ABSTRACT OF THE DISCUSSION

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Mr P. J. Tuley, F.I.A. (introducing the paper)**:** There are two key themes to my paper. The first is that for every risk that there is in the fund, there should be great clarity about which of the stakeholders to the fund bears the consequences of that risk and, indeed, that reward.

The second is that I believe every fund should have not just a risk appetite, in the sense of a defined capital strength, but a well-developed risk appetite in the sense of boundaries to the quantum of capital that is too much or too little, and description of what actions would be taken when the capital becomes excessive or when the capital becomes deficient.

Both of those lead to a plan that would give a good blueprint for managing these funds through their extremely long lives. As we have all seen recently, having a very good plan is a great comfort when you come to very stressful times, and indeed when you come to very benign times as well.

Mr P. J. Roberts, F.I.A. (opening the discussion)**:** I should like to focus on an early issue raised in this paper, that the concept of Treating Customers Fairly (TCF) is based on absolute standard rather than reasonable expectations. I would interpret this to mean that discretion, so inherent in with-profits products which means, amongst other things, the ability to change practices with changing circumstances, is being challenged by the author. Historically, with-profits funds have used discretion in tandem with the estate to manage evolving commercial and economic conditions in a number of ways.

The first is by enabling guarantees to be written at a price which in the long-term is lower than the market demands at outset. Although a market-consistent charge for writing a guarantee should be levied at outset, the actual cost of the guarantee will emerge over time and the profit or loss compared to the initial charge should be available to recycle back into policy benefits.

This presents a different offering to third way variable annuity products in that with-profits contracts would be expected to perform better in good scenarios as profit is recycled but would give policyholders more volatile lower returns in poorer scenarios, as the loss is recycled, although the guarantee underpin would remain. If we believe that equities will outperform bonds in the long-term, then the former situation should outweigh the latter.

The second is by sharing the experience of non-investment risk between different generations of policyholders, thereby smoothing out the impact of adverse experience on a single generation. We have seen for example, how longevity risk, borne on older style deferred annuity contracts, or contracts with guaranteed annuity options, have been shared more broadly over generations of policyholders.

The final way is by smoothing investment experience between policyholder generations. However, as the author points out in ¶2.8(4), practice has changed in the recent past, although I would interpret this as being largely driven by regulatory pressure with the introduction of the conduct of business rules rather than commercial decisions.

However, if I take the author's arguments to the extreme, where we move to a position of minimal discretion with a much reduced estate, will with-profits still work? I think the answer is a qualified "yes", provided firms can develop suitably detailed frameworks or plans. I envisage products where risk-sharing between generations of policyholders and between shareholders and policyholders can be maintained within one framework. The framework would need to be articulated in detail, focusing on who bears which risk between shareholders and policyholders, and where risks are borne solely by policyholders, how those risks are shared. The framework must not focus solely on risk sharing but also describe how emerging profits and losses on the risks are calculated and managed. It would be easier to draw up this framework for certain risks than others. For example, it should be possible to manage investment guarantee and longevity risk within a thinly capitalised with-profits fund, although investment smoothing risk

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would prove more difficult and may have to be sacrificed unless a sizeable estate can be maintained.

Perhaps it is time for actuaries to challenge how TCF has been interpreted in light of the landscape defined by the House of Lords ruling on Equitable Life, and in that context, I would welcome more debate by the profession in the areas highlighted by the author.

Regulators have been trying to get companies to define more clearly how the with-profits business is operated and place limits on the discretion which companies can exercise. The problem of TCF is a complex one and there are no simple or absolute answers. All one can say is that one's view of TCF depends on the perspective in which you approach the meaning. In this respect, it is very difficult to try and shoehorn all companies into a single approach or definition, which is to some extent, what the FSA have been trying to do over the last few years. As far as managing existing business is concerned, we should not lose sight of the fact that most policies in-force today were taken out well before the current regulations and, for some, even before asset shares became the benchmark for payouts. I agree with the author that we need clarity around who bears what risks and in that respect, we should recognise that there are numerous stakeholders. There are different types of policyholders, different generations of policyholders, the inherited estate, if one thinks of that as a separate entity, and of course shareholders in some companies.

However, in this age when we are all looking for clarity, transparency and simplicity, we do need to strive to achieve those objectives in respect of the financial management of with-profits business, and especially in relation to new business. In these uncertain times, I would have thought that with-profits, with its underlying guarantees and objective of smoothing short term fluctuations, should be an attractive product proposition, but this will require clarity as to how discretion will be exercised and how risks will be socialised between different policyholders, between policyholders and the estate (if any) and between policyholders and shareholders.

One specific area I would like to comment on is the distribution of excess surplus in the run-off of a closed fund. This requires particular attention as the ability to correct the situation if things get out of control, diminishes as the fund runs down.

There are three particular aspects I want to mention: the pace of distribution of any excess surplus, the impact of expenses and the position of mutuals writing non-profit business. The pace of distribution is all about balancing the interests of policies maturing in the near future with those with long, outstanding durations. Given that any distribution of the estate is a windfall, companies should have significant discretion in what they consider to be appropriate. The longer term policies are the ones that bear most of the risk in a fund which is in run-off. They are the ones that may suffer most from a reduction in equity backing ratio and are also the ones which, because of the way that most companies levy charges for guarantees, bear most of this cost. So I would see good arguments for taking a prudent, back-ended approach to distributing the estate, even if this means that some policies, at least in the good scenarios, will do very well in the end; the same policies could equally do badly if events go the other way.

Turning to expenses, if the with-profits fund is part of a going-concern business, then it should be possible to protect the declining fund from rapidly escalating expenses. However, if the company as a whole is closed to new business, then the impact of fixed costs will inevitably result in cost escalation well above inflation. Rather than allowing this to impact on the longer term policies, it would seem reasonable to use part of any inherited estate to set up expense provisions to meet not only the short term closure costs but also at least some of the long term diseconomies of scale.

Finally, on the question of mutuals writing mainly non-par business, if there is sufficient capital to support this business without exposing the declining block of with-profits business to significant risk, then I see no reason why this shouldn't be a potentially viable business model. Whether it is acceptable to the current members will depend on who those members are, their voting rights and the normal governance processes of the mutual. For some mutuals, it is not just with-profits policyholders who are members. There should be no automatic requirement to distribute all of the inherited estate to the current group of with-profits policyholders if members are prepared to accept alternatives.

