

## Appendix 25 B

How with-profits business would operate without intergenerational transfer

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

**July 2009**

This paper has been written at the request of the Policyholder Advocate by **Chris O'Brien, MA FIA ASA**, who is a qualified actuary and the Director of the Centre for Risk and Insurance Studies, Nottingham University Business School.

**Mr O'Brien's paper is separate from the legal analysis of policyholder rights and interests in the inherited estates which are contained in this Appendix 25, and the Policyholder Advocate's legal advisers express no views on, and accept no responsibility for, its contents.**

## **Introduction**

With-profits business is currently operated with an inherited estate that is transferred between generations. That causes problems when a reattribution of an inherited estate is proposed, and can lead to the inherited estate being used in a way that favours shareholders over policyholders.

The purpose of this note is to set out how with-profits business might be operated without an estate and then how it might be operated with an estate that helps protect solvency but which avoids the problems of intergenerational transfers and inappropriate uses of the inherited estate.

## **Operating with-profits business without an inherited estate**

There are two ways in which an inherited estate might be unnecessary: if the responsibility for guarantees, options and smoothing are met by shareholders or alternatively from asset shares. The former possibility is open only to proprietary insurers, not mutuals; the latter possibility could be open to both. We set out below how such a proposal might work, and some issues. We then consider how the issues arising could be addressed by an estate that was not transferred across generations.

### ***Meeting guarantees etc from the shareholders' fund***

Sandler (2002) said the shareholders should charge for and provide guarantees and life insurance cover in with-profits life business; in this note we regard life insurance cover as a form of guarantee. We will also regard options as a form of guarantee, which can be provided and charged for by shareholders. Sandler said smoothing would be provided by a

smoothing fund, which would be neutral. The implication of his review was that new business would be financed by the shareholders.

We could take this a step further and say the smoothing is also provided by shareholders: the shareholders make a charge for this and then provide smoothing as promised.

So, policyholders forgo part of the premium, which passes into the shareholders' fund of the insurer (as distinct from the long-term insurance fund). That part is meant to pay for these guarantees (including life cover), options and smoothing. Let us assume that the charge would be the market cost of guarantees, etc.

What shareholders receive is those charges, and not a 10% share of profits.

The outcome is that there is no estate. The insurer's liabilities are primarily the asset shares and cost (market cost) of guarantees, options and smoothing. The assets available are the assets that back asset shares, and the accumulation of the charges that equate to the market cost of guarantees, options and smoothing. The assets equal the liabilities and there is no estate. .

This also implies that we avoid a situation where shareholders use an inherited estate to pay for shareholders' tax, acquire assets specifically intended to be of strategic benefit for shareholders or to finance or subsidise new business.

Let us assume that the charge for guarantees, etc is fixed at the outset when a policy commences. The shareholders recognise that the guarantees last for many years, and the charge reflects this. If there is a subsequent increase in the cost of guarantees, this may be matched by an increase in the value of the assets used to back the guarantees. For life insurance cover, an increase in cost would be met from a reinsurer if the insurer had effected reinsurance. However, the guarantees in with-profits business are complex and

long-term, and there may be no suitable assets available to match the liabilities, at least precisely. Furthermore, there are risks such as counterparty risk or operational risk to which the insurer will still be exposed. This model of the operation of with-profits business therefore assumes that the shareholders provide additional finance if the market cost of guarantees etc increases, in order to fund any deficit that arises. So, if there is a fixed charge for guarantees, etc, which cannot be varied over the lifetime of the policy, that charge may be set at a level that many policyholders find unattractive.

One way for the shareholders to manage this risk is for the charges for guarantees, etc to be variable over the lifetime of the policy. If guarantees are looking to be more expensive than originally thought, they increase charges. If smoothing is onerous they can increase the charge or reduce the smoothing they do, and so on. In this way, they maintain the equality of assets and liabilities, without the need to an estate.

This variability of charges means policyholders are subject to the potential for charges on existing policies to increase, which may well be unattractive. Indeed, this is near to where we are with some weak proprietary firms, with only a small estate, which are closed to new business and have increased charges and reduced smoothing (although some other insurers have also done that). So, just at the time when customers expect value from their with-profits policy, the shareholder makes the policy more costly or less attractive. If switching between providers was easy, that would help provide a market solution to the problem. However, regulation is almost certainly needed to prevent unfair treatment of customers.

