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TRANSPARENT WITH-PROFITS — FREEDOM WITH PUBLICITY

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ABSTRACT

With-profits business has flourished for over a century as a means of providing access to equity-type investment whilst smoothing the volatility risk. Today's world demands greater transparency, and with-profits has come under increasing criticism in this regard. The Working Party concludes that it remains good value as an investment vehicle and suggests how its transparency can be significantly improved.

The paper first analyses the characteristics of with-profits, which it notes has been permitted for stakeholder pensions. It then analyses the various criticisms of with-profits and considers how they can be rebutted without destroying its essential nature, pre-supposing the implementation of the Association of British Insurers' (ABI) Raising Standards scheme.

The paper concludes that greater transparency is both necessary for rebuttal and also achievable without destroying the with-profits concept, to this end proposing a model for the internal analysis of identified classes of with-profits business and the inclusion of specified additional information in the statutory returns to the regulators. It also proposes that policyholders be given slightly more information than is specified under Raising Standards. Finally the paper analyses the implications for the life assurance industry, which it considers acceptable.

KEYWORDS

Additional Disclosure; Criticisms of With-Profits; Raising Standards; Reporting Model; Transparent With-Profits

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When a man assumes a public trust, he should consider himself public property. Thomas Jefferson

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1. Overview and Executive Summary

1.1

> "Life insurers must now be hauled (inevitably kicking and screaming) into the 21st century. They must be forced to reveal the way bonuses are calculated, charges structured and sales staff bribed with hefty commission payments to sell what are too often unsuitable products to investors blinded by figures so complex that even a judge may not understand them completely."
>
> Sunday Telegraph — 24 December 2000.

Although the article in the 'Money' section concentrates on both the recent problems experienced by Equitable Life and its policyholders and AXA's attribution of the inherited estate between shareholders and policyholders, its tone expresses an endemic concern about with-profits as an investment option. Indeed, the article goes on to state that:

> "even those policyholders who realise they are being badly fleeced are trapped in badly performing plans by early surrender penalties and hefty terminal bonus weightings."

1.2 By way of contrast, as recently as ten years ago the United Kingdom life assurance industry and the actuarial profession would not have been challenged for stating that with-profits business had successfully met all the challenges of the 20th century, and should continue to flourish in the new millennium, just as it had for more than 200 years.

1.3 What has happened in the last decade to change public perception so substantially? Possible candidates are:

(a) pensions mis-selling;
(b) generalised criticism of life assurance;
(c) declining nominal investment returns;
(d) falling annual bonus rates;
(e) static or declining total claim values;
(f) demutualisation windfalls (life companies and building societies);
(g) life company mergers and takeovers;
(h) regulatory changes (e.g. illustration bases);
(i) possible shortfall on mortgage endowments; and
(j) pensions legislation (e.g. stakeholder, to protect against rip offs).

1.4 The Working Party was formed late in 1999, to respond, within a limited timeframe, to the critical perception of with-profits, and to support the inclusion of the with-profits investment option in the stakeholder pensions framework. This paper represents the culmination of its work, and concentrates on analysing the criticisms made of with-profits, without directly countering those which it considers misguided, and on suggesting changes to answer the criticisms and make the product more transparent. It does not include any substantial volume of original research. For completeness, Section 4

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summarises the current position regarding the inclusion of a with-profits investment option in stakeholder pension offerings, although the published regulations are in the process of being amended. It, therefore, reflects the Working Party's understanding, based on regulations that will be amended and on conversations and correspondence with Her Majesty's Treasury (HMT) and the Department of Social Security (DSS), which are responsible for stakeholder legislation.

1.5 The most fundamental feature of with-profits is that benefits are subject to discretion. This is essential for the smoothing of returns between generations of policyholders under varying conditions, which is characteristic of with-profits. Full pre-determination of benefits (either as amounts or through the application of an unchangeable set of rules) is incompatible with the with-profits concept. Nevertheless, the Working Party believes that the operation of with-profits can be made substantially more transparent without losing its essential nature.

1.6 The Working Party has explored several potential solutions to address the lack of transparency of with-profits, whilst retaining for the company sufficient discretion to manage the business appropriately. The most effective solutions can be summarised as 'freedom with publicity'. This means that, whilst companies should be allowed to maintain a wide range of discretion in managing with-profits, they must explain how such discretion is currently being, or may in future be, used in determining policyholder benefits.

1.7 The Association of British Insurers (ABI) announced, in October 2000, its Raising Standards (RS) proposals, under which accredited companies will undertake, *inter alia*, to provide, for all their life assurance and pensions products currently being sold, information that is clear and comparable, both at issue of a policy and yearly thereafter. For unit-linked products, permitted charging structures have been restricted in order to improve understanding. Similar principles have been applied to with-profits products.

1.8 This paper uses much of the RS terminology, and seeks to build on the RS proposals as they affect with-profits. Relevant aspects are that RS requires accredited companies to provide customers with clear explanations about how with-profits works, how exit payments are determined, and what factors affect how much these payments are. Accredited companies must also provide a yearly statement, detailing the previous and current values of the investment, along with the projected benefits. Finally, accredited companies must notify investors of any substantial changes that the company has made to the way in which it manages the with-profits fund.

1.9 RS introduces the term 'special publics' for identifiable groups of people with a distinctive interest in life assurance. The special publics include:

(a) government departments;
(b) regulators;

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(c) IFAs;
(d) financial journalists, for both the trade press and national media; and
(e) consumers' representatives.

1.10 RS recognises that with-profits is more complex than unit-linked business, and therefore provides for companies to issue two alternative with-profits documents, namely a simplified guide (see Appendix C), to be issued automatically, and a detailed guide (see Appendix D), to be issued on request. Initial market testing of various alternatives had demonstrated that such documents are challenging for most customers to read and understand. Surrogate testing of the specimen documents indicated that these are about as long and complex as is acceptable. Therefore, it would be clearly inappropriate for the Working Party to propose either that these documents be made more complex or that much additional material be included. Nevertheless, the Working Party recommends that, each year, companies should notify policyholders of the annual investment return earned and the investment mix. They should also provide information to enable them to understand the reasons for the bonus rate decisions in the context of their previously stated policy. The Working Party also recommends that companies indicate the impact of miscellaneous profits and the amount of any charges taken to cover the cost of guaranteed annuities, pension review costs, etc.

1.11 The RS proposals, extended as proposed in ¶1.10, increase transparency at the individual investor level significantly, and to the maximum extent practicable, without creating an information overload that would tend to reduce the comprehension of the information provided. However, the proposals do not address the fundamental criticism that the design and operation of with-profits business is inherently unfair to policyholders as a class. This led to the regulatory requirement to ring-fence stakeholder business.

1.12 The Working Party believes that this fundamental criticism can best be addressed by each company dividing its with-profits business into a suitable number of classes, and reporting certain aggregate information for each class in its returns under the Insurance Companies Act 1982 (ICA 1982). The Working Party has developed a model (Figure 1) which companies could use to manage each class of with-profits business in a transparent manner. A full explanation of the model and its operation is given in Section 7.

1.13 In essence, the Working Party is proposing that all companies manage with-profits in a clear and transparent manner, which separates, for each class of business, accumulation of the asset share (or 'fair share') from the impact of smoothing and guarantees on payouts. A prerequisite is that each company has a detailed written record of how each class of with-profits business (as defined in Section 7.2) is managed. Adopting this approach will

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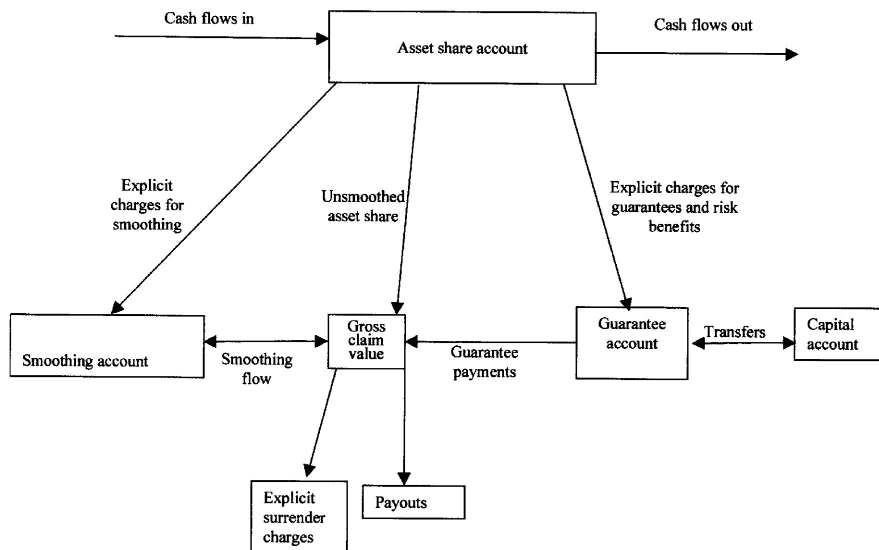

Figure 1. Summary of model

enable companies to demonstrate to interested audiences (most likely the special publics identified in ¶1.9, but to policyholders on request) that each class of business is being managed fairly for the benefit of investors. In addition, the Working Party is recommending that the Appointed Actuary certifies, in the ICA 1982 annual returns, that the classes are being managed in the way described.

1.14 Companies may need to respond more quickly to changing economic conditions and consumer pressures in future, as a consequence of the greater scrutiny of policy payouts that may occur, because of increased transparency. It will be necessary for the management of with-profits business to adapt to such changes in circumstances.

1.15 The Working Party accepts that the level of additional disclosure increases the risk of anti-selection by informed policyholders, and considers this in some detail in Section 9.1. It believes that, while the risk of anti-selection is material, it is more than outweighed by the need to operate with-profits in a more transparent manner, in order to demonstrate the value of with-profits investment.

1.16 The Working Party believes that its proposals will enable with-profits to survive in the third millennium. Without such change, the with-profits concept will die. Section 6.3.3 demonstrates that with-profits investment has provided a comparable return to direct investment in equities, despite its alleged high costs. It also provides a visible demonstration of the

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benefits of smoothing. Unsophisticated investors are less likely to remain invested in equities during periods of volatility, and once they have realised losses, they may never return. From an economic perspective, however, the need for greater self-reliance means that people should stay invested in equities. With-profits offers such an option, and should not be thrown away simply because companies and actuaries are uncomfortable with disclosing how they manage the business. This is not in the interest of the life insurance industry, where with-profits is one of its unique selling points. Equally, it is not in the interests of individual investors or of the national economy.

2. Introduction

2.1 *Background*

2.1.1 The U.K. life assurance industry has faced significant criticism over the last decade, beginning with pensions mis-selling, and, more recently, the projected failure of some endowment mortgages to repay the mortgages, the attribution of inherited estates to shareholders and the impact of guaranteed annuity options on policyholder benefits.

2.1.2 In response to these and other criticisms, a number of leading life companies, with support from the ABI, launched, in October 2000, the RS proposals. Details of the scope and objectives of RS are set out in Appendix A. Broadly, the initiative seeks to ensure that customers receive information that is clear and comparable, buy appropriate products and receive a good standard of service. The initiative has been endorsed by leading companies. Full details of the proposals can be found on the RS internet site (www.raisingstandards.net).

2.1.3 In response to criticisms levelled at with-profits business and the threat that the with-profits option would not be allowed under the stakeholder legislation, the profession established a Working Party on Transparent With Profits (TWP) in November 1999, with the following terms of reference:

> "The Working Party is tasked with preparing proposals for the transparent operation of with-profits business presenting,
>
> - by 18 February, an initial report that focuses on the use of with-profits for Stakeholder Pensions, and
> - in the latter part of 2000, a comprehensive report also encompassing the implications for in force business and methods of enhancing public understanding of the nature of with-profits business."

2.1.4 The Working Party's initial objective was to ensure that the merits of with-profits were recognised during the consultation process, leading to the introduction of stakeholder pensions in April 2001, with a view to its being

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accepted as a suitable investment medium. Subsequently, it developed proposals to enhance public understanding of the nature of with-profits business, which are founded on the assumption that the RS proposals will be adopted by any company writing new with-profits business on the transparent basis, and can therefore be used as a foundation for further evolution.