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Mr G. D. Clay, F.I.A.: I am somewhat concerned that the circumscribed relevance of certain points is not immediately apparent. For example, does a comment apply only to closed funds or to all funds? I think that with very close reading, those with experience of managing a with-profits fund can infer the meaning.

In ¶2.1 the paper contrasts the position now with that 20 years ago, and it asks in ¶10.5 how low the equity backing ratio (EBR) can now be and remain credible against the proposition offered when the policy was effected 20 years ago. I suggest that this is a biased question as some of the policies claiming now, have been in force for over 50 years, and the proposal was made when EBRs were much lower than they are now!

I think it may be appropriate to reflect on the evolution of with-profits since World War Two. After all, Redington, a Past President regularly used to review for his board the economic and fund history of the previous 50 years, regarding it, as did the board, as information relevant to the decisions they were about to make. I summarise his comments from my knowledge of the same company.

In 1950, the EBR was less than 20%, and a large part of that was property, a fair part of which was actually mortgages. Therefore the true EBR, as we would now understand it, was almost certainly less than 10%.

Redington encouraged the board to buy equities from the early fifties on the basis of the higher return to be expected on equities rather than on fixed interest, and he comforted them that the perceived risks were overstated because the future market value was effectively irrelevant essentially because, even on closure to new business, a with-profits fund would experience many years of positive cash flows as premiums were received before a corresponding period of negative cash flow with, finally, the remaining equities providing a positive cash flow *ad infinitum* once all liabilities had been met. Incidentally, there was no suggestion of paying out the inherited estate to with-profits policyholders in such circumstances.

The EBR rose steadily, or relatively steadily, over the next 40 years, and it eventually exceeded 90% in the 1990s. It has been reduced subsequently as a result of management actions as the prospective equity risk premium has reduced. However, it does remain at the high end of a much wider market spectrum than I think used to apply.

A second with-profits feature that has changed greatly over the last 50 years is terminal bonus (TB). It was introduced by 3 companies in 1956, largely in response to the rise in equity dividends and therefore market values; its size then grew enormously over subsequent decades.

For a 25 year endowment assurance, the total bonuses on a maturity claim in 1950 might equal half the sum assured. In the 1990s, the total bonuses (reversionary and terminal) might be six times, or for some companies even ten times, the sum assured. Bonuses have become a far bigger part of the total benefit. Over the last 10 years bonus rates have fallen substantially, in line with the decline in the average achieved investment returns over the lifetime of the claiming policies.

What do we perceive from the analysis of these two aspects of with-profits? Obviously, the world has changed in 50 years, and so the product we are selling has changed. But what are we supposed to do with the product we sold which has remained in force all the time? I fear there is an unstated assumption that one should not have sold such long-term policies; but companies did sell them, and so we must manage them because people did buy them, mainly I think for protection; some were whole life, some were endowments to age 65.

Did anyone complain before about 2000 that these enormous changes in asset mix, which had been made on investment grounds as a sensible response to inflation, and which had led to enormous increases in claim values (at least in nominal terms) were unfair to any policyholders? No. The changes were applauded as using to policyholders' advantage the flexibility and discretion that management had to respond to changing circumstances. I fear that the author's recommendation of increased prescription, greater definition and attempts to describe how the fund would react across the whole enormous possible range of future circumstances would, in fact, make with-profits funds impractical to manage fairly in the future as it emerges.

In Redington's 1981 paper, the Flock and the Sheep, he repeats points that he had given to the board over his final 15 years as the actuary and which had informed his comments as a

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director subsequently. His key message is that more attention could prudently have been given to the benefits paid to the Sheep (i.e., cohorts of like policies) than to the Flock (i.e. the overall solvency of the fund).

It is noteworthy that it was universally accepted in all the discussions around that time, and previously, that with-profits could not be pushed so far that its benefits equalled unit-linked benefits, because in essence that is when each sheep receives contractual benefits which are subject to no management discretion.

There is a reference in ¶5.2 to deliberate underpayment of claim values, at least against asset shares. I think the period referred to is undoubtedly pre-1990, and I suspect it may go back to the 1950s. To my knowledge, the first suggestion that something like an asset share might be relevant to the management of bonus rates for a with-profits fund was made in about 1970.

I do not believe that targeting claims on asset shares would have been compatible with Policyholders Reasonable Expectations (PRE), or therefore TCF, for my former company prior to 1990 because that is roughly when the idea of an asset share was first exposed to its policyholders.

It is also worth noting that, UK life companies started to issue with-profits products, as a pure investment only product in 1956 when personal pensions first attracted income tax relief. Most of those were annual premium policies, but if you judge by the press comment, there is now an implicit assumption that all with-profits products are single premium investment-only products, and probably rather short term ones. Investment-only products became dominant only from about 1990. All prior products had a significant life cover element, at issue at least, although inflation submerged the importance of the basic sum assured relative to the total maturity benefits rather rapidly.

I turn now to some detailed points. In ¶5.3.4 there is reference to the recent asymmetry of emerging smoothing costs. Broadly speaking, I think all funds made a smoothing profit between 1958 (after the Suez dislocations in the market) and about 2000, apart from some very heavy losses on claims in perhaps 4 years after the 1973-1974 cumulative fall in equity values of round about 70%. Perhaps there is a long-term consistency in making smoothing profits for 40 years or so and then smoothing losses over the next 20 (or more). Asymmetry probably depends on what period you pick, so data mining is an obvious danger.

In ¶6.6 there seems to be an implicit assumption that policyholders in an open with-profits fund have some expectation to a distribution from the inherited estate. Why? On what basis is that part of fair treatment rather than a windfall?

In ¶12.4 there is a comment that there are significant divergences between open and closed funds. Is this a general comment or is it intended to relate only to EBRs?

In ¶2.6(2), there is a reference to cutting surrender values to stop, as I would interpret it, a run on the fund. In the 1970s, as interest rates rose rapidly, the regulator actively encouraged companies to do that. I think many companies imposed a £1 surrender value on all policies effectively preventing surrenders while they sorted themselves out. Was that really unfair? There was no such comment at the time. In fact several of those companies then became insolvent, mainly where they had sold deferred annuities with a cash option, had matched the assets to the deferred annuity liabilities and therefore were unable to pay the guaranteed cash option values after the rise in interest rates.