### ***Meeting guarantees from asset shares***

An alternative is to charge guarantees, etc costs to asset shares. The insurer estimates that, for example, guarantees, etc cost 3% of each premium and deducts 3% of each premium, which accumulates in the long-term insurance fund and say it amounts to £X. The insurer

values its liabilities for guarantees, etc and this may be exactly equal to £X, in which case the assets and liabilities balance.

However, the experience of the fund may turn out to be different. In that case, the policyholders absorb the difference: this is mutual risk-sharing. For example, if the cost of guarantees is £1.2X, the insurer could increase the deductions from asset shares, by a retrospective adjustment and/or adjustments relating to future periods. If the cost is only £0.8X, it can immediately increase asset shares. Equality of assets and liabilities is therefore maintained. Policyholders are taking risks; but they should receive rewards that are commensurate.

This does raise some issues. For example, precisely how is an increase in guarantee costs shared among policyholders; there may be policyholder groups with different interests. Further, policyholders may feel it is not very satisfactory for the charge for guarantees to increase just when they become valuable: perhaps tantamount to withdrawing the guarantee or contrary to what has been implied.

### **Potential problems**

There is still a potential problem that the fund can become insolvent, in both cases, i.e. whether guarantees etc are met by the shareholders' fund or from asset shares. The shareholders' fund may run out of money. In the asset share case, the assets may be inadequate to pay the guaranteed benefits. There may be legal constraints on the increases in charges or changes in smoothing.

It is therefore appropriate for insurers to give priority to matching assets and liabilities. Together with controlling the type of guarantees given and the amount of new business written, this is critical as a means of managing the risk of insolvency.

We therefore expect insurers to hedge, to a significant extent, the risks in some way, using reinsurance for life cover, and using an investment strategy involving bonds or derivatives to meet financial guarantees. Hedging smoothing may be more difficult. Doing all this will potentially reduce the return for policyholders. It is not easy to say what is the optimal reinsurance/hedging. Perhaps the ‘risk appetite of the fund’ is used to determine what to reinsure and hedge, but that does not say how the risk appetite is set. In a proprietary insurer, the interests of shareholders and policyholders will differ. If guarantees become more valuable, shareholders may wish to reduce the likelihood of their being required to provide additional financing by moving to safe but low-yielding investments. However, this can reduce the potential payout for policyholders. One approach would be to say that reinsurance/hedging was determined with reference to the interests of policyholders, which would appear suitable: however, there may be different interests of different policyholder groups. Designing a coherent risk management policy therefore raises a number of issues.

### **‘Safety charges’ and an estate**

The cost of guarantees for a 25-year policy, say, is difficult to estimate, and the market cost may be an unreliable figure. One possible approach is for the charge for guarantees etc to exceed the expected cost, even if that is taken as the market cost of guarantees. The excess of the actual charge over the market cost can be termed a ‘safety charge’.

First, consider the case where guarantees, etc are met by deductions from asset shares. Here, the safety charges accumulate within the long-term insurance fund: a ‘safety sub-fund’; they are amounts available in excess of liabilities, and they form an ‘estate’.

Indeed, since regulation requires a minimum solvency margin (excess of assets over liabilities) this is a way to provide it. An alternative in a proprietary insurer is for this to be met from the shareholders’ fund.

One may ask why a policyholder would be prepared to forgo more than the market cost of the guarantees, etc. Clearly it is not easy to determine the market cost, and policyholders may be comforted by the idea of a safety sub-fund, even though they are paying for it. It is clear that the safety sub-fund is effectively policyholders' money.

When a policyholder leaves the fund, his or her portion of the 'safety sub-fund' is payable to him/her. Indeed, we can envisage two forms of asset share, one including, and one excluding the safety charge. The liability to the policyholder is the asset share excluding safety charge. However, if the fund has adequate assets overall to pay the asset share including safety charge when the policyholder leaves the fund, that is what he or she should receive. When all policyholders have left, there is no safety sub-fund (or other assets) left for anyone.