2.1.5 The Working Party (Graham Clay (Chairman), Ralph Frankland, Tony Horn, John Hylands, Chris Johnson, Rob Kerry, John Lister and Ruth Loseby) was drawn from major with-profits companies, covering both proprietary and mutual companies, plus a consulting actuary who was taking a major role in the development of RS.

2.2 *The Approach Taken*

2.2.1 The Working Party undertook a variety of activities to meet its terms of reference. Specifically:

(a) It reviewed draft stakeholder legislation, and made representations, via the Life Board, as to changes that it would like to see and possible amendments to guidance notes.
(b) It produced a paper on alternative with-profits approaches that would satisfy the draft stakeholder regulations, and presented this, in April 2000, to the profession's conference on Current Issues in Life Assurance. This paper also formed the basis of presidential discussions with the DSS and the Treasury.
(c) It reviewed recent press criticism of with-profits business and the level of information provided to with-profits customers, at both the point of sale and in ongoing communication.
(d) It worked with the ABI to analyse past performance of with-profits, and to review the with-profits concept generally.
(e) It maintained, through its membership, links with the development of RS.
(f) It presented an interim report, on how with-profits could be made more transparent, in November 2000, at the profession's Life Convention. Feedback from this presentation has been used in developing this paper.

2.2.2 The Working Party found that many of the criticisms commonly directed at with-profits in fact apply more widely, either to all life assurance products or to investment products in general. In preparing this paper, it has concentrated on criticisms that are uniquely applicable to with-profits.

2.3 *Report Structure*

2.3.1 The remainder of this paper is divided into sections covering the following areas:

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Section 3 Typical characteristics of with-profits fund business;
Section 4 A with-profits fund for stakeholder pensions;
Section 5 Criticisms of with-profits;
Section 6 How can valid criticisms be addressed?
Section 7 A reporting model for with-profits;
Section 8 What level of disclosure is appropriate?
Section 9 What issues arise from the recommendations?
Section 10 Implementation; and
Section 11 Conclusions.

2.3.2 It is hoped that the paper will provide a basis for members of the profession and the industry as a whole, to promote with-profits investment in future. It is emphasised that the Working Party has not set out to prescribe how companies should manage their with-profits funds; different funds can, and do, have very different characteristics, which require different management methods. However, the Working Party does believe strongly that it is in the interests of both providers and policyholders that significant improvements are made in the communication of how with-profits business is managed.

3. Typical Characteristics of With-Profits Business

3.1 Legally, a with-profits contract is one where the benefits include bonuses which are determined at the discretion of the directors of the company. In practice, this discretion is constrained by the representations that the company makes to its policyholders, the terms of the contract, the company's custom and practice, and how each of these are interpreted. These determine policyholders' reasonable expectations (PRE). The proper interpretation of PRE continues to evolve, as a result of decisions by the Ombudsman and the Courts, but a comprehensive interpretation has yet to emerge.

3.2 The Working Party considers that the typical characteristics of a with-profits contract, compared with other long-term savings vehicles commonly available, are:

(a) the smoothing of benefits;
(b) the build up of guarantees over time; and
(c) the fact that, in many cases, the policy participates, through the operation of a bonus pool, in the profits and losses of the company.

The combination of these characteristics makes with-profits a unique investment option. Historically, it has provided an enhanced investment return to many investors who would not otherwise have exposed themselves to equity type assets. Each of these characteristics is discussed below.

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3.3 *Smoothing and Guarantees*

3.3.1 It is important to distinguish between smoothing and guarantees.

3.3.2 The Working Party considers smoothing to be the transfer of value, over time, between segments of the policy portfolio, which may be between policy types or between generations of policies or between different terms of policies. Over time, and across the class as a whole, the Working Party believes that such smoothing should have no net cost.

3.3.3 If smoothing transfers cannot be targeted on a zero balance, for example if the company considers that PRE prevents sufficiently rapid changes in claim values, the difference should be viewed as a contribution to, or distribution from, the inherited estate rather than as smoothing.

3.4 *The Nature of Guarantees*

3.4.1 Partly as a result of the Equitable Life case, there has been considerable discussion of the nature of guarantees under with-profits policies, and the need for companies to be clear about who would bear the cost of meeting these guarantees so that PRE are appropriate.

3.4.2 It is to be expected that any guarantee provided will have a cost. Unless this cost is borne by the inherited estate, it will either be charged explicitly to premiums or to asset shares, or implicitly via the asset mix. In the latter case, the cost of the guarantee will be reflected, over time, in the bonus declaration.

3.4.3 In principle, where the cost is not borne by the inherited estate, a company has to distinguish between:

(a) guarantees for which an *explicit* charge is made against the individual policyholder, either as a charge deducted from the premium or a charge deducted from the asset share; and
(b) guarantees where the cost is managed *implicitly*; that is the cost of meeting a guarantee provided to an individual policyholder is borne by the policyholders by restrictions on the management of the relevant class of business.

3.4.4 Explicitly charged guarantees are provided in return for a charge to the premiums or asset shares. Examples of such guarantees might be: benefits provided on death, disability or critical illness; or investment guarantees, such as guaranteed annuity options, that are met by an explicit charge. If the explicit charge proves to be inadequate, the risk lies, not with the policyholder, but with the recipient of the charge, who might be the shareholder, the inherited estate, or other classes of policyholder. There is a parallel with a unit-linked policy, where these benefits are paid for by a deduction from the premium prior to investment, or, alternatively, by cancellation of units.

3.4.5 Implicitly managed guarantees arise where the aim is to provide a guarantee, at no explicit cost, to those individuals who benefit from the

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guarantee, but by managing the business in such a way that costs are, instead, met by a defined class of policyholders. These guarantees effectively require the management to act in a way that spreads the cost over the whole class, for example by adopting a more conservative asset mix or by reducing the level of regular bonus.

3.4.6 Although each guarantee will be charged for, either explicitly or implicitly, certain guarantees can be provided in either way. For example, the guaranteed capital value at maturity of a with-profits contract could be met by means of a derivative contract which is explicitly charged for, or it could be met by a more restrictive investment management policy, with a consequential prospective loss of return on the funds.

3.5 *Distribution of Profits through a Bonus Pool*

3.5.1 Historically, participation in profits evolved as a method of sharing profits, which arose mainly from mortality, with policyholders. In the 19th century profits were initially distributed as reductions in premiums, and later as enhancements to the guaranteed benefits by way of regular bonuses. Subsequently, other sources of profit, in particular investment profits, became more significant, and were reflected in the bonuses.

3.5.2 The growth in the returns on equity investments (both income and capital gains) to which with-profits funds were exposed gave rise to substantial additional profits after 1950, and raised problems of maintaining equity between older and newer policyholders. Also, because these returns depended on the market value of assets, there was a clear risk that they might disappear subsequently. This led to the introduction of final (alias terminal or maturity) bonuses, as a mechanism to distribute potentially ephemeral profits without increasing the level of guarantees under a policy. As a result, the with-profits concept, that had started with the sharing of mortality profits, evolved to one which mainly relates to investment profits.

3.5.3 In addition, many with-profits funds have always participated in the profits (or losses) earned on non-profit business (including unit-linked business) and in the general business risks of the company.

3.5.4 As the 21st century starts, new products are increasingly being insulated from any sources of profit or loss other than investment profits. For example, classes of business are being set up with explicit charges to cover expenses, the expense profit or loss accruing specifically either to the shareholders or to the inherited estate.

3.5.5 Pooling of business within a with-profits fund occurs both within and between generations and classes of policyholders. This is a feature of the collective nature of with-profits funds. Other pooled funds, such as unit trusts and unit-linked contracts, allow pooling between classes of investor, but use unit prices that provide no smoothing between generations of unit holders. In most cases, they do not provide any guaranteed minimum benefit.

3.5.6 This pooling between generations is directly related to the

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smoothing of total benefits over time that is characteristic of with-profits. Without pooling between generations, each tranche of business would receive benefits that would reflect directly the performance of the underlying assets over the period that they had been invested. Pooling between generations enables the policy benefits to reflect a smoothed return on the underlying assets over the period in which they have been invested. The extent of the pooling is closely related to the extent of the smoothing of total benefits.

4. A With-Profits Fund for Stakeholder Pensions

4.1 Reflecting the simplicity of the stakeholder proposition, as opposed to the complexity and lack of transparency surrounding with-profits business, initial indications were that a with-profits investment option would not be available as part of stakeholder pensions. Following representations by the industry, its representative body the ABI, and the actuarial profession, a with-profits investment option has been included in the stakeholder regulations. However, such with-profits funds will have to satisfy certain conditions, specifically:

(a) Separate accounting records must be maintained in respect of all income and expenditure relating to that part of the business.
(b) A stakeholder pension scheme may not invest assets in a with-profits fund that includes assets other than for stakeholder pension schemes.
(c) Deductions from the fund for all purposes cannot exceed, in the aggregate, 1/365% of the value of the fund on a daily basis.

Discussions that have taken place with the DSS regarding the interpretation of point (b) indicate that the regulations are intended to allow the stakeholder fund to operate as a sub-fund of the main with-profits fund. A separate pool of assets would, therefore, not be necessary, provided that the investment return is allocated as though there were separate pools.

4.2 It is not yet known how many companies will offer a with-profits option as part of their stakeholder pension range. The ring-fenced nature of the fund means that all guarantee and short-term smoothing costs will need to be financed within the fund, unless a company is prepared to support the fund from the inherited estate or from shareholders' funds. Therefore, stakeholder with-profits may be offered only with low guarantees and limited smoothing, thus impairing two of the fundamental attractions of with-profits investment, and making the with-profits option less attractive to investors.

5. Criticisms of With-Profits

5.1 The criticisms outlined below are drawn from comments that have been made by customers and special publics over the last year. They overlap

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considerably, and some may be mutually incompatible, at least in regard to a single company. The Working Party acknowledges that this section does not record all the criticisms made, but it believes that their essential nature and full range has been captured. The vague nature of some of the criticisms is, itself, an indication of the lack of transparency of with-profits business.

5.2 The over-arching criticism levelled specifically at with-profits investment (rather than at insurance or investment products in general) is the lack of transparency in its operation, particularly in the information presented to customers, which could conceal unfair treatment of policyholders.

5.3 *Specific Criticisms*

5.3.1 *Lack of transparency*

There is a general concern that the opacity of with-profits and the complex design of products is contributing to the customers' lack of understanding. Hence they do not understand:

(a) what they are buying;
(b) whether it is appropriate;
(c) whether it is good value;
(d) the extent to which the underlying investments are held in equities;
(e) that Market Value Reductions (MVRs) may be applied on withdrawal; or
(f) the circumstances in which MVRs may be applied.

5.3.2 *Poor value*

5.3.2.1 Although it is recognised by the special publics that smoothing is wanted by many investors who would not wish to expose themselves to the full volatility of direct equity investment, the cost is perceived to be high relative to the value given. There is a belief that such smoothing can be provided more cheaply through the use of derivative and hedging strategies.

5.3.2.2 The guarantees are seen as being of very little value.

5.3.2.3 The right to apply an MVR is perceived to negate most of the benefits of smoothing and guarantees, i.e. such benefits are only of any value on death or at certain pre-specified dates.

5.3.3 *Fair value and stakeholder*

Many special publics believe that it is difficult to tell whether customers are getting a fair return on their investment. Hence, companies offering with-profits business under the stakeholder banner will have to operate it within a ring-fenced fund to ensure that total expenses are restricted to the 1% p.a. limit and that there is no investment leakage.

5.3.4 *Bonus rates*

5.3.4.1 Each time, in the last decade, that bonus rates have been announced, a common observation by customers (and also various special

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publics) has been that the size of any reductions is mysterious. They find it very difficult to understand why regular bonus rates have been cut when the performance of investment markets has been good. Such concerns are muted while final bonuses remain high and payouts are increasing (or at least falling only gently), but criticism becomes more vehement when payouts are being cut noticeably.

5.3.4.2 The high level of final bonuses causes concern, particularly where it exceeds some 25% of the total payment. This is seen to undermine the argument that with-profits is a relatively secure way of gaining exposure to the equity markets. The absence of any explanation of how final bonuses are decided causes concern that they could be removed overnight for no justifiable reason.

5.3.4.3 A separate criticism is that final bonus rates are influenced more by marketing pressures than by the achieved investment performance, particularly if the latter would result in major changes in claim values.