Mr A. J. M. Chamberlain, F.I.A.: There are relatively few areas where I take a different view from the author but I would like to mention a few points. Although this does not necessarily mean I agree with everything else, I do feel I concur with the broad thrust of the paper.

I do wonder if, as the author suggests, the pooling of fortunes so fundamental to the concept of insurance should be as completely discarded as suggested in ¶2.1. Paternalism may be unfashionable, or at any rate it was until the recent crisis, but pooling of risks and rewards is still an important mechanism in many fields and management of a with-profits fund may still benefit from this approach.

I think I would also differ from the author on some of his analysis of the differences between PRE and TCF. But I would only really be debating the meaning of PRE because I do not think I

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differ materially from his thoughts on TCF, so this might be of only historical interest. I think I differ from Mr Roberts in his suggestion that there was a difficulty in the way the paper talked about changing of practices because I do not think that the paper restricts the changing of practices, but it does indicate that you cannot change what is fair no matter how slowly. I think I would agree with that. I think it was also true of reasonable expectations. PRE also included a concept that things would need to change if circumstances changed, but what those reasonable expectations were did not change, because I never thought they were a number.

I wonder if the author also restricts the concept of asset shares too much when he limits augmentations to those which are permanent. It is my view, that the greater use of enhancements to asset shares which are expected to survive but which, in adverse circumstances, can be retracted is the better way of managing the fund. Other parts of the paper do indeed seem to support this view, although not the definitions the author gives.

I also disagree slightly with Mr Clay, because although the term "asset shares'' may have developed at the time he spoke of, I certainly remember in 1979 the use of retrospective reserves as the means of setting terminal bonuses which means it must have been pretty old by then.

When looking at the inherited estate, there are some old ideas which I think need to be recalled. Firstly, in the past, there were regular references to every generation of policyholders being expected to contribute to the estate. The reasons why this was so were not always clear, and like many statements that are made, it was clearly a simplification, but the deliberate underpayment the author referred to in ¶5.2 might well be partly explained by this to the extent as Mr Clay says they were indeed deliberate. I also feel that the shareholder tax issue is often given undue prominence today. In truth, the assessment for corporation tax on the long-term insurance business of an insurance company is a single assessment, and although there is a calculation which uses the mainstream corporation tax rates, and which is clearly intended to capture profits attributable to shareholders, this tax is, and remains, a tax that falls on the insurance business. I do not think it is obvious that the incidence of his tax, just like any other factor that may change, should mean that the profit sharing formula that is laid down for a fund needs to be amended.

I do agree with Mr Clay that the paper makes too much reference to the smoothing rules which act as a drain on the inherited estates today but omits mention that the growth in payouts, almost unbroken from the post-war period through to the mid-90s, probably saw some significant opposite effects, and indeed will have contributed significantly to the build-up of inherited estates.

Looking at the issues addressed in the paper, I would set out some additional principles of my own which complement those the author has included.

Firstly, shareholders should not be assumed to be philanthropic. Their underwriting of the fund is a reality but the presumption that they will do so was never a foundation of the business that I still think has more characteristics of a joint venture, even if the shareholders can be seen as the managing partner.

Secondly, each policyholder has made a contract with the company and with the fund. Different policyholders have different products, different guarantees, even different premium rates. Particularly following the Equitable case, I think it is a better view that the bonus system should not be used to reassess the charges levied or the premiums charged. The logical extension of this would mean that all policyholders gain or lose from the margins, positive or negative, in those charges, and the experience that emerges, not just those policies which were paying for, or contributing to, that source of profit or loss.

Unlike Mr Clay, I do accept that the inherited estate should be distributed in a closed fund or where it becomes redundant, and I would hold this view whether or not the FSA had made rules in the conduct of business source book.

The much talked about tontine effect is covered in several parts of this paper in relation to the distributions. I applaud the author's resistance to the knee-jerk reaction to that expression, and his avoidance of the temptation to advocate rapid distribution of the estate before the risk reductions in a closed fund in particular make this prudent.

Maturing policyholders today have largely enjoyed the risk bearing capacity of the estate,

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albeit not always to their profit, and it would be just as an unfair to distribute it prematurely as too late, for the reasons the author describes.

In many demutualisations in the 1990s, I felt the balance between those who had been longer in the fund, and those with longer to go in the allocation of benefits, was wrong. With some notable exceptions, the assumption that a long time in the fund was equivalent to a large contribution to the estate held sway. I do not believe this was particularly true, with the contributions to the estate tending often to come at exit rather than at any other time. But more importantly today, the estates are typically working hard and their distribution unjustly risks the reasonable expectations of those policyholders with long outstanding terms.

Fairness is a difficult concept to deal with in practice, although, like the proverbial elephant, we all think we can recognise it, and the author has contributed well to the description of its application to the management of a with-profits fund.

Mr A. Arbaney, F.I.A.: TCF should not prevent advances in techniques. There have been improvements in recent years in the techniques used for the financial management of with-profit funds. In my view, these techniques support the TCF principle. I am referring primarily to the use of market consistent methodology in the assessment of liabilities and the identification of 'hedging' assets for the cost of guarantees.

Where the cost of guarantees is met by the estate, it is a natural improvement in financial management to hedge those costs, even if this was not being done when the policy was written. If the costs are being met by asset shares, it is in my view, even more important to hedge those costs as otherwise any volatility in such costs will fall on policyholders and make their payouts potentially more uncertain.

This brings out the subtlety in the application of treating customers fairly. Hedging usually involves 'hypothecation' of assets backing the cost of guarantees. This same term, 'hypothecation', can also be used for the practice of allocating different asset mixes to different groups of policies. The latter is a totally different issue and one where the conclusion as to whether 'hypothecation' is appropriate might be completely different.

There are also other techniques in the pipeline which will improve financial management, primarily through better management of risks, and I would urge that TCF should not inhibit the introduction of such techniques. In fact, I would hope that at some point in the future, TCF would require adoption of modern financial management techniques where this does not conflict with contractual terms.

My second point relates to ¶12.3, which refers to comparison with peer companies. I do not think this is a process that can be used for most TCF decisions. Companies differ in many respects, with different financial strengths, different histories and different fund structures. Within a single company that has several sub-funds, the decisions can be unique and different for each sub-fund.