Alternatively, where guarantees are being met by shareholders, a safety charge is not strictly necessary if the shareholders' fund is meeting not only the guarantees but is also providing the capital for the minimum solvency margin. A safety charge could be made, however, providing policyholders with extra security. Since the safety charge is monies in excess of the market cost of guarantees, it is not passed to the shareholders' fund to pay for guarantees, but is instead retained in the long-term insurance fund. The outcome is that the assets in the long-term insurance fund exceed the liabilities and there is an estate. The argument that the safety sub-fund is policyholders' money still stands. As there are two sets of money providing guarantees - the shareholders' fund and the safety sub-fund - we have ambiguity as to who is responsible for what, the very ambiguity we have now with the inherited estate. It could be arranged on the basis that the shareholders' fund pays for guarantees in the first instance, and the safety sub-fund only if the shareholders' fund is exhausted. It is again the case that a policyholder leaving the fund takes his or her portion of the safety sub-fund with him/her, assuming the fund is solvent.

Is a safety sub-fund desirable? It gives extra security, which policyholders will place some value on. Indeed, there is a need to meet the cost of guarantees arising from non-market risks, which are not provided for as part of the FSA's realistic balance sheet, so some safety charge is appropriate for that reason.

If we do not regard the safety sub-fund as a liability, this has the merit of enabling it to meet the minimum solvency requirement: after all, both the safety sub-fund and the minimum solvency requirement have the same objective of enabling the fund to survive in adverse circumstances.

### **New business financing**

New business can be financed by shareholders, from the asset shares of existing policies, from an estate or by other means (external financing or reinsurers). The financing essentially involves a loan to cover initial costs and what is needed at the outset to cover the cost of guarantees. The loan is repaid from premiums paid by the new policyholder. The party providing the finance runs a persistency risk (including a risk that the cost of guarantees etc. becomes more onerous before the loan is repaid).

The shareholders' fund is an obvious choice to finance new business in a proprietary insurer. The shareholders may use external finance, or reinsurance, to assist them with this.

If asset shares were to provide the finance, there needs to be a charge: this reflects the risks to the existing policyholder, in particular the persistency risk that the new policyholder leaves the fund early; and the opportunity cost of the existing policyholder being unable to invest in equities and bonds. We would not regard this persistency risk as the type of risk that policyholders expect to run from their asset shares. Indeed, the persistency risk is greatest when circumstances are adverse, e.g. stock markets decline or

the insurer's reputation is damaged, which are also difficult times for the existing policyholders.

Using the estate to finance new business means that an estate has to be accumulated in the first place. However, it would not be appropriate to create an estate in order to finance new business: it is not in the interests of policyholders to forgo part of their premiums in order to enable new policyholders to enter the fund. If an estate is used to finance new business, an issue is how the rewards of writing new business are split between shareholders and others: an ambiguity best avoided.

It may be argued that writing new business brings some advantages to existing policyholders, for example, as regards expenses, tax and investment possibilities. Such arguments need to be subject to critical scrutiny. Care must be taken to ensure that decisions are taken in the interests of existing policyholders. In particular, justifying writing new business on the grounds of there being economies of scale that result, and which benefit existing policyholders, is very unlikely to be valid.

## **Uses of an estate**

The above envisages policyholders' premiums being invested in the interests of the existing policyholders. There is therefore no room for using an estate to make investments for the benefit of shareholders, for paying shareholders' tax or for subsidising new business.

## **Additional comments**

The above is an outline of an alternative way of operating with-profits business. However, a number of variations are possible, for example, how smoothing is provided.

Sandler suggested a number of the above ideas, but at the at time there was no quantification of the market cost of guarantees and no assessment of the size of insurers' inherited estate as is now done. Re-visiting the approach to operating with-profits business is therefore appropriate.

## **Conclusion**

In a proprietary insurer, shareholder financing of guarantees and new business provides clarity and transparency, with explicit charges being levied. However, shareholders need some mechanism to assist them in providing long-term guarantees, which are not easy to hedge. One possibility is for charges to be variable, albeit with some regulatory control. An estate may also have a role to play in providing additional safety for policyholders. It can arise from 'safety charges' in premiums, which are accumulated: the resulting safety sub-fund provides further security for policyholders. However, this requires clarity over the roles of the estate and the shareholders' fund.

The estate is not an inherited estate but is returnable to policyholders when they leave the fund.

There are some separate considerations for mutuals.

### **References**

Sandler, R. (2002) *Medium and long term savings: a review*. London: HM Treasury.