5.3.4.4 The underlying concern is the lack of any apparent constraint on the exercise of the discretion to vary final bonus rates, exacerbated by the general absence of any explanation of the reasons for the level of bonus declared each year.

5.3.5 *Retrospective charging*

Customers and IFAs suspect that policy benefits are being reduced to pay for the company's past mistakes, whether pensions mis-selling, mortgage endowment shortfalls, or guaranteed annuity options. The two latter topics are currently at the forefront of people's minds, following the issue of millions of letters to policyholders informing them of the extent, or otherwise, of any projected shortfall, and the Equitable's closure to new business. The general concern is that the cost to the company will impact returns to customers, whether via bonus declarations or MVRs. In some cases, it is claimed that the potential for benefits to be affected by anything other than investment performance was not explained clearly at the inception of the policy, i.e. it was not made clear that the concept of 'with-profits' automatically embraces 'with-losses'.

5.3.6 *Charging for expenses*

Whilst many unitised with-profits (UWP) contracts limit the total expense charges to the explicit charges on the contract, most conventional (and some unitised) contracts are charged with the total expenses incurred. Expense overruns can, therefore, be charged to policyholders. This would not necessarily be their expectation at the point of sale.

5.3.7 *Poor termination values*

5.3.7.1 The September 2000 edition of *Money Management* contained an article on conventional with-profits (CWP) products, entitled 'Manipulation

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factor', which analysed surrender values, and concluded that many companies are paying surrender values which are less than asset share in order to enhance maturity payouts. The article claims that:

> "... many with-profit policyholders ... are alarmed at the often huge difference between what their policies are currently worth and what they get back if they cash in early (endowments) ... ."

5.3.7.2 Clearly, the lack of transparency surrounding the size of individual asset shares and the basis of calculating surrender values raises suspicions, whatever the validity of the accusations.

5.3.8 *Inflexibility*

Some special publics believe that with-profits is a less flexible investment vehicle than others, such as collective investment schemes. This concern appears to revolve around an assumed requirement that premiums or contributions must be paid regularly, and the perception that surrender and transfer values offer poor value.

5.3.9 *Companies are under-paying to build up their inherited estates*

5.3.9.1 It is assumed that inherited estates have been built up over many years, substantially as a result of paying claim values that were less than asset shares. Because there is no clarity surrounding how companies currently determine payouts, there is a widespread perception that recently claiming customers, as a class, have not received their 'fair share'. It is also assumed that many companies are continuing to pay less than 'fair shares' in order to build up their inherited estates, with the intention that, eventually, this should benefit their shareholders.

5.3.9.2 The various attributions of inherited estate to shareholders have focused attention on this, with the substantial publicity about AXA's recent reconstruction increasing the profile of this issue.

6. How can these Criticisms be Addressed?

6.1 *General*

6.1.1 Whether each of the criticisms in Section 5 is real or merely perceived, it is clear to the Working Party that change is required, and that, in order to meet public concern, companies need to demonstrate that they operate with-profits business in a transparent and fair manner.

6.1.2 In essence, the Working Party is proposing that all companies separate, for each class of business, accumulation of the asset share (or 'fair share') from the impact on payouts of smoothing and guarantees. It has developed a model (set out in Section 7) which companies could use to

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manage each class of with-profits business (as defined in Section 7.2) in a transparent manner. Adopting this approach for a class of business will enable companies to demonstrate to interested audiences that the class is being managed fairly for the benefit of its investors.

6.1.3 The Working Party believes that an essential prerequisite for achieving transparency is that all companies should have, in a form that could be published, a detailed written record of how they manage each class of with-profits business, incorporating their strategies for bonus determination, including smoothing, and for determining surrender and transfer values.

6.1.4 The Working Party also proposes that certain enhancements are made to the annual RS reports to policyholders. These are described in ¶6.2.5.

6.1.5 The Working Party has considered each criticism set out in Section 5 in formulating its proposed model, but does not consider it necessary to respond to each one directly.

6.2 *The Over-Arching Criticism*

6.2.1 The majority of criticism levelled at with-profits by customers arises from a lack of understanding which results, primarily, from poor communication by providers. RS seeks to address many of these criticisms. In particular, customers must receive (in addition to other appropriate material) specific documents relating to the management of with-profits, both at the point of sale and then on any significant subsequent change of practice. Appendix B records the items to be included in these documents. Appendices C and D show two example documents (the first to be sent automatically to all customers at the point of sale, and the second to be provided on request).

6.2.2 As a general principle, the Working Party believes that companies should provide sufficient information each year to enable customers to understand the reasons for the company's bonus rate decision, in the context of its previously stated bonus policy. Ongoing communication with the customers should also be aimed at informing customers and setting expectations. The information given will clearly depend upon the practice of the specific company.

6.2.3 The RS description of with-profits (see Appendix B for its requirements) includes a description of what is taken into account in calculating the 'fair share' or asset share. In particular, it addresses how expenses are charged to the business, whether the policyholder is exposed to other risks (such as guaranteed annuity options), what smoothing and guarantees are provided, and how payments on exit are determined (including the approach to MVRs). The specimen documents in Appendices C and D indicate the style and level of detail that are appropriate.

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6.2.4 In addition to improvements in point of sale material, the RS requires that customers receive a yearly statement, which includes the information set out in Section E.1.4. A generic example of the yearly statement is given in Section E.2.

6.2.5 RS sets a minimum standard. The Working Party recommends that companies also disclose the investment return achieved for the class over the year and the current asset mix. It also recommends that companies indicate whether or not the policyholder is exposed to miscellaneous profits or losses, and, if relevant, their impact, including the amount of any charges taken to cover the cost of guaranteed annuities, pension review costs, etc.

6.2.6 A specimen yearly statement incorporating the Working Party's proposals, is shown in Appendix F. Its format and content would need to be made consistent with the company's RS documentation, and, in particular, would need to meet the 'clear communications' test.

6.3 *Some Specific Criticisms*

6.3.1 Some of the criticisms have been addressed as part of RS, particularly in the area of transparency. Those remaining are mainly around the perceived poor value and inflexibility of with-profits investment.

6.3.2 The Working Party has not sought to address directly the criticism that guarantees and smoothing can be achieved more cheaply through direct investment and appropriate hedging strategies.

6.3.2.1 However, it considers that this perception is unduly coloured by what, in the context of life assurance products, is recent history. The investment climate has been remarkably benign over the last 20 years, and it seems unlikely that such conditions will continue to occur.

6.3.2.2 The histogram on page 53 of the report by Dimson *et al.* (2000) graphically demonstrates this. It shows real returns on U.K. equities in each of the last 100 years in 10% p.a. bands, and discloses a broadly normal distribution. However, over the last 20 years, there are three years in the central (0 - 10%) band, 15 years better and only two worse.

6.3.2.3 The report also identifies the dangers of data mining inherent in the selection, using hindsight, of successful stock markets or individual securities. It is equally dangerous to base parameters for costing future guarantees on the experience of a particularly favourable period.

6.3.2.4 The paper Hare *et al.* (2000) indicates a much higher level of cost for such guarantees than most, if not all, companies currently charge to their with-profits funds.

6.3.2.5 The Working Party also observes that, despite the extended bull market, there are currently some policies (particularly pensions) where

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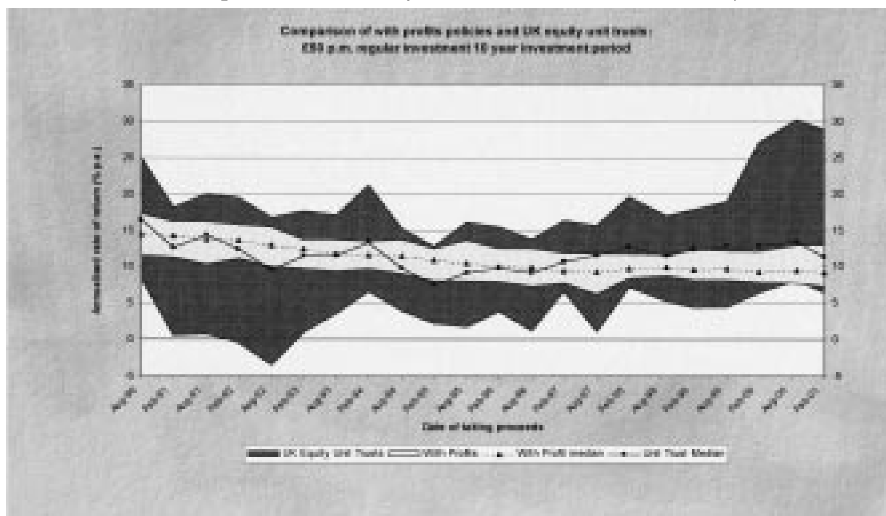

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Figure 2. Comparison of with-profits policies and U.K. equity unit trusts; £50 p.m. regular investment, 10-year investment period

guarantees are biting, i.e. the value of guaranteed benefits exceeds each policy's 'fair share'.

6.3.3 The Working Party, with the ABI's assistance, has examined whether with-profits had provided investors with poor returns relative to direct equity investment. Figure 2 combines the results of the November 1999 and February 2000 *Money Management* surveys of with-profits insurance policy returns with equivalent analyses of unit trust returns. In each case, a regular investment of £50 per month was assumed, for a ten-year period, ending on the date specified.

6.3.3.1 Returns are net of all expenses. Life assurance premium relief (LAPR), available on policies issued before 19 April 1984, has been ignored, as has any potential capital gains tax payable on unit trust proceeds. To the extent that this distorts the comparison, it favours the unit trust performance.

6.3.3.2 The shaded areas show the range of the annualised percentage rate of return achieved by each type of product over a ten-year period, ending in each of the ten years 1991-2000. For example, for February 1991 this is the range across all the providers in the sample of the annualised rate of return on an investment, started on 1 February 1981 and completed on 1 February 1991.

6.3.3.3 Two points are apparent from this analysis:

(a) Returns on unit trusts are much more variable than returns on with-profits policies over every ten-year period. For example, over the decade

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ending in 1992, unit trust performance varied between 16.7% p.a. and −3.5% p.a., while with-profits policies delivered between 15.5% p.a. and 10% p.a., i.e. ranges of 20% p.a. and 5% p.a. respectively.

(b) Average returns show less volatility for with-profits policies than for unit trusts. Note that, on average, maturing with-profits policies gave better returns than unit trusts in half of the comparison periods, with the converse true in the other half.

6.3.3.4 The Working Party concludes, from this analysis, that, whilst the asset mix of the two products was not entirely comparable, with-profits investment provided a similar return to investors, despite its allegedly higher expenses and its perceived high charges for smoothing and guarantees.

6.3.4 The criticism that the right to apply an MVR on withdrawal, other than at certain specified dates, undermines the benefits of with-profits investment, arises mainly because companies have not convinced commentators that they apply MVRs only when appropriate, on investment grounds and in order to protect the remaining members of the fund.

6.3.4.1 RS will ensure that MVRs are not used to recover expenses or to generate additional profit, and that they are restricted to the difference between the value of units (including any final bonus) and the equivalent value had the investment return been credited to the units purchased. Any deduction from claim values to cover expenses would have to be shown as an explicit charge.

6.3.4.2 A secondary reason for this criticism is that, when an MVR is applied, investors do not benefit from guarantees and the smoothing approach may be varied, possibly substantially. The Working Party has been unable to determine market practice, but believes that it is important that companies disclose the smoothing policy (if any) they adopt on withdrawals, and also identify the circumstances in which they might change that policy. Paragraphs D.12.5 and D.12.6.1 indicate suitable RS disclosure.

6.3.5 Although the RS's increased disclosure of the performance of a policyholder's investment and the factors affecting that performance should help to increase customers' understanding of with-profits, it will not address all the special publics' criticisms, which mainly apply at fund level.

6.4 *The Need for a Model*

6.4.1 In order to address the criticism that companies are paying less than 'fair shares', the Working Party believes that it is necessary to develop a model for the operation of with-profits business that can be used to demonstrate that payments to policyholders, as a class, are fair, and that there is no systematic underpayment.

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6.4.2 The model needs to be able to make it clear that even if there is any pattern of building up a buffer to support smoothing, the buffer will eventually be distributed to policyholders.