The difficulty is not with agreeing the principles, and I agree with many of the principles stated in the paper, but with the application of those principles in practice.

As an example, ¶11.7.5(3) refers to the distribution of any excess of inherited estate over economic capital. This would mean that the economic capital is excluded from payouts to those policies that mature in the short term, but would eventually be included in payouts in the longer term as the size of the economic capital will naturally reduce over time. This deferral to later policy payouts may be regarded as unfair. What if in a particular case retaining 100% of economic capital is deemed unfair, but retention of a proportion of economic capital is deemed fair? What proportion would be fair? If 50% seems reasonable, what about 40% or 60%? Each decision can have different impacts on policyholder payouts at different durations.

There are many factors bearing on each TCF decision and I do not think guidance would be able to identify the appropriate course of action given the wide variety of different situations that arise. What I believe is needed is the equivalent of many pieces of case law, but without going to court. The FSA has insight into most TCF decisions. I suggest that the FSA should publish details of these decisions and of the factors leading to the decisions, on an anonymous basis. This would be useful for the profession.

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Mr T. J. Sheldon, F.I.A.: While the concept of asset shares is not that new, as Mr Chamberlain has remarked, both the availability and the reliability of data to support assumptions, and the required computing power, not just to calculate asset shares but to use them in the financial management of a with-profits fund, are relatively recent.

Contracts were generally regular premium and were considered to be long-term savings with financial encouragement to complete the term. Contrast that with the position today under the UK regulatory regime, where surrender values are expected to be broadly in line with asset shares. With-profits business was aligned with the ethos of mutuality and the principle of sharing risks, even if those risks were not analysed to the extent that they are today. Crucially, there was also greater trust in the industry. Against that background, it is perhaps not surprising that we struggle to define PRE and TCF and make clear exactly what risks are being borne by policyholders.

Most companies writing with-profits business relied on their estates to provide investment freedom, absorb the costs of guarantees and smoothing and generally act as a buffer against adverse operating conditions. While the management of with-profits business is today considerably more scientific, the underlying principles are I believe, unchanged.

The author suggests that management actions should be aligned with the need to maintain the desired level of economic capital, whether that capital is met purely from resources within the fund or relies to some extent on shareholder capital outside the fund. Such an approach would seem consistent with the conduct of business rules regarding excess surplus since it is natural to regard excess surplus as that amount not required to manage the risks to the business and hence be linked in some way to ICA or to economic capital.

It is, for example, necessary to consider what level of equity backing ratio should be used for the economic capital calculation. While the current level is typically used, what matters is not just the level of EBR in the fund at any point in time, but the freedom to invest in equities and other risky assets. If, for example, the current EBR is, say, 50%, but investment managers have permission to increase that to 60%, then I would suggest that the 60% figure should probably be used in the economic capital assessment.

Section 7 of the paper analyses various methods of charging for the cost of guarantees. The prospective method where the cost is commonly expressed as an annual charge to the asset shares (which may be adjusted over time to reflect both past experience and changing economic conditions) lends itself to the market-consistent approach to valuing guarantees, if only because the charge can then offset, at least to some extent, the value placed on the guarantees in the realistic balance sheet.

Profits which emerge in the estate as a result of those charges can then be fed back to policyholders' asset shares through the excess surplus mechanism or through other management actions.

The retrospective method described in ¶7.9, on the other hand, is more aligned to the emerging cost or "real world" assessment of guarantees. That approach is likely to be less beneficial to the realistic balance sheet, though arguably more in line with the management of a with-profits fund. It might though, be characterised more as pay-after-you go rather than pay-as-you-go and can suffer from a lack of smoothing.

With-profits funds have generally been managed on the basis that solvency is paramount and that such a view would be consistent with PRE. In ¶10.7 the paper suggests that this would also be true of TCF.

In the context of reducing equity backing ratios in falling markets, it is though, not entirely clear what may or may not be consistent with TCF or indeed PRE since solvency and investment management objectives may well overlap to some extent.

During the last bear market at the start of this century, those funds which were swifter in disposing of equities on the way down, not only achieved better fund performance as shares fell in value, but were also better placed to take advantage of the subsequent bull market by being able to restore their equity backing ratios closer to historical levels.

In conclusion, the author argues that we need to reduce the breadth of discretion, though I suspect many will say that the regulator has done that already, and that greater clarity comes

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from understanding who bears what risks and to what degree or risk appetite. While that sounds reasonable, there is still the need to communicate all this in terms of potential exercise of discretion to policyholders, at least to those and their advisers who are still interested and listening.

This is where the real difficulty comes because of the need to retain some discretion which ultimately cannot be circumscribed because of solvency constraints, assuming that guarantees continue to be offered at meaningful levels.

Mr A. D. Smith (Student)**:** I do wonder whether we are missing the big picture here when it comes to protecting investors. Treating customers fairly is a nebulous principle, a bit like making people happy. Fairness is not only subjective but also biased.

So we should all welcome attempts to clarify what TCF means, especially from the author. Building an actuarial consensus is a good start and the author's paper is very welcome in this regard. But an actuarial consensus is only as good as the regulator's future respect for that consensus. I think insurers still fear that future regulatory action on TCF may be unpredictable, contradictory or retrospective. This represents an operational risk which should theoretically be reflected in insurers' capital assessments. While such a situation holds, TCF has the unintended consequence of increasing uncertainty for everybody, making insurance more expensive and reducing providers' profit margins.

I hope our profession will work closely with the regulator in future to develop clarity as to how TCF is to be enforced, but also to avoid the current imbalance where some of the safest products bear the most onerous and confusing regulation.

Mr C. D. O'Brien, F.I.A.: I have three comments in the context of management actions, which we now understand better than we did before because we see the financial position of large with-profits insurers in their realistic balance sheets, where an important achievement is incorporating management actions in the assessment of assets and liabilities. We can then better understand how the fund is being managed and what the financial position of the companies is on a realistic basis.

However, it is not compulsory to incorporate management actions in the assessment of liabilities, in which case the balance sheet is then maybe prudent, but prudence does not really mean anything unless we understand what is missing from the realistic position. So I think if insurers are presenting realistic balance sheets without incorporating management actions, or without incorporating them fully, they should be disclosing what management actions they have in hand but which have been omitted from the calculations. We can then get a better handle on what the state of the fund is.

