are also issues in ensuring equity between classes of policy in a reattribution.

The general practices of the firm in determining bonuses may be relevant in ensuring equitable treatment of different policy classes. For example, if policies with monthly premiums have the same bonus as policies where the premiums are paid annually, it could be reasonable to expect them to be treated similarly in a reattribution.

Minimum or fixed element in the policyholders' incentive payment

It may be considered appropriate for the firm's policyholders' incentive payment (PIP) to:

- include a fixed element as well as an amount related to the policy itself (size, term, etc); or
- provide for a minimum amount.

A minimum payment, or a fixed element, may be regarded as compensation for the burden on all with-profits policyholders of having to consider the reattribution proposals, many of whom will participate in the consultation process.

Alternative possibilities for the allocation of benefits in a reattribution

We have seen that a number of approaches are possible, and a firm carrying out a reattribution will determine what it desires. There may, however, be some practical issues in making the

detailed calculations on a policy-by-policy basis to achieve the desired result. Some of these constraints may reflect what data is available for each policy.

In practice, it can be expected the payment to policyholders in a reattribution will be derived from some formula. If the formula was based on asset share, it would tend to give relatively more benefit to policies that had been in force for a longer, rather than shorter, period. One approach could be to devise an algorithm, which might be based on asset shares, but applying adjustment factors that differ between policyholder groups in such a way to produce the desired result.

The desired result may reflect some form of retrospective or a prospective approach, or have some elements of each. However, we would still expect some comparison to be made between the outcome (i.e. the incentive payment that was offered to a policyholder) and what the policyholder was giving up from expected future distributions from the inherited estate. This comparison would be relevant in a policyholder's decision on whether to accept the incentive payment that was offered.

3.03 Equity for non-electing policyholders

We would expect a reattribution scheme to protect the position of non-electing policyholders, i.e. those who decide not to accept the incentive payment that is offered.

That protection may be to ensure that non-electors' position is unchanged, or that they are not worse off, as a result of the reattribution. By 'position', a number of issues may be covered. For example: the security of the fund, its investment strategy and the expected payouts are important.

Considering this requires examining what the position of the fund will be post-reattribution, bearing in mind that the incentives in managing the fund may change following the reattribution.

However, the position of the fund will be affected by a number of factors, not all of which are under the firm's control. For example, investment conditions and the amount of new business written will be relevant. Forecasts, and possible ranges, of these factors, can be made at the time of a reattribution, but they are not certain. There is also uncertainty about regulatory policy. Therefore, the reattribution scheme may need to consider a number of future scenarios and the position of non-electing policyholders under each. The outcome may be that the protection for the position of non-electing policyholders is described in terms of the outcome of a number of scenarios.

4.00 The AXA Reattribution

There has been only one reattribution of an inherited estate on the basis of policyholders being given the option to forgo rights to a distribution from the inherited estate (AXA Equity & Law, 2000).

4.01 Allocation of the policyholders' aggregate incentive payment

AXA Equity & Law included a common amount (£100) to all policyholders as part of their offer. In addition, the allocation of the PIP payment between policyholders was determined on the basis of some policy-specific factors.

Examples of the cash payment offered to AXA policyholders are:

- conventional with-profits life policies:
 - £100, plus 1.2% of the with-profits sum assured plus 2.4% of the reversionary bonus
- unitised with-profits policies:
 - £100, plus 2.7% of the value of the with-profits units, plus (for policies on which regular premiums continue to be paid) 1.35% of the sum of the future with-profits premiums payable in the future;
- personal pension deferred annuity policies:

- £100, plus 12% of the with-profits deferred annuity sum assured, plus 24% of the reversionary bonus;
- personal pension unitised with-profits policies:
 - £100, plus 2.7% of the value of the with-profits units, plus (for policies on which regular premiums continue to be paid) 1.35% of the sum of the future with-profits premiums payable in the future.

4.02 Position of non-electing policyholders

The AXA scheme included a number of provisions for the future financial management of the fund relevant to the non-electors and that for the electors. The financial management was to consider the financial strength of, investment strategy of and distributions from the funds, taking into account what was regarded as appropriate for both non-electors and electors.