6.4.3 The Working Party proposes that the operation of a with-profits fund be analysed for each class of business on the basis of a model structure and the aggregate results for each class of business be disclosed in the statutory returns under the Insurance Companies Act 1982.

6.4.4 A proposed model is set out in Section 7. The Working Party has developed this model of how a transparent with-profits class of business might operate. The principles for the operation of this model would have to be consistent with the disclosure made to customers about how the with-profits business is operated.

6.4.5 It is envisaged that companies would be allowed to develop their own model structure, but the Working Party recognises that, in practice, the statutory reporting requirements may require the specification of a uniform structure.

6.4.6 The Working Party believes that a number of companies already use a similar model for internal purposes, but it is not aware of any companies that publicise their results.

6.4.7 The model would be designed to support disclosure of aggregate data for each business class to the special publics, but the same information could be given on request to individual customers.

6.5 *Further Specific Criticisms*

6.5.1 Another criticism of with-profits is its inflexibility. The Working Party considers that this reflects the historic position, mainly for CWP products, rather than being justified for current UWP products offered in the market.

6.5.1.1 Firstly, new UWP products generally include flexibility, allowing premium holidays, and they may also make waiver of premium an integral part of the contract and, in some cases, include redundancy cover.

6.5.1.2 Secondly, the majority of leading companies have ceased to charge all the acquisition costs to policyholders in the early years of pension policies, whether through front-end loading or surrender values that are low relative to total premiums paid. Acquisition costs are now spread over a number of years (sometimes the whole term), thus removing the persistency risk from the individual policyholder, and hence significantly improving the return to those who surrender early. This structure is likely to reduce the level of eventual maturity values.

6.5.1.3 The Working Party, therefore, believes that modern UWP contracts cannot be criticised validly for inflexibility. However, they continue to be perceived to be inflexible.

6.5.2 The Working Party believes that inherited estates have generally declined as a proportion of assets over the last ten years, so that the

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perception that estates are being intentionally built up is misguided. Where a company has intentionally been building an inherited estate in recent years, this should have been reflected in the projection of benefits given to new policyholders.

7. A Reporting Model for With-Profits

7.1 The model below is already applied, in concept, by some companies. It provides a framework for describing the operation of a class of with-profits business and for quantifying the various cash flows and/or costs. This model provides a template to describe the operation of a with-profits fund, comprising one or more classes, in a transparent manner. Variations are possible, although additional complexity will make it difficult to maintain transparency. However, the model will automatically simplify for stakeholder pensions because of the ring fence. The Working Party envisages that, in due course all companies writing new with-profits business will disclose information based on a model of this type for all UWP business, but that, on practical grounds, some companies will never provide such disclosure for CWP business. The Working Party recommends that information from this model should be disclosed in the statutory returns, and, although not automatically sent to policyholders, should be available on request. The extent to which information from this model should be disclosed is addressed in Section 8.

7.2 *Accounting Structure*

7.2.1 Accounts would be maintained for each class of business that comprises a single pool for smoothing and distribution of bonuses. This means that the smallest possible class would be one covering a single bonus series, and the largest possible class one covering all the transparent with-profits business (provided that the same participation rights, smoothing rules, and bonus policy apply to all business). There is no requirement that common bonus rates apply to all business within a single class, or that different classes of business cannot have common bonus rates for many years without creating an expectation of permanent alignment..

7.2.2 If solvency were to come under extreme pressure, a company with more than one class of business may need to treat all business as a single class. The terms of the Policyholders' Protection Act could be relevant in such circumstances.

7.2.3 There would be a separate asset share account and smoothing account for each class of business, but, for most companies, only one guarantee account.

7.2.4 There is no requirement for each class of business to be supported by a separate asset pool. Several classes of business may be supported by a single asset pool, and the investment return allocated between classes. It is

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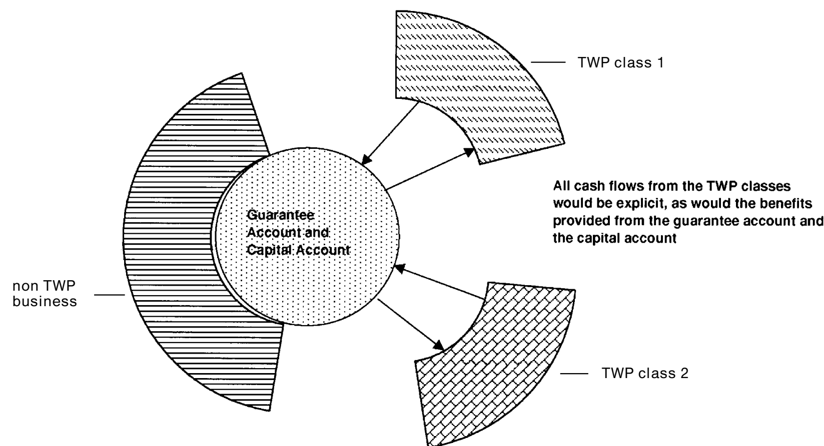

Figure 3. Fund overview

not necessary, for the allocation of investment returns, that the same asset mix is held for every class, just as the allocation of investment returns to asset shares within a class does not have to assume the same asset mix for every policy within that class. However, the investment returns allocated to a particular class of business must be consistent with the mix of assets backing that class of business.

7.2.5 Examples of different classes of business within a company might be:

(a) where there are different exposures to business risks, including expense risks, for example UWP products with fixed charges and the shareholder bearing all the expense risk, and other products where expense profits or losses are shared 90:10 between policyholders and shareholders;
(b) U.K. and foreign business;
(c) life and pensions business; or
(d) where there is more than one identifiable with-profits fund, due to a previous take-over or merger, e.g. Prudential and Scottish Amicable.

7.2.6 Figure 3 sets out, in simplified form, how these accounts might operate for a company with two transparent classes of business, as well as other business.

7.3 *The Model in Detail*

7.3.1 Figure 4 depicts the cash flows that will affect the final payout on a policy. The top part deals with premium payments and the accumulation phase. The lower part deals with the payment of claims.

7.3.2 The model, as described, does not incorporate the annual bonus declaration, and, therefore, makes no mention of any shareholder transfer

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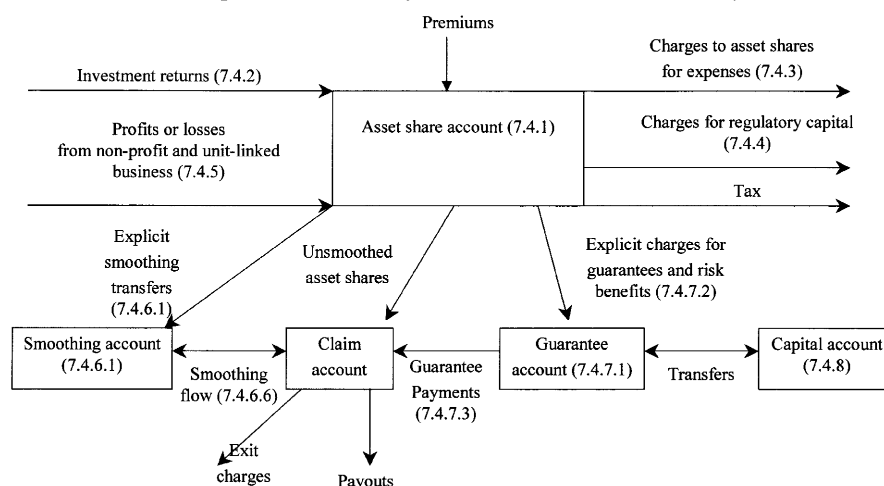

Figure 4. Detail of fund model

that would result from a 90:10 apportionment. Such transfers would occur from the asset share account in respect of regular bonuses and from both the asset share and smoothing accounts in respect of final bonuses.

7.4 *Explanation of the Terms used in Figure 4*

7.4.1 *The asset share account*

The asset share account accumulates all premiums and investment income, net of deductions of explicit charges for expenses, tax, regulatory capital, and risk benefits and guarantees.

7.4.2 *Investment returns*

The investment returns credited to asset shares are used. If a margin is intended to be taken between the investment return earned on the fund and the return credited to asset shares, this would need to be included in disclosure projections. If such a margin has actually been taken, this should be mentioned in the yearly statement to policyholders.

7.4.3 *Charges to asset shares for expenses*

(a) If the charges are fixed, then these will be explicit and clearly visible to the customer.
(b) If the expenses charged to asset shares are variable, then the company should provide, in each yearly statement, an updated benefit projection reflecting these expenses.

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As experience emerges, the company will need to monitor actual costs, as well as the costs included in pricing.

7.4.4 *Charges for regulatory capital*

(a) Regulatory capital is the excess of the mathematical reserves (including resilience reserves and solvency margins) over the asset shares.
(b) If regulatory capital is provided externally to the asset share and smoothing accounts for a class of business, the cost of this capital would need to be charged to asset shares. Companies would need to be aware of, and charge for, the level of capital support provided from one class of business to another.
(c) If regulatory capital is provided from within the asset share and smoothing accounts for a class of business, then, generally, there would be no charge.

7.4.5 *Profits from other business*

If the fund participates in profits or losses from any non-profit or unit-linked business, the effects should be disclosed as part of the revenue account prepared for the class.

7.4.6 *The smoothing account and smoothing flows*

7.4.6.1 The smoothing account exists to accumulate any explicit transfers for smoothing and, except to the extent that there is a transfer from the guarantee account, to absorb all differences between claim values and unsmoothed asset shares.

7.4.6.2 The Working Party believes that, in the absence of any explicit smoothing transfers, each class of business should be managed such that, over time, the balance on the smoothing account would average at zero. Furthermore, any positive balance on the smoothing account should only be distributed to the class of business with which it is associated. Conversely, any deficit on the smoothing account should only be recovered from that class of business.

7.4.6.3 Where there are explicit smoothing transfers during the lifetime of the policy, then these will accumulate in the smoothing account to support smoothing of claim values over time. For a continuing class of business, the balance on the smoothing account would, in normal circumstances, remain positive, and this balance should be distributed over the lifetime of the policies in that class.

7.4.6.4 The value of the smoothing account should be disclosed yearly.

7.4.6.5 There are issues for new accounts, where, initially, the smoothing account is small and there can only be a limited amount of smoothing on early payouts, and for closed accounts, where the distribution of the smoothing account generates a tontine effect.

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7.4.6.6 Except to the extent that there is a transfer from the guarantee account, the smoothing flow is the difference between asset shares and payouts (gross before any explicit exit charges) on all claims in that class of business, not just on maturities. Hence, it will include the miscellaneous profits (or losses) on that class of business.

7.4.6.7 The amount of the smoothing flow and explicit smoothing transfers would need to be disclosed annually in the returns to the regulator. To counter the criticism that the office is systematically paying substantially less than asset shares on early surrenders, the aggregate smoothing flow arising from surrenders should be shown separately from the aggregate smoothing flow on maturities, deaths and other exits.

7.4.7 *Costs of guarantees and risk benefits*

7.4.7.1 The guarantee account exists to accumulate any explicit charges for guaranteed benefits less any excess of claim values over the sum of asset shares and smoothing transfers. Where there is no explicit charge for the guarantee, then this process is managed through the asset share account (see ¶¶3.4.5 and 7.4.7.5).

7.4.7.2 Charges for guarantees that are levied explicitly against premium or asset shares and any explicit charges for risk benefits are transferred to the guarantee account. An estimate of the anticipated guarantee charges should be included in the point of sale information.

7.4.7.3 Guarantee payments will occur every year in respect of risk benefits (for which an explicit charge has been made), but only in some years to meet investment guarantees. The order in which smoothing and guarantees are applied would be a commercial decision of the company.

7.4.7.4 Guarantees that are managed implicitly are managed through the asset mix of the asset share account and the bonus policy of the class of business. For example, any derivatives purchased to provide an investment guarantee would be included in the asset mix of the asset share account. The Working Party believes that the actual cost of a guarantee provided implicitly does not need to be disclosed separately. However, its effect is included in the investment return shown in the yearly statement.

7.4.7.5 Where an implicitly charged guarantee applies, the difference between the guaranteed payout and the unsmoothed asset share would normally be met wholly from the smoothing account (see ¶7.4.6.1).

7.4.7.6 If the profits or losses on the guarantee account accrue to a specific class of policyholders, as opposed to the shareholder or the inherited estate, then transparency requires that those policyholders are fully informed of the risks that they are accepting in respect of this class of business.