Secondly, there are a number of comments in the paper about the firm's risk appetite. I get the impression that risk appetite is a matter for the discretion of the board of directors; they can either adopt a high risk appetite or a low risk appetite. Clearly, when deciding what risks to accept and what to manage or hedge, they will have reference to the representations made to policyholders. But beyond that, it seems to me that the discretion is not really there. We would expect a firm to make decisions about its risk appetite in the same way as it makes decisions about every other decision in the company, pricing strategy, etc., on the basis of what is best for shareholder value.

It is difficult to imagine a firm consciously saying, "We will adopt a low risk appetite" if that produces a lower shareholder value than can be obtained by adopting a high risk appetite, because that is saying, "We accept that there could be a bid for the company at a value higher than we are currently achieving.'' It seems to me the question of risk appetite needs some further thought, and it also raises some issues about mutuals, where clearly the objectives are likely to be somewhat more complex than maximisation of shareholder value.

Thirdly, I think we probably need more analysis and discussion. The paper leaves some discomfort about what really is meant by 'fair' in all these questions where we are trying to make judgments about what is fair or unfair.

One perspective which does not solve the problem but which I suggest is useful to think

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through is that some of these issues about insurance company practices will end up in the courts, and what would the courts say about those practices? They would say, "What were the terms of the contract?" The terms of the contract will be imprecise, so what the courts will do is say,"Can we attribute some implied terms to the contract?" The first port of call is then to say fairness requires that the insurance company complies not with just the explicit terms of the contract, but also the implied terms of the contract.

I think it is a useful discipline to think about what are the implied terms. It doesn't necessarily give us all the answers but it is useful to think it through. While I agree that we want more discussion about management actions and management of with-profits funds, we do have to think that the next discussion might not be in this hall but might be at the Law Society.

Mr S. King (Visitor — Financial Services Authority)**:** I shall make a few comments, as a practitioner, as someone responsible within the FSA for carrying forward discussions with firms around the issues that are the subject of the paper.

Clarity for the stakeholders around the way a with-profits fund works is a very important issue. It has been, and has underlain, a lot of the work that the FSA has done on with-profits in recent years.

I think if you step back a stage it seems to be pretty clear that a lot of stakeholders concerned with with-profits remain rather unconfident in it. It is not a product that generates widespread confidence from people like the Treasury Committee or a lot of consumer representatives. It is against that backdrop, I guess, that one looks at the author's comments and suggestions for ways that things could be made better.

I thought the author's comments around clarity where risk is shared between the policyholder, between the firm and the shareholder were very valuable. For the practitioner some of the questions it led me to think about were: how could you do that? I thought there were a few hints in the paper, but some of the FSA bits of paper we have created have perhaps not borne the fruit that we might have hoped. I do not know whether you agree with that or not. Before we create more bits of paper we should be clear how practically would they be used.

I guess an interesting litmus test would be to think about how a firm would describe this balance of risk between policyholders, shareholders, and so forth; if we had written this a year ago how would it have served us today? Could we have written something a year ago that sets out that balance of risk and responsibilities that would have proved robust to the rather challenging year which I guess we have all lived through?

I know some firms would say if this proposition were put to them this would be tying their hands, it would make life very difficult. They would worry about gaming, consumers using a more explicit set of rules to enter and leave funds to the optimal timing.

Personally, for most consumers I come across that is not a reality, frankly. But there may be some out there who would do that.

Professor A. D. Wilkie, C.B.E., F.F.A., F.I.A.: As I understand it, in quite a lot of continental countries there is a great deal of with-profits business of one kind or another. The way in which profit is distributed there is much more prescribed than here. I do not know the details, but it strikes me that it is something that would be worth looking at. It is on the lines of doing an analysis of surplus on an arbitrary prescribed basis, which may or may not have anything to do with realistic values, and then calculating traditional mortality surplus, expense surplus and investment surplus, and those amounts are divided between shareholders and policyholders in some defined proportions.

Having a defined system like that seems to me better than rather vague concepts of fairness. It has always struck me that "policyholder's reasonable expectations" ought always to have been no more than that the system of distribution of profits would not be drastically changed.

A second quite separate thought is in relation to closed with-profits funds. The problem, as the author has pointed out, is that effectively if you declare too much bonus too soon, you may not have enough left, and if you declare too little too soon you may have too much at the end.

One way round that has been suggested is an agreed unitisation of everything, preferably with

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no guarantees at all, so people have not much more than a unit trust type of investment with something special on death.

Another way that I have thought of would be to distribute bonuses in the form of preference shares of rather a peculiar kind. I know a mutual company would not normally be issuing preference shares, but they would be a bit like preference shares that would have a nominal cash value. Interest would be paid on them preferably at a floating rate; this would be equitable for all the preference shares that were issued at different dates.

When the fund is finally wound up, the remaining assets would be distributed among the preference shares equally so that they would have an uncertain future payout, although they have had a determined interest rate in the meantime. These preference shares, if possible, should be tradeable, traded on the market.

The fund would need to publish enough information fairly continuously for reasonable values of these preference shares to be assessed by investors, who need not be the policyholders that received the payout at all. So the policyholders or their heirs would receive the preference shares, sell them at the market price, and other investors would be speculating on what the payout at the end of the fund would be.

Mr S. C. True, F.I.A.: There are two things that the paper is seeking; for the profession to regain its influence and, secondly, to share practice. I will try to do both.

It seems to me in all the discussions, I have not heard anyone talk about claim values or the customer. What do consumers want? Do they actually care about what the EBR was within the with-profit funds? Do they actually care about the amount of discretion exercised by actuaries? No, they do not. The vast majority of consumers simply care about the money they put in and the money they get back out (their "claim values").

If we want to regain influence in the wider community, I suggest we start talking about claim values and consumers and start using layman's language as well. It is laudable that we manage with-profits funds to an extreme level of detail, that we use fiendishly complicated financial models, but we have to start talking about what really matters to the consumer at the end of the day, otherwise all the commentators, or the policyholder advocates who choose to unpick with-profits business, will lay all the blame for anything remotely bad at the door of actuaries.

It is interesting when you look at with-profits tables, for instance, the bottom quartile companies are always lambasted for how appalling their actuaries must have been in the past; especially with some companies paying out many hundreds of times the premiums that people put in.