7.4.7.7 Where the profits or losses on the guarantee account accrue solely to the specific class of policyholders who are explicitly charged for a guarantee, then these guarantees can be managed through the smoothing account rather than through a separate guarantee account.

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7.4.7.8 Any margins or charges designed to build up an estate would need to be included in the explicit charges against asset shares that are credited to the guarantee account, and would need to be included in disclosure projections.

7.4.8 *The capital account*

7.4.8.1 The capital account, which provides protection to the guarantee account, after any external catastrophe reinsurance, can be the inherited estate, or the shareholders', or an explicitly specified combination of both. Specification of the protection provided by the capital account requires the company to identify how it manages the risks arising from guarantees and risk benefits, and facilitates the regulators using a risk-based capital approach to monitoring solvency against the size of the capital account. Any charges that are made for the support provided by the capital account would need to be identified.

7.4.8.2 In extreme circumstances, the inherited estate and, in a proprietary company, the shareholders' funds, may prove insufficient. In such circumstances, other classes of business may be required to support the guarantees of a class in difficulty.

7.5 *Operation of the Model*

7.5.1 The Working Party has not addressed the issue of who should own the guarantee account and the capital account, because it is not considered essential to improving transparency. The cash flows that affect policyholder benefits are explicit and visible in the model set out in Figure 4.

7.5.2 Yearly disclosure in the statutory returns of the value and development of the various accounts for each class of business should provide evidence that those policyholders are collectively receiving their 'fair share'. An accumulation of an unattributed estate would be visible in the growth of the guarantee account and/or the capital account. Any estate that accumulates in the smoothing account or the asset share account has to be distributed to policyholders in that class — in accordance with the principles for that class of business.

7.5.3 Where an explicit charge is made against asset shares for expenses, this gives visibility to the impact on the policyholder. How the company uses those charges to pay commissions, expenses, or shareholder profits then becomes a commercial issue for the company.

7.5.4 This model also leads to the concept of a smoothing exposure. At any point in time, this is the difference between aggregate asset shares and aggregate values payable (including final bonus and any MVRs, but before deducting any explicit exit charges) if all policies were to leave the fund at that time. The smoothing exposure gives a measure of the extent to which capital is at risk to meet benefits payable.

7.5.5 Solvency assessment could use a risk-based approach. The nature

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of the representations that have been made to policyholders and the availability of capital from outside the long-term business fund would be relevant. The focus would be on the adequacy of the guarantee account and the size of the smoothing account in the context of the smoothing exposure.

8. What Level of Disclosure is Appropriate?

8.1 The Working Party considers that the adoption of this or a similar model will enable companies to answer any remaining criticisms not dealt with under RS, or the greater disclosure to policyholders recommended in this paper. However, there remains the issue of how the proposed model should be reported on, and to whom. The Working Party and, based on feedback from the 2000 Life Convention, the profession feel that most policyholders would not welcome full disclosure of the elements of the model, primarily because they will find the RS material sufficient, and secondly because additional information would tend to obscure the message in the RS material.

8.2 Recognising the need for openness, however, the Working Party recommends that information from the model (e.g. the smoothing account for a class of business) should be disclosed in the statutory returns. Further, the Appointed Actuary should be required to certify that with-profits business is being managed in accordance with both industry-wide and internal principles which have been communicated externally.

8.3 To assess the effectiveness of the proposed model and level of disclosure, the Working Party considered their probable effect in some of the circumstances which have contributed to the current criticisms of with-profits, i.e. would the issues have been dealt with or recognised at an earlier stage.

8.4 *Pensions Mis-selling*

The proposed model and additional disclosure under the RS proposal would not, in themselves, have prevented customers being mis-sold inappropriate pension plans. However, as the extent of mis-selling was progressively recognised, the additional disclosure would have identified the risks to which the inherited estate and/or with-profits policyholders were exposed, and this might have enlightened the debate about where the costs of pensions mis-selling should be charged.

8.5 *Endowment Mortgages*

To date, most endowment mortgages have paid more on maturity than the guaranteed death benefit, i.e. the mortgage amount. For policies sold recently, where the premium has been targeted to provide a given sum based on an assumed future investment return, increased disclosure of the investment performance that is being credited and the annually updated

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projection of benefits on a policy would have to facilitate early identification of any systematic issues. This issue also affects unit-linked policies.

8.6 *Guaranteed Annuities and Equitable Life*

8.6.1 The proposed model would have demonstrated that Equitable was not making any explicit charges for the cost of guaranteed annuity options.

8.6.2 A risk-based capital assessment might have highlighted Equitable's reliance on the assumption that its approach to bonuses was compatible with the representations that it had made to policyholders. However, before legal action started, it seems unlikely that any assessment would have included the eventual court ruling in the range of potential outcomes. Hence, it is open to question whether an appropriate solution would have been developed substantially earlier.

8.7 *Inherited Estates*

8.7.1 To obtain maximum benefit from the model, whose implementation has been feasible for, at most, ten years, it would probably need to have been in use since each company started to write with-profits business, i.e. at least 50 years ago. Any historical analysis is, therefore, hypothetical.

8.7.2 Application of the proposed model to all with-profits business would disclose the future evolution of the inherited estate. Such transparency would counter the generally erroneous criticism that companies are continuing to increase their inherited estates (as a proportion of the aggregate asset shares) by underpaying claimants overall.

8.8 The implementation of both the RS and Working Party proposals would disclose how with-profits business is being operated. This should increase substantially the public confidence in the with-profits concept, but such disclosure would have had a limited impact in the circumstances analysed in this section.

9. What Issues Arise from the Recommendations?

9.1 *Anti-Selection Resulting from Disclosure of the Smoothing Account*

9.1.1 *Anti-selection on entry into the contract*

If the smoothing account is substantially positive, this may attract new business hoping to benefit ('carpetbag') from the future distribution of the smoothing account. Such business would tend to dilute the benefit for existing policyholders. However, if the smoothing account is substantially negative, new business may cease, as prospective policyholders might anticipate that they would have to give up part of their returns to restore the smoothing account to balance.

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9.1.2 *Anti-selection on exit from the contract*

If the smoothing account is positive, a voluntary exit gives up the right to benefit from the run down of the smoothing account. If the smoothing account is negative, there is no anti-selection if an MVR is being applied, but, if an MVR is not applied, then continuing policyholders are exposed, as the impact of managing the account's return to zero is spread over fewer policies. It would be prudent for companies to monitor closely the volume of discontinuances and their impact on the smoothing account. It might prove necessary to apply MVRs more extensively than has been the practice in the past.

9.1.3 Anti-selection is likely to be highest if the smoothing account is in deficit in the early years for a new class of business, as it would be apparent that early payouts have, on average, exceeded asset shares. Policyholders might believe this to increase the likelihood that future bonuses would not fully reflect achieved investment returns, thereby discouraging them from making further investment into the fund. Furthermore, they might be encouraged to surrender their policies, particularly in the absence of an MVR.

9.1.4 Anti-selection is unlikely when the smoothing account is in surplus. Positive cash flows to the account could be viewed by policyholders as encouraging, in that there is potential to pay enhanced bonuses as the smoothing account is run down.

9.1.5 The Working Party noted that the proposed disclosure rules for money purchase pension plans (MPPP) require disclosure in the yearly statement of the transfer value and also of projected benefits at a set, single, real investment return. It is proposed that, in the main, the projected value will be based on the smoothed asset share, while the transfer value will be that actually payable. Hence, whenever an MVR is being applied, it will be possible to establish the approximate difference between the smoothed and unsmoothed asset shares. This creates an anti-selection risk. For business covered by the MPPP requirements, the Working Party's proposals do not add to that risk. However, they do extend it to other categories of business.

9.1.6 The Working Party does not believe that companies should be over-concerned about the impact of anti-selection, since policyholders, generally, will not know the timing of how any surplus or deficit in the smoothing account will be either distributed or replenished in the future. Only if the class becomes closed to new business will the surplus/deficit position directly determine benefits.

9.1.7 Although the Working Party believes that the scope for anti-selection can be managed, it recognises that perceptions will inevitably exist among the special publics, and would probably be communicated to policyholders. This could influence policyholder behaviour in ways that might be to the detriment of the smoothing account, with a consequential impact on future claim values.

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9.2 *Existing Unitised With-Profits Business*

9.2.1 The Working Party considers that an assessment of the impact of the proposed model on existing UWP business is an important test of its value.

9.2.2 If existing business were excluded, it would be likely that an active smoothing policy would be needed initially, i.e. follow asset shares relatively closely.

9.2.3 If existing business were included, the model would apply to the combined total of new and existing business. A larger and more varied cohort of business would permit a less active smoothing policy, i.e. a greater degree of smoothing. This would be to the advantage of the policyholders, and would reduce the anti-selection risk. The proposed model would also provide new policyholders with the confidence that they were being treated fairly and transparently. Existing policyholders would gain comfort that their policies were being managed in line with new business.

9.2.4 The Working Party regards the concept of grouping (new and existing business) cohorts together in a class of UWP business as being healthy for the management of with-profits under the proposed model.

9.2.5 In order to include existing business, a company would need:

(a) data to determine the asset share account for the existing business; for a UWP business, most offices should hold this data already; and
(b) to establish the initial size of the smoothing account, either retrospectively, based on historical data (if available), or prospectively, as part of an attribution exercise (i.e. establish a smoothing account sufficient to support the intended bonus and smoothing policy on existing business on best estimate assumptions).

9.2.6 The effort required to include existing business is likely to be substantial, and should not be under-estimated. Nevertheless, the Working Party hopes that, in due course, all offices writing new with-profits business will include all in-force UWP business.

9.3 *Conventional With-Profits Business*

9.3.1 The application of the proposed model to CWP business is more complex than for UWP business. UWP tends to be administered on relatively modern systems, and is sufficiently recent that reasonably accurate and comprehensive records are normally available.

9.3.2 Many CWP administration systems are incapable of calculating accurate asset shares or of recording them on a policy-by-policy basis. This makes it difficult, or even impossible, to calculate the appropriate balance in the asset share and smoothing accounts. Further, the proposed model presupposes active management of CWP surrender bases, which would have a consequential impact on the administration systems.

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9.3.3 The practical implications of quantifying the asset share account and the smoothing account, and of amending administration systems for CWP, are such that the Working Party suspects that many companies would consider the certain cost to policyholders disproportionate to the much less concrete potential benefit.

9.4 *Implications for the Management of With-Profits Business*

9.4.1 The Working Party believes that managing PRE effectively will be critical to the future operation of with-profits business.

9.4.2 The requirement to operate asset share and smoothing accounts, and to show the explicit charges for guarantees and risk benefits, will mean that companies will have to give greater consideration to the risks arising from guarantees, and how they are managed.

9.4.3 In particular, companies will have to consider:

(a) whether they have made sufficient disclosure to policyholders to allow the guarantees to be managed implicitly within the class of business;
(b) for guarantees that are being charged for explicitly, whether the charges are sufficient to cover the risk; and
(c) for all guarantees, whether they have appropriate reinsurance and/or sufficient capital in the fund, to avoid any adverse impact on claim values that would be contrary to PRE, while keeping the fund's risk of ruin to a level that shareholders and regulators would consider acceptable.

9.4.4 The Working Party believes that, unless a company has communicated to policyholders how its with-profits benefits would be likely to be affected in a range of adverse scenarios, PRE may severely constrain the company's ability to respond to an adverse outcome. It, therefore, recommends that companies take steps to ensure that all risks to policyholders' guarantees or realistic expectations are effectively communicated to them. All such risks should, of course, be identified in the Financial Condition Report, along with the necessary management action to control such risks.

9.4.5 Increased disclosure of the operation of transparent with-profits business may lead to closer scrutiny of policy benefits and payouts by customers and IFAs. Each company will need to communicate the principles on which the smoothing account is managed, although the company may retain flexibility about the detailed operation of smoothing and MVRs. As economic conditions and consumer needs change, the company will need to explain the decisions that it takes in the context of its previously communicated principles, and this may lead to quicker responses to those changing conditions. The future of with-profits will depend on the ability of its managers to adapt to changing conditions.

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10. Implementation

10.1 The Working Party recognises that implementing the proposed model, along with an increased level of disclosure, is not an easy task. It will take each company a considerable effort, applied over a number of years. There are, however, several ways in which the process can be eased, particularly if it occurs alongside, or soon after, the implementation of RS.

10.2 The ABI could encourage providers to promote with-profits business effectively, and also do it directly. This promotion would encompass the public, IFAs and special publics. If a degree of consistency between providers could be achieved in how with-profits is promoted and explained, this would be beneficial. For the avoidance of doubt, the Working Party does not believe that with-profits should be managed identically across the spectrum of providers. However, if the spirit of with-profits is captured consistently, this should lead to increased understanding, and hence increased long-term trust in the concept of with-profits.

10.3 The Working Party believes that it would be beneficial to provide more effective communication of the benefits and workings of with-profits to the special publics. The public tends to rely on the opinions offered by the special publics (especially the media) on the relative benefits offered by various types of investment. Many people regard with-profits as no more complex than any other type of investment — they are all incomprehensible. Such people would tend to rely on how the media commentate on with-profits. The problem is that many journalists are deeply suspicious of the with-profits concept. The Working Party suspects that a significant proportion of this suspicion results from a lack of awareness of the changes already made to with-profits products. It is important that these misconceptions are addressed by the industry with the support of the profession.

10.4 The Working Party does not propose any change in the role of the regulators. It assumes that its proposed additional reporting requirements could be incorporated with the changes required as part of the implementation of the FSA's *Integrated Prudential Source Book*, which are understood to include the incorporation of much of the information that currently has to be disclosed in with-profits guides.

10.5 In the meantime, the actuarial profession could consider amending its professional guidance to achieve a greater consistency across the industry on the key issues concerning with-profits. Whilst the Working Party did not consider this issue in detail, various possibilities would seem to present themselves. Firstly, GN22 could be extended to include guidance on how transparency should operate and be managed in the interests of policyholders. Secondly, GN2 could be amended to require reporting of the development of the smoothing accounts in the Financial Condition Report. Finally, GN1 could be expanded to include consideration of the cost of

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guarantees and development of the smoothing account in determining appropriate bonus recommendations.

11. Conclusions

11.1 The Working Party has recognised and believes that the profession and life industry should recognise the need to adopt a more transparent approach to with-profits. As the leader writer in the *Financial Times* wrote about it on 21 December 2000:

> "the old brew of paternalism, obscurity and slick marketing is no longer acceptable".

11.2 Over time, RS will move accredited companies a long way towards operating their with-profits funds in a transparent manner, both at the point of sale and subsequently, through the requirement to provide at least yearly statements. The Working Party fully supports this development, and believes that all companies should provide information to with-profits investors, in accordance with the RS proposals. Indeed, it recommends, in addition, that the yearly statement:
(a) should provide investors with a breakdown of the asset allocation, reasons for change and the investment return earned over the previous year; and
(b) should indicate the impact of miscellaneous profits or losses and the amount of any charges taken to cover the cost of guaranteed annuities, pension review costs, etc.

11.3 In addition to improving information provided to investors, the Working Party believes that companies need to amend the management of with-profits business. To this end, the Working Party has developed a model detailed in Section 7, and recommends that companies move to operate in this way. Such a change would take time to implement, but it should be possible in the short to medium term for all UWP business. CWP business may take significantly longer, and some companies' existing business may be left out of the process completely.

11.4 As indicated previously, it is important that companies not only operate, but are seen to operate, in a transparent manner. Only in this way can all the criticisms levelled at with-profits be dispelled. The Working Party, therefore, recommends that information from the model (e.g. the smoothing account for a class of business) should be disclosed in the statutory returns. Further, the Appointed Actuary should be required to certify that each class of business has been operated in accordance with the principles outlined to customers. The Working Party recommends that the additional material should be aimed, primarily, at audiences such as the regulator and special publics, but that it would be given to policyholders on request.

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11.5 The Working Party recognises that its proposal to disclose information about account balances to interested parties may give rise to some anti-selection. It believes, however, that the impact of this can be managed.

11.6 The Working Party believes that further work is desirable. Firstly, analysis of the theoretical value of the guarantees provided by with-profits, and secondly, research into the value, as perceived by policyholders, of both smoothing and guarantees.

11.7 With-profits has much to offer comparatively risk averse customers, i.e. those who wish to achieve a better return than on deposit accounts, but do not want to subject themselves to the full volatility of direct equity investment, despite the likelihood of a higher return in the long term. The with-profits option will, however, only remain open to customers in the long term if companies operate with-profits in a more transparent manner. The profession has to face the fact that recent events experienced by the industry have undermined the public's faith both in with-profits and in actuaries. The only defence is greater openness.

Acknowledgements

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APPENDIX A

THE RAISING STANDARDS QUALITY MARK

A.1 *Introduction*

A.1.1 The Raising Standards scheme will encourage brands to make three promises addressing the three main areas of consumer concern identified:
— clarity and comparability of information;
— appropriateness of the products purchased; and
— customer service.

A.1.2 Brands wishing to make the promises must meet the tough standards underpinning them. These standards have been developed by the financial services industry in consultation with providers, regulators and consumer groups.

A.1.3 Brands meeting or exceeding *all* of the standards will be allowed to display a quality mark. Brand is the name used by a company in its presentation to consumers, and includes all sub-brands that the consumer associates with the main brand, for example Patience Unit Trust Ltd and Patience Life are both part of the Patience brand.

A.1.4 An independent body, the Pensions Protection and Investments Accreditation Board (PPIAB), will grant the right to use the quality mark to brands that have demonstrated that they meet all the standards. The directors of this body are non-industry practitioners, and the Board has been set up under independent trust.

A.1.5 The standards complement regulation and seek to go beyond those prescribed by regulation.

A.1.6 The second promise incorporates the protection that is already offered by the Financial Services Authority (FSA), making clear that this is a statutory protection. Of course, the FSA retains responsibility for making sure that brands are complying with its regulations. The PPIAB has responsibility for making sure that the brands using the quality mark continue to meet the standards, and are using the quality mark appropriately.

A.2 *Scope*

A.2.1 The quality mark scheme is a voluntary U.K. based scheme, which covers products that are bought by individuals to meet long-term savings and protection needs. These include individual life and pensions products and retail collective investment schemes, such as unit trusts and ISAs. Group products are currently excluded, except where the contract is essentially with the individual, such as group personal pensions and stakeholder pensions. All of these products sold under a brand must meet the standards if the brand is to be granted use of the Raising Standards quality mark.

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A.3 *The Promises*

A.3.1 The promises that brands will make are:

(1) We will:
- — communicate in clear language;
- — inform you regularly about how your products are doing; and
- — set out the benefits and costs of products clearly.

(2) If, for any reason, you decide in the first 30 days that you do not want the product you have bought, we will give you your money back less, for single premium investments, any fall in the investment value.
Qualified advisers will recommend that you buy products suitable to your needs. You have statutory rights to compensation if, at any time, it is shown that a recommendation was unsuitable when it was made.

(3) We will be here to help you throughout your relationship with us.

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APPENDIX B

RAISING STANDARDS — WITH-PROFITS SUMMARIES

B.1 *The Aim of With-Profits Summaries*

B.1.1 The aim of the with-profits summary is to give customers clear information about how a with-profits investment works. This should improve customers' understanding, and help them identify important differences in the way that brands manage their with-profits business. This is not intended to restrict the ability of brands to respond reasonably to changing circumstances.

B.1.2 There are two versions of this document:

— *A simplified with-profits summary*. This version is written for the average customer. It is designed to raise the general level of understanding of a with-profits investment. This only requires a high-level description of some key elements, which means that the overall length of the summary will be kept short.

— *A detailed with-profits summary.* This version is aimed at more sophisticated customers. It is designed to provide more detailed information, in order to be able to compare and contrast products offered by different brands.

B.1.3 You must provide a with-profits summary at point-of-sale to all customers who buy a new contract with an option to invest in a with-profits fund. You have the option of:

— providing a simplified with-profits summary at point-of-sale; the simplified with-profits summary must mention the availability of the detailed version; you must provide a detailed with-profits summary to customers if they request this additional information; or

— providing the detailed with-profits summary at point of sale to all customers. In this case the simplified with-profits summary is not required.

B.1.4 The following rules apply to both versions of the with-profits summary:

— Each summary should be read in conjunction with the Key Features Document (KFD). You may combine the with-profits summary with the KFD where this would be helpful to the customer.

— Each summary should contain all the information required in a single document. The detailed with-profits summary must not rely upon information contained in the simplified version.

— You must provide a separate with-profits summary for each class of with-profits business that is managed in a materially different way; for example to distinguish conventional and unitised with-profits business, or

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if you manage single premium investment bonds differently from regular payment savings plans.
— The summary must be a technically correct description of your with-profits methodology. To get accreditation, it must also pass the PPIAB clear communications test.

B.1.5 In the detailed with-profits summary, you must cover the key aspects of how you manage with-profits business. These are:
— how the bonus system works;
— how you manage payouts (typically through the use of asset shares);
— the investment policy of the with-profits fund;
— the smoothing of investment returns;
— how to decide payouts on maturity or surrender (and the relationship to the asset share, where asset share calculations are involved); and
— when you might review your approach to managing your with-profits business.

B.1.6 The simplified with-profits summary covers similar information, but requires less detail to be provided. The with-profits summary mock-ups give a guide to the minimum level of detail required in each version.

B.2 *When you need to Write to Customers about a Change in Approach*

B.2.1 You must write to all customers who have received a with-profits summary if you subsequently review your approach and this results in a significant change in policyholders' reasonable expectations. 'Significant change' is defined as one where the effect of the change in the methodology causes the expected level of payouts to change by more than:
— 10% for an individual class of policies; or
— 5% in total across all policies.

B.2.2 If your current management approach results in expected payouts that vary from year to year by more than these limits, you do not have to inform customers.

B.3 *With-Profits Summary Rules and Guidelines*

B.3.1 Call the document *A guide to investing in with-profits* or similar. You can include the company and fund name in the title, or any other details that will help to distinguish the type of business that the summary covers; for example: *A guide to investing in the Any Company with-profits pension fund.*

B.3.2 The headings in the summary must be in a question format. You must use the standard sequence shown below.

B.3.3 The same headings and sequence of questions must be used in both the simplified and detailed versions. The main difference in the two

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versions is the level of detail required, which is illustrated by the mock-ups provided. The descriptions given in the answers to the detailed with-profits summary should also be supported by simple numerical examples, where this is possible.

B.3.4 Use the same terminology in your answers as in your KFD and other product literature.

B.3.5 The mock-ups provide an illustrative example of one type of with-profits policy. You will need to describe the relevant characteristics of your with-profits business in a similar level of detail.

B.3.6 The following additional points should be read in conjunction with the minimum content outline when preparing your answers to these questions:

(a) *What is a with-profits investment?*
Describe briefly the main features of your with-profits business. The list of features provided in the content outline may need to be adapted for some types of product.

(b) *What affects how much I might get?*
The mock-ups are based on a relatively simple product design. You may need to expand this section significantly for other types of product.
You may wish to refer to other information you provide on the asset mix of the fund.

(c) *What are the bonuses?*
If you use an alternative distribution mechanism, describe how it works. Use an appropriate heading instead of: 'What are the bonuses?'
You may wish to refer to other information you provide about the bonuses.

(d) *How do you decide the bonuses?*
The content outline assumes that there is a regular bonus and a final bonus. If other types of bonus are used, describe the method of deciding the levels of each type of bonus.
Describe the tools used to manage payouts in general terms, without using technical terms such as 'asset share'. If you use other methods of smoothing, describe how they work.
If you use an alternative distribution mechanism, describe how you decide how much of the profits are paid. Use an appropriate heading instead of 'How do you decide the bonuses?'

(e) *What are the guarantees?*
The description may refer to the KFD to explain the circumstances when the guarantees apply. For example, this may be necessary if the guarantees vary for different products covered by the summary.

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(f) *What if I decide to move out of with-profits?*
This does not need to include details of any exit penalties if the charge is clearly described in the KFD.

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APPENDIX C

RAISING STANDARDS — A SPECIMEN SIMPLIFIED GUIDE TO WITH-PROFITS INVESTMENT

A Guide to Investing in the <Company Name> With-Profits Fund

C.1 *Introduction*

C.1.1 This guide explains the main points about a method of investing called 'with-profits'.