To pick on a point raised by Mr Sheldon earlier on, presentation and the explanation of discretion is absolutely key in regaining influence. I will illustrate this by sharing some practice. I have served on a with-profits committee for the past couple of years, the balance of which was non-executive directors, some of whom were non-actuaries. As a result, there was a great deal of education going on and robust challenge, which was very helpful to the practising actuaries. We were also fortunate in the sense that the funds were closed. The management of a closed with-profits fund is easier than an open one.

Three things were extremely valuable to us. One was the realistic balance sheet. There is no doubt that this is a relatively recent development imposed on the industry, but it is extremely helpful. The market consistent valuation is certainly a huge step forward. Second was a run off plan which looked rather similar to what a lot of you will remember as a financial condition report, which tests what might happen to the fund under various circumstances. That was extremely powerful as well. The third was the ICA. The way that these 3 items were linked together and used in the management of the with-profits funds was extremely powerful.

Our ability, as an industry, to cope with unprecedented shocks, must not be overly constrained. To this end, we must protect our ability to exercise discretion in these exceptional times. I will certainly back the other contributors who have said we must retain discretion, albeit we need to explain very clearly what levers we can pull in exercising this discretion (be it investment policy, amending surrender values, changing regular bonus rates, or maturity payouts).

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Mr A. M. Stoker, F.I.A.: Although the paper mentions mutuals, the focus is very much on with-profits funds in a proprietary office. Whilst I accept that in a proprietary context it is probably appropriate to distribute surplus inherited estate, I wonder whether this is the only course of action which meets PRE for a mutual. Is it right that today's generation of with-profits policyholders benefit from the "windfall" from distribution of surplus? Alternatively would it be reasonable to use the estate to transfer the business into a non-profit mutual? After all, non-profit mutuals provide a useful contribution in the banking sector. My second point concerns the valuation of assets. We heard Mr Clay quote Redington's view that "market values are irrelevant" and we certainly hear life companies today arguing that since they intend to hold bonds to maturity, it is only defaults that impact their on-going solvency and not the mark-to-market movement. In today's markets, where corporate bonds have fallen significantly in value, I therefore wonder how and whether companies should be allowing for this when calculating the asset shares on which maturity values are based. Clearly this issue is less relevant in relation to calculation of surrender values since surrenders could force companies to sell assets ahead of their maturity.

Mr P. J. Nowell, F.I.A.: It was found in past surveys that the customer seemed to think that they understood with-profits. You bought a 25 year endowment and you saved. Each year you got something saying that you had got a bit of bonus added and at the end of the 25 years you got a nice surprise because it was a lot more than that. This is something that was understood. It may not be absolutely right, but the customer thought that he understood it.

I would have thought if you look at what the customer should think that the with-profits contract does, it is not a "deposit-plus". I know that is what the IFAs try to make it sound like because it is an easier sell. But I suppose it must be somewhere between a unit-linked policy and a deposit, but probably nearer a unit-linked policy.

I think if firms start from the premise that that is the sort of thing that the customer should expect, and then work back from the answer to say what it is we are going to promise in the way of payouts and so on, and also what investment policy should we have so that we achieve something which, whatever happens to markets, is going to be not unreasonable as being between a deposit and a unit linked contract. That might be to do with the amount of fall that would be expected in a claim value, depending on market movements and what level of underlying guarantee is being given.

We can, these days, model all of this, so we can look at all sorts of realities, lots of simulations, and see what happens in those circumstances. If you come up with an investment, bonuses and guarantee policy, which is robust in as many of these circumstances as you possibly can, you can prepare some realistic management actions which work, even in circumstances like this or even worse. That might be a combination of investment policy, of dynamic hedging and some underlying option strategy to cover most of your downside risk. It is true that, on the one hand, you can sell a lot of equities as the market falls, but on some days at the moment it must be quite hard to reduce equity holdings. Then how do you cope with fluctuations, dips and bounces in the market as opposed to trying to pick vaguely the bottom of a bear market?

By doing a lot of simulations, you can work out a reasonably robust strategy which means you do not rush in, you do a certain amount at a time, so that when it comes to a particular problem like this, it is not an unusual circumstance but one you have already "seen".

If you have all of this together, it seems to me that solvency and valuation issues should be covered even on the many different bases we have to do now. With a robust strategy, you probably should be solvent under virtually any circumstances, because the reality is right and therefore to some extent if something odd happens to one of these valuation techniques, it is probably because there is an error in the logic or an error in the valuation technique. If you are going to remain solvent and payout on time and in full then the valuation system ought to tell you that.

So in terms of treating customers fairly, it seems to me that we should be looking at what the customer sees to start with, and then working back to do all this technical work underneath which the customer does not need to know about. The FSA probably needs to be convinced that

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it works but the customer is really not concerned. What he is concerned about is that in the changing world going forward, he is going to get what he expects.

Mr P. W. Wright, F.I.A.: I used to be the Appointed Actuary and then the with-profits actuary, of a unit-linked company that reassured all of its with-profits business. Some years ago I had a conversation with the FSA on how the company monitored that we were treating our with-profits customers fairly. I explained, "We produce annually from the FSA returns, and before that from magazines, the payouts on maturity and surrender at all the important durations for our policyholders and in every case the payout is currently in the first quartile. In fact, the payouts are quite a bit better than our unit-linked customers' equivalent".

The FSA's response to this was, "That is irrelevant. The payout is irrelevant". I did eventually persuade them that it was at least of some relevance. There is a danger that the FSA, and perhaps the Actuarial Profession, are not seeing the wood for the trees.

There has been a lot of talk recently with re-attributions of estates as to the nature of the duty to distribute estate from a proprietary 90/10 fund that is open to new business. While I appreciate many companies may say "I should have that problem now!", I am a bit surprised that this issue has not had a wider debate.

I looked at the fundamental tenets in ¶2.6 of treating customers fairly that the author proposes. I looked at (4), the second sentence of which says, "Management actions, and any shareholder duties, should be viewed from the customers' side as if they were an independent commercial body to the shareholder, while recognising the shareholders' rights." Two things about that. First of all, I do not think that it helps me decide whether the author is absolutely in favour of forcing a distribution on effectively a closed fund assessment or not, because subject to shareholders' rights could mean anything. Secondly, I believe that the established practice in a proprietary company is to put it the other way round, and I agree with what I think Mr O'Brien was implicitly stating, that the company is run for the benefit of shareholders, subject to treating its customers fairly, which is quite a different interpretation on the rules.