C.1.2 We've produced the guide to describe how we manage the money invested in our with-profits fund. The fund is one of the investment choices we offer in our range of pension plans. You might initially choose to have all, or some of your money (or none) invested in our with-profits fund.

C.1.3 This guide summarises our current approach to managing the pension plans investing in our with-profits fund. If we make a significant change to our approach in the future, we'll write to tell you.

C.1.4 We've answered some of the questions you might ask. The guide mostly assumes you continue the policy through to the maturity date you select. However, the final section explains certain important differences if you choose to move out of with-profits before then.

C.1.5 If, when you've read this guide, you still feel unclear or unsure about investing in with-profits, you should seek further advice from your financial adviser or contact us directly. If you want more information, please ask for our detailed version of this guide. Our full contact details are in the Key Features Document.

C.2 *What is a With-Profits Investment?*

C.2.1 With-profits is an investment that smoothes out the return on your money over the period of time you hold your policy. So, you'll see a steadier return year on year, rather than watching the value of your policy fully reflect the rise and fall in stock markets.

C.2.2 *How does it work?*

C.2.2.1 Your money is pooled with other investors' money to form a fund. This works in much the same way as any other pooled fund (such as a unit trust). The fund invests in a mix of company shares, property, bonds (which are a type of loan to the government or to companies) and cash. The proportion that is put into each of these different investments, which are known as assets, will vary for different with-profits funds.

C.2.2.2 The challenge is that, while shares and property typically rise more in value than bonds and cash over a long period such as 20 years,

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the return is also much more volatile. One year the investment may do very well — but the next could see a big slump.

C.2.2.3 So instead of simply sharing out what the fund makes — or loses — each year, a with-profits fund evens out some of the fluctuations in performance over the time you hold the policy. Although smoothing means that we spread profits from one year to the next, our aim is to pay out all of the profits earned by the fund over the long term.

C.2.2.4 By combining your savings with other investors, you can get a better spread of assets than you could achieve by investing on your own. The fund also smoothes the return on your policy. This means that the investment risk of a with-profits fund is lower than many other ways of investing in shares.

C.2.2.5 Unlike simpler stock market investments, we offer some guarantees about the amount of money you'll receive when your policy matures, or if you die. If this happens, the regular bonus we add to your policy each year cannot be taken away. So, if the stock market crashes before your policy matures, you'll receive at least the guaranteed amount at that time.

C.2.2.6 We assess what is a 'fair share' of the profit for each of the investors in the with-profits fund, and use this to decide the level of bonuses.

C.3 *What affects How Much I might get?*

C.3.1 The biggest factor determining how much you'll get is the performance of the investments in the fund. Other important factors are:

— the smoothing of investment returns
— the results from certain other types of business where the fund shares in the risks and rewards
— our charges, which are described in your Key Features Document
— the effect of the guarantees we offer to you and to other policyholders.

C.3.2 The investment performance will depend on how much of the fund is invested in the different types of asset. For example, it is likely that a fund which invests 85% of the money in shares will perform better over the long term than one which invests only 70%. This is because shares generally provide a higher return than bonds or cash.

C.3.3 However, there are restrictions concerning how much of the fund's assets we can put into the stock market. This is because we have to make sure our fund is big enough to cover all our liabilities to policyholders at any one time. If the value of the assets falls below a certain level, we'd need to put more money into low risk assets such as cash.

C.3.4 The performance of different types of asset varies considerably over time. So we may change the balance of assets in the fund to:

— improve long-term performance
— maintain the financial security of the fund.

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C.3.5 The yearly statement we send will include a summary of the mix of assets, so you'll be able to see how the fund develops over time.

C.4 *What are the Bonuses?*

C.4.1 Bonuses are the way we pay you your share of the profits of the fund.

C.4.2 There are two types:

— regular, which are added throughout each year
— final, which we pay when your policy matures.

C.4.3 In normal circumstances, we aim to pay about half the investment return over the long term as regular bonus, and half as a final bonus. The profits we haven't paid out as regular bonus will build up to provide the final bonus. In the meantime, they increase our flexibility to invest in higher risk but higher return assets such as shares.

C.4.4 We usually decide the amount of the bonuses once a year. We apply different levels of bonus for different groups of investors. The group you'll be in will depend on the date on which you made your investment in the with-profits fund, and the type of policy you have.

C.4.5 The yearly statement we send will include details of our current bonus rates for your group.

C.5 *How do you Decide the Bonuses?*

C.5.1 When working out the regular bonus, we look at the past, present and future altogether. Our aim is to make gradual changes to the regular bonuses from year to year. We take profits (or losses) smoothed out in earlier years, add in the current year's returns, and make a judgement about how the assets will perform in the future.

C.5.2 So our long-term view of future investment is very important in deciding how much to pay out each year. For example, if we expect investment returns to fall, we'll reduce the regular bonus to bring it in line with our expectations, even if actual returns in recent years have been higher.

C.5.3 When your policy comes to an end, and we assess what to pay as your final bonus, we look at what would be a fair share of the total fund for investors in your group. This will depend on how profits have built up over the years. The final bonus will also depend on payouts made in previous years; we aim to ensure that the maturity payouts do not change in big steps from one year to the next.

C.5.4 In very unusual conditions, the total profits earned for your group could be less than those we have already paid out as regular bonus. If this is the case, then there would be no final bonus added to your policy. The guaranteed minimum value would then apply on maturity, or if you die.

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C.6 *What are the Guarantees?*

C.6.1 If you keep your plan going to maturity, or if you die, we guarantee to pay a minimum value.

C.6.2 This minimum value increases the longer you hold the policy, because we take into account the regular bonuses you have received.

C.6.3 But if you choose to move out of with-profits before reaching maturity, the guarantee won't apply.

C.7 *What if I Decide to Move Out of With-Profits?*

C.7.1 You may decide to cash in your policy before it matures, perhaps because you want to switch out of with-profits into another fund, take early retirement, or transfer your policy to another company. If you do, we may make an adjustment so that you get a fair share of the total fund value.

C.7.2 Depending on how the fund has performed over the period of your investment we may either:

— add a final bonus
— or reduce the unit price.

C.7.3 We don't smooth your return as normal, because the smoothing is designed to benefit investors who remain with us for the full term of their policy. We decide how much of the smoothing benefit to take into account. This depends on:

— investment conditions over the term of your investment
— how long you have been invested in the fund
— the total amount of money being withdrawn from the fund at that time.

C.7.4 Finally, if you leave before five years you'll only get a final bonus if investment performance has been exceptional over the period of your investment.

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APPENDIX D

RAISING STANDARDS — A SPECIMEN DETAILED GUIDE TO WITH-PROFITS INVESTMENT

A Detailed Guide to Investing in the <Company Name> With-Profits Fund

D.1 *Introduction*

D.1.1 This guide explains the main points about investing in our with-profits fund. The fund is one of the investment choices we offer in our range of pension plans. You might initially choose to have all, or some of your money (or none) invested in our with-profits fund.

D.1.2 This guide summarises our current approach to managing the pension plans investing in our with-profits fund. If we make a significant change to our approach in the future, we'll write to tell you.

D.1.3 We have produced two versions of this guide. There's a shorter version of the guide, which we send to all customers applying for one of our pension plans. The version you're reading now contains additional information we provide on request.

D.1.4 We've answered some of the questions you might ask. The guide mostly assumes that you continue the policy through to the maturity date you select. However, the final section explains certain important differences if you choose to move out of with-profits before then.

D.1.5 If, when you've read this guide, you still feel unclear or unsure about investing in with-profits, you should seek further advice from your financial adviser or contact us directly. Our full contact details are in the Key Features Document.

D.2 *What is a With-Profits Investment?*

With-profits is a type of investment that shares out the performance of the with-profits fund (the 'profits') to its investors, through a system of bonuses. In deciding the bonuses we smooth the return on your policy. So, you'll see a steadier return year on year, rather than watching the value of your policy fully reflect the rise and fall in stock markets.

D.3 *The Fund*

Your money is pooled with other investors' money to form a fund. This works in much the same way as any other pooled fund (such as a unit trust). The fund invests in a mix of assets, consisting of company shares, property, government bonds, company bonds and deposits. The proportion that is put into each of these different classes of assets will vary for different with-profits funds.

D.4 *Smoothing*

D.4.1 Shares in companies and property are higher-risk than the other

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types of investments. Their value tends to fluctuate more, but over the longer term they also tend to produce higher returns. Because of this the fund aims to keep a significant part of its assets invested in shares and property.

D.4.2 The challenge is that the return on shares and property is also much more volatile. One year the investment may do very well, but the next could see a big slump. So instead of simply sharing out what the fund makes — or loses — each year, a with-profits fund evens out some of the fluctuations in performance over the time you hold the policy. Although smoothing means that we spread profits from one year to the next, our aim is to pay out all of the profits earned by the fund over the long term.

D.4.3 By combining your savings with other investors, you can get a better spread of assets than you could achieve by investing on your own. The fund also smoothes the return on your policy. This means that the investment risk of a with-profits fund is lower than many other ways of investing in shares.

D.5 *'Fair Share' Payouts*

D.5.1 There are a number of different factors that contribute to the profits and we have to decide how to share these profits out when we set the bonuses. We do this by tracking your 'fair share' of the assets of the with-profits fund.

D.5.2 Your fair share depends on the profits earned by the fund over the period of your investment. We then adjust this to allow for smoothing. Finally, we look at the total fair share for different groups of investors and use these results to decide the bonuses we pay to each group.

D.5.3 The way this works is described in more detail in the later sections of this guide.

D.6 *Guarantees*

D.6.1 Unlike simpler stock market investments, we offer some guarantees about the amount of money you will receive when your policy matures, or if you die. If this happens, the regular bonus we add to your policy each year cannot be taken away. So, if the stock market crashes before your policy matures, you'll receive at least the guaranteed amount at the end of the term.

D.6.2 In all other circumstances the amount you might get back isn't guaranteed.

D.6.3 The level of guarantees we offer affects other aspects of how we manage the with-profits fund. This is described in the answers to the other questions.

D.7 *What affects How Much I might get?*

D.7.1 What you'll get back will depend on:

— the profits earned over the period of your investment in the fund

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— the way that we apply the smoothing process
— how we group investors when we decide the bonuses.

D.7.2 A number of factors affect the total level of profits earned by the fund. Different types of with-profits policy use different ways of calculating how much of the total profits will be used to pay bonuses. This section describes the way we do this.

D.7.3 The main factor affecting the profits is the investment performance of the assets in the with-profits fund. Other important factors are:

— the profits (or losses) that result from other types of business issued by the fund
— any difference between the amount we have paid to investors moving out of the with-profits fund and the fair share of the total fund value for those policies at the time
— our charges, which are summarised in the Key Features Document
— the guaranteed minimum value, if the guarantees apply when you leave the with-profits fund.

D.7.4 The shareholders of our company also provide capital to support the with-profits fund and are entitled to some of the profits. Our shareholders are entitled to the difference between the charges we take from our with-profit policies and the costs of managing our with-profits business.

D.7.5 If the fund suffers from an exceptional loss, we have to decide how this is to be shared. The loss may reduce the profits available to support bonuses on your policy, or we may decide that this will be covered by other capital in the fund, so that your policy is not directly affected.

D.8 *The Mix of Assets in the Fund*

D.8.1 The investment performance will depend on the mix of assets in the fund. We normally aim to hold between 75% and 85% of the fund in higher-risk (and so, potentially, higher-return) assets, such as stocks and shares and property. The rest is in fixed-interest investments, such as government bonds, company bonds and deposits.

D.8.2 The performance of different types of asset varies considerably over time. So we may change the balance of assets in the fund to:

— improve long-term performance
— maintain the financial security of the fund.

D.8.3 The yearly statement we send will include a summary of the mix of assets, so you'll be able to see how the fund develops over time.

D.9 *What are the Bonuses?*

D.9.1 There are two types of bonus. This is how they work.

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Regular bonus
— The regular bonuses increase the value of your policy over time.
— We decide the regular bonus once a year.
— We add it to your policy by increasing the price of the units you have in the with-profits fund throughout the coming year.