I would maintain very strongly that although the conduct of business rule, which was inserted to stop new business being written deliberately to drain an estate, is correct and is appropriate in the context of treating customers fairly, it is unreasonable to impose a duty on an open fund to make the excess distribution test on a closed fund basis.

The final point I would make is that there is a lot of talk about EBRs and having to keep them up. However there is no iron law that says that equities and property have to outperform gilts, and over quite a long period. So if a requirement is imposed to keep up an EBR, what do you do when the result of that is detrimental to the policyholder? Who is going to explain to the policyholder that this was in fact treating him fairly when in reality, the company would have wanted to have reduced the EBR?

Mr R. Purves (Visitor)**:** I was struck some years ago, when reading the Penrose Report, by a comment that Lord Penrose made. He said in essence that one of the problems with life insurance business, or with-profits business, was that it is too complex to be understood through the prism of one particular technical specialism. It was too complex to be understood only, and to be managed only, by people with actuarial qualifications; or to be understood and managed only by people with, say, legal qualifications or with other financial qualifications.

I think that the point he was trying to get to was that we are in a position where the management of business is complex enough that you cannot, as a single profession, hope to impose a dominant view on regulators and customers. It strikes me that is perhaps particularly difficult for the actuarial profession because your profession, above all others, is technical in content. It is subtle in its analysis; it is detailed.

My own experience of being an advocate is that it can be exceptionally difficult to communicate the fundamental logic of where actuarial analysis takes you. I very strongly endorse therefore the comments of previous speakers who said, in essence, let us think about what the customer needs from the customer's point view and work backwards from that.

My own experience from dealing with actuarial issues in court is that the more complex, the

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more complicated, the story you have to tell, the less likely you are to sell it to your tribunal. It does not matter whether the tribunal is a judge or a regulator. But, if you can frame what you are trying to achieve in terms of outcomes, and deploy all that analysis to achieve the outcomes in a way that is saleable and explicable in straightforward language, that, it seems to me, will take us a long way towards a shared understanding between regulators, lawyers and actuaries.

Mr I. G. Maidens, F.I.A.: It does seem to me that when we talk about management actions, and wanting to be clearer about what management actions are consistent with treating customers fairly, that we always need to bear in mind that what is actually fair at any point in time can only be measured in the circumstances at that time.

Until recently, I was involved with a company which had a wide range of with-profits funds within it that ranged from those which were paying out multiple hundreds of per cents of asset shares to those that could barely struggle to meet 75% of asset shares. Each of those with-profits funds needed to be managed differently. The circumstances in which they find themselves today could not have been predicted ten years earlier.

I think that to try to predict what is fair in terms of management actions at any point in time and actually codify that is extremely dangerous. It can lead to a position that may ultimately act to the disadvantage of with-profits policyholders and the with-profit fund generally. We have seen in some with-profits funds that demutualised a number of years ago, that people thought it was in the interest of policyholders to codify the way the funds were being managed at that time and to set out management actions and principles of financial management which could not be changed without going back through a fairly complex court process. In some cases this has made it very difficult for the managers of those with-profits funds to react to changing circumstances in an effective way.

I am very much an advocate of being clear how we are going to exercise discretion but let us not try to paint ourselves into a corner in relation to management actions because we simply do not know what is going to happen in the future. For example, arguments about capping guarantee or capital charges may seem very sensible now but ultimately if the choice is between increasing a capital charge or a guarantee charge or failing to satisfy regulatory reserving requirements or potentially even becoming insolvent on a Company Act basis, it is probably going to be in everybody's interest to increase the guarantee charge. The Government is not necessarily going to stand behind life companies in the way that it did behind banks.

The President (Mr N. B. Masters, F.I.A.): I thank the author for a succinct and insightful paper. I want to pick up on a couple of matters which resonated with me. The first one was Professor Wilkie's remarks about fairness being in the eye of the beholder.

I am currently chief actuary across a number of countries, and, in particular, our German subsidiary. This debate would have been meaningless to them. Their concept of treating people fairly is to do with, as Professor Wilkie pointed out, a formula. It is to do with the policy terms being the same as they were in previous periods. With this kind of approach, it is perfectly acceptable that new money going into the German fund can provide an economic subsidy to the back book. Indeed, this is what the German regulator requires.

So to put it into the context of how far different "treating customers fairly" is just across Europe, I suppose that probably gives us a context to why the European regulators do not necessarily all want home country regulation. My conclusion is that it is very important to understand the historic and cultural context, when deciding what it actually means to "treat customers fairly".

The other comment that resonated with me, and which has been mentioned several times, is concerning the nature of the guarantees. Mistakenly, we tend to think that we know about the pricing of the financial guarantees. I believe we have little real idea how to start pricing the interaction between policyholders' behaviour and financial guarantees. My own organisation has recently been trying to implement replicating portfolios, matching not just on one economic scenario but across the whole range of possible economic scenarios. If anybody has tried to look at the kind of dynamic lapsing you might get relating to guarantees in a German, or Swiss life

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fund, you will know that they are virtually unhedgeable. The cost is consequently very difficult to assess.

This leads me to believe that judgement and management discretion are still powerful tools in setting participation rates. This is the only way we can achieve any form of stability in order to meet the policyholders' need for steady returns.

I was very struck with the author's discussion of that process of moving out of equities and into bonds and a natural hedging, as it were, as markets go down. We have recently been developing CPPI products, where there is a formula by which you shift from an equity/gilt mix down to pure gilts. As equity markets fall the positive feature of CPPI is that, at the bottom, you simply cash in and, if you want, go back into equities. With a with-profits fund you do not necessarily have that choice. Maybe this gives us an insight into how surrender values ought to be looked at.

Picking up on the remark of Mr Stoker about looking at closed funds and their relevance, this gives us again some perspective on the whole of our discussions where we have been talking about what is effectively a part of our industry which has been closing down, and we have been working quite hard to close it down. The biggest single sellers now in Germany, Switzerland and indeed in Italy, are the with-profits bonds.

Mr C. V. Pountney, F.I.A. (closing the discussion)**:** Given the subjective nature of the material in this paper, it is inevitable that different shades of opinion have been expressed in the discussion. That has been the case at every previous discussion of PRE and related topics. However, on one point at least I believe there is broad agreement this evening; namely, that we need greater clarity in the definition of how firms intend that risks and rewards should be shared between the different stakeholders. Of course that does need to be tempered with the caution that we do need to retain discretion where it is necessary to protect the long-term future of the organisation. Any firm wishing to apply for internal model approval under Solvency II is likely to be undertaking a review of their risk appetite statements in the near future, and this timely paper will have underlined the importance of that exercise.

Having read this paper and returned to the discussions of earlier papers dealing with PRE, I found myself drawn to a very simple definition; customers expect both to receive their contractual entitlements and to be treated fairly when a firm is exercising discretion. My conclusion is that PRE is not dead. PRE embraces both contractual obligations and treating customers fairly and so PRE is the broader concept. Although that is contrary to the views expressed by the Court of Appeal and possibly a number of speakers, it does seem to be consistent with the author's views in ¶10.7 where he virtually says the same thing.

Contractual entitlements are legally enforceable, whereas fair treatment is less easily defined. That has been amply demonstrated by the discussion in the paper and this discussion. Perhaps in future the discussion needs to concentrate on the interpretation of TCF, accepting that it is part of PRE, and the two are mutually compatible. I think this paper has taken us a long way forward in that task but I think we still have a long way to go, as the discussion has demonstrated.

In ¶2.6 it is suggested that the meaning of TCF might ultimately be decided by the courts. I am not sure that is either desirable or possibly very likely. As we know, courts tend to decide on points of contract law. I do agree with the tests of fairness suggested in ¶2.6 but I was left with a feeling that perhaps there was something missing from the picture, and that something is an overarching set of principles that will explain why these particular tests, and perhaps a few more, such as suggested by one or two of the other speakers, might be the right ones. So this may be an area where further work by the profession is needed.

Turning to a point of detail, section 3 deals with asset shares, and there is a suggestion that the full asset share, as defined in ¶3.1, is the appropriate guide to claim payouts. I think there are some pitfalls around this area. Specifically, I think there is a slight confusion in the full asset share in that it combines a retrospective element, the bare asset share plus discretionary additions, with a prospective element, which is the market-consistent value of guarantees and discretionary smoothing. I am just left with a slight worry that, under stressed market conditions, it does not seem quite right to set individual surrender values on a basis where you are marking

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to market the non-contractual guarantees, particularly where implied volatilities might be particularly increased at that point in time. That would seem to benefit leavers by surrender at the expense of stayers.

Sections 4 and 5 deal with the inherited estate. Here I do agree that the full asset share does appear to be the best measure of quantifying policyholders' entitlements in order to arrive at the inherited estate. It is here that the author deals with the potential conflicts of interest that can arise. Clearly, this is the key area where a risk appetite statement is needed in order to clarify intentions.

Section 6 develops the theme, recommending that firms should have developed risk mitigation plans, anticipating adverse conditions and describing how the firm would react. Several speakers have commented on the difficulty of anticipating future eventualities. While I think nobody would disagree that this is sound advice, I think that the difficulty of anticipating such eventualities should not be underestimated.

The later sections have not really been discussed in much detail but there is an interesting commentary taking us through management actions in normal times, then through actions following some sort of stress event leading to abnormal times, and then, even more interestingly, what should happen after recovery to a new state of normality, whatever that might be.

The paper does represent the personal views of one individual. That is a strength as well as a weakness. It is a strength because the views expressed are very clearly articulated rather than being obfuscated, as is so often the case when a committee drafts a report. But it is a weakness because the balance that might have been achieved through debate, as in a working party, may be lacking.

Mr Tuley (replying): I thought the final comment of Mr Pountney that this paper is a single view, and has strengths and weaknesses was extremely important. The only merit of a paper of this form is to engender debate and to tease out what is good or bad practice.

There were other comments in the debate over the high level nature of the observations in the paper. When you get down to practicalities, what do you actually do? A paper of this form does not help.

Again, that comes back to the debate, whether it be in a working party or a sessional meeting such as this. We can tease out examples. We can ask the FSA for case studies, which personally I thought was a dangerous path. However, it is always difficult to capture ideas in a paper of this kind. One is always conscious of the other side of the equation. I made the statement that a with-profits fund should be run as if it were a commercial entity of its own, purely for the policyholders, but I also had to put in a statement this was always having regard to their shared rights, because they are shared rights. This is not a policyholder sole venture. This is often for a proprietary, a joint venture.

So I think the debate is very important. I hope that the paper has helped push on this debate. I agree very much with Mr Purves that actuaries are foolish if they think they can regain every power which perhaps we had as a profession 20 years ago. All I am asking for is to push the influence we have further up the percentage scale.

The President (Mr N. B. Masters, F.I.A.): Thank you very much indeed. Ladies and Gentlemen, it has been an enormous pleasure for me to chair this meeting. I have enjoyed the paper enormously and it is helpful to me, as I am sure it will be helpful to many practitioners facing issues relating to the attribution of costs of guarantees. May I also thank the closer for his wise words and his common sense, not to mention his ability to pull together what was a wide-ranging debate.

WRITTEN CONTRIBUTION

Mr P. J. Tuley, F.I.A.: There was a strong desire in the debate for overarching principles to guide actuaries in assessing TCF — principles that go beyond those put forward in ¶2.6. There

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was also recognition that clarity and transparency were commendable. Conversely, a plea was made that we should not lose the sharing of fortunes, namely the smoothing of experience which is a, if not the, unique feature of much UK with-profits business.

I fear the two aspects, universal principles yet the social sharing of fortunes, act against one another. Principles that are precise and effective in guiding actuaries in day to day judgements would founder on the unique situation, and history, of particular funds or insurers.

Therefore, I return to what I trust is a central theme of the paper; great clarity is needed as to which stakeholder bears which risk. In ¶2.7 the paper adds the need to champion the interests of the with-profits customers as if they were an independent commercial body. The latter suggestion was challenged by at least one speaker. However I feel we must move away from acting as if we were kindly shepherds of the "flock" of customers and become more aggressive in dealings with other stakeholders such as third party service providers, management suggesting new business opportunities, and naturally shareholders.

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