Final bonus
— We usually pay a final bonus to increase the value of your policy on maturity or if you die.
— You may also get a final bonus in certain circumstances if you move out of the with-profits fund.
— We decide the final bonus at the end of each year for the coming year. We may change it at any other time during the year if investment conditions change significantly.

D.9.2 We apply different levels of bonus for different groups of investors. The group you're in will depend on the date on which you made your investments in the with-profits fund and the type of policy you have.

D.9.3 The yearly statement we send will include details of our current bonus rates for your group.

D.10 *How do you Decide the Bonuses?*

D.10.1 When we decide the bonuses we look at the profits (or losses) spread by smoothing from earlier years, as well as the profits earned by the fund in the current year. We then work out how much of the available profits to pay out in the form of bonuses and how much to carry forward to future years.

D.10.2 *Regular bonus*

D.10.2.1 We decide how much of the total profits to pay out as regular bonus. This is based on:
— the profits earned in the fund over recent years
— our long-term view of future economic conditions.

D.10.2.2 The long-term view of future investment returns is very important. For example, if we expect investment returns to fall, we'll reduce the regular bonus to bring it in line with our expectations for the future, even if actual returns in recent years have been higher.

D.10.2.3 Our current objective for the fund is to pay:
— around 50% of the average investment return over the long term as regular bonus
— the rest as final bonus.

D.10.2.4 This is an average for all investors in the with-profits fund. The percentage that applies to your investment will depend on when you enter and leave the fund.

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D.10.2.5 The guaranteed minimum value will increase as we add regular bonuses. This means that we have to limit the regular bonus, so that the assets in the fund can support the increased level of guarantees. If we didn't do this, the guarantees in the fund could become large enough to require us to increase the percentage of the fund's assets invested in lower-risk fixed-interest assets. This would mean that we'd expect to achieve a lower total return over the long term on your investment, even though the regular bonus would be higher.

D.10.3 *Final bonus*

D.10.3.1 This section describes how we calculate the final bonus on maturity, or if you die. See *What if I Decide to Move Out of With-Profits?* for details of how we calculate final bonus in other circumstances.

D.10.3.2 We expect the profits we haven't paid out as regular bonus to build up. We would then use these profits to pay a final bonus.

D.10.3.3 There are a number of factors we consider when we decide the final bonus:

— the fair share of the total fund value for all investors in each group. This will depend on how the total profits have built up over the term of each investment.
— the adjustment we make for smoothing the profits.
— our expected investment returns for the coming year. We aim to avoid making changes to the final bonus during the coming year, and do so only if investment conditions change significantly from those we expected.
— changes in payouts from one year to the next. We aim to avoid changing the payouts on maturity in consecutive years by more than 10% for similar policies.

D.10.3.4 We apply the smoothing by averaging the profits earned in the fund. We normally apply the averaging over a four-year period, but we do give more weight to the profits earned in the more recent years. When conditions are more difficult, we may have to change this approach to make sure that:

— it operates fairly for all investors in the fund
— the fund can meet the guarantees it provides.

D.10.3.5 The way that smoothing works means that in any one year the amount paid out for each group may be more, or less, than the fair share at that time. We normally expect the payouts to be within 10% of the fair share for each group. In more unusual conditions the difference between these two may be more than 10%. Over a period of several years we aim to make the average payout equal to the fair share.

D.10.3.6 The investment performance of the assets in the fund can vary

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considerably over time. Although we aim to smooth out some of the effects of the fluctuations, bonuses can still vary quite a bit over different investment periods.

D.10.3.7 In very unusual conditions, the total profits earned for your group could be less than those we have already paid out as regular bonus. If this is the case, we wouldn't add a final bonus to your policy. The guaranteed minimum value would then apply on maturity, or if you die.

D.11 *What are the Guarantees?*

D.11.1 If you keep your investment going to maturity, or if you die, we guarantee to pay a minimum value. We work out the guaranteed amount by valuing each unit you hold using the price on the date that units are sold.

D.11.2 We add regular bonuses to your investment by increasing the price of the units. This means that the guaranteed minimum value includes all regular bonuses previously added to your investment.

D.11.3 If you move out of the with-profits fund before normal retirement or for other reasons, the value of your units isn't guaranteed. See below for details.

D.12 *What if I Decide to Move Out of With-Profits?*

D.12.1 This section describes what happens if you choose to move out of the with-profits fund. This may happen if you:

— take early retirement
— switch into another investment fund
— transfer your investment to another company.

D.12.2 We apply some charges whenever you move money out of any of our investment funds. These charges are described in your Key Features Document.

D.12.3 We increase the price of your units in our with-profits fund by adding regular bonus. This may mean that the value of your units when you sell them is quite different to your fair share at that time. Any difference between the amount we pay and your fair share will produce profits (or losses) for the fund. Those profits will affect the bonuses that we can pay to those investors who remain in the fund.

D.12.4 Because of this, if you move out of the with-profits fund, we may also adjust the price of the units you sell.

D.12.5 If you move out of the with-profits fund, your fair share is calculated in the way we described for policies reaching maturity, but we don't apply our normal smoothing process. The reason for this is that we aim to use smoothing to the advantage of those investors who remain in the fund over the longer term.

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D.12.6 *When we may pay more than the unit price*

D.12.6.1 We may pay more than the price of the units you sell if their value represents less than a fair share of the market value of the assets in the with-profits fund at that time. We do this by adding a final bonus.

D.12.6.2 Our aim is to hold back some of the investment returns when we decide the regular bonus. In normal conditions, profits will build up and we expect to be able to pay a final bonus.

D.12.6.3 The way that we calculate the final bonus depends on the period of your investment. This means:

— If you keep your policy going until just before your maturity date, we expect to pay a final bonus almost equal to the amount we'll pay to investors reaching maturity at that time. The final bonus will include the full benefits of smoothing.
— If you've been invested in the with-profits fund for less than five years, you'll get a final bonus only if investment performance has been exceptional over the period of your investment.
— In other circumstances we add a final bonus so that over a period of several years we aim to pay out on average the fair share. But, you won't normally get the full benefits of smoothing.

D.12.7 *When we may pay less than the unit price*

D.12.7.1 We'll reduce the price of the units you sell if their value represents more than a fair share of the market value of the assets in the with-profits fund at that time.

D.12.7.2 We do this to maintain a fair level of future payouts to everyone still invested in the fund. If we didn't, the extra amount that you'd get would have to come from other investors.

D.12.7.3 It is most likely that we'll need to apply the reduction following a large fall in stock markets, or after a period of several years where investment returns are consistently below the level we normally expect. But it could also happen if there are unexpected losses on other types of business.

D.12.7.4 It is less likely that we'll need to apply a reduction over longer periods of investment. This is because our aim is to hold back some of the profits to pay a final bonus. The profits held back build up over a number of years to provide a buffer that protects the fund against periods of poor performance.

D.12.7.5 We constantly monitor investment conditions and the total level of money being moved out of the fund, and may apply a reduction at any time if we believe it to be necessary to protect the fund. If the extra amount being paid out is small then we may choose not to apply the reduction at that time.

D.12.7.6 When we calculate the reduction, the way that we apply smoothing means:

— If you've been invested in the with-profits fund for less than five years

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when you move out of the fund, you won't normally get any smoothing benefit. For example, if there is a large drop in share prices during this period, you should expect us to take the full effects of this fall into account when we calculate the amount we pay you.

— We apply a gradually increasing smoothing benefit for longer terms of investment.

D.12.7.7 We never apply the reduction if you keep your investment going to maturity, or if you die. In these circumstances the guaranteed minimum value applies.

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APPENDIX E

RAISING STANDARDS — YEARLY STATEMENT FOR YOUR PERSONAL PENSION PLAN

E.1 *Requirements*

The following is an extract from Sections 7 and 8 of the RS manual. Section headings relate to the manual.

E.1.1 *Yearly statements*

E.1.1.1 The aim of the standard for yearly statements is to make sure that customers see regular information about how their plan is doing. This will help build awareness, manage customer expectations and keep customers informed about the progress of their investments.

E.1.1.2 This section combines the clear and comparable documentation rules from standard 1A and the rules on yearly statements from 1C.

E.1.2 *When to send out yearly statements*

E.1.2.1 You must send yearly statements for products that are sold after accreditation, which have significant investment content. Send the first statement within 14 months of the start of the plan and at least once a year after that. It is not sufficient simply to provide information on request or on a website. It must actually be sent to the customer or delivered by hand.

E.1.2.2 An explanation of 'significant investment content' is in scope Section 4.

E.1.2.3 This standard represents the minimum frequency for sending statements. You can send statements more frequently and must do so for certain products.

E.1.2.4 You can choose not to send a statement in certain circumstances. For example, if the policyholder has died, or if the policy is within a year of maturity.

E.1.2.5 You don't have to provide a yearly statement in addition to another regular communication. For example, you could enhance the annual bonus notice or tax certificate to meet the standard by including and presenting additional information based on the guidelines.

E.1.2.6 You can give customers additional information as part of the yearly statement as long as the extra information improves the usefulness of the statement. You can consolidate yearly statements for several plans as long as the consolidated statement uses the standard sequence and headings relevant for each component product.

E.1.2.7 You can provide the yearly statement in print, fax or email format. The yearly statement should normally go directly to customers unless they have specifically asked you to send documentation to their adviser. Financial advisers may request that you don't enclose marketing material

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with the yearly statement other than offering the option to increase the payments into that plan. If the option to top-up payments is offered, include the following wording (or similar), 'before taking this option, you should seek advice'.

E.1.2.8 Customers are responsible for making sure that you have their current address. You may choose to send a covering letter with the statement.

E.1.3 *Yearly statement rules and guidelines*

E.1.3.1 Call the document the yearly (or half-yearly) statement.

E.1.3.2 Don't use questions for main headings. Use the standard wording as shown in the questions and headings tables in the additional sections.

E.1.3.3 You must include all relevant contact details on the first page of the statement, as described in 'How to contact us'.

E.1.3.4 Use bold type for totals in tables wherever possible.

E.1.3.5 The sequence and location of the information in the 'reference data' section are discretionary.

E.1.4 *Your plan summary*

E.1.4.1 This section must be on the first page of the statement.

E.1.4.2 Include in the summary only the key information and figures that the customer needs.

E.1.4.3 You must include last year's value, the current value and last year's payments. Last year's value need not be provided until two years after accreditation.

E.1.4.4 The current value of the policy is the surrender or transfer value, allowing for any market value reduction *if applicabl*e. But you must also show the 'paid up' value if it is less than the surrender or transfer value. If this applies, also include these values for the previous year.

E.1.4.5 You must include projected maturity values on the three FSA growth rates for products that have a specified maturity date. You don't have to include intermediate projections. You must also include a cross-reference to the full *'What you might get back'* section.

E.1.5 *Payments into your plan/income drawn from your plan*

Show total payments into your plan and funds withdrawn since the previous statement.

E.1.6 *Your plan value*

For a with-profits plan, or a plan with a single fund that a customer can't switch out of, use the heading 'Your plan value' instead of 'Your investment funds'.

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E.1.7 *What you might get back*

E.1.7.1 You must include this section for all products that have a specific maturity date. For example, personal pension and endowment savings plans.

E.1.7.2 For schemes such as a pension plan, you may choose to use the customer's chosen retirement date to personalise the heading. For example, 'What you might get when you're 65'.

E.1.7.3 Don't split the table over two pages. The FSA warnings and notes must be on the same page as the table. You may choose to put the warnings and notes before or after the table.

For comparability, always put the growth rate percentages along the top of the table, not down the side. Use the same format for the table in the yearly statement as for the original point-of-sale illustration.

E.2 *Illustration*

Prepared for Jo Smith Plan Number 1234567
Statement period 2.6.2000 — 1.6.2001
Page 1 of 4

Here is your statement for your <name> Personal Pension Plan. It shows what your plan is worth now, the payments into your plan, and how much pension you might get when you're 65. Please keep this statement with your other pension plan documents.

Your plan summary

Plan value

Last year's transfer value on 2.6.2000	£0000.00
Current transfer value on 1.6.2001	£0000.00

Payments into your plan

Last year's pension payments	£0000.00
Last year's life insurance payments	£0000.00

Pension you might get

Your pension will depend on how our investments grow, and interest rates when you retire. This is an idea of the taxable yearly pension you might get in today's money. Please read the full notes on page 3, 'What you might get when you're 65'.

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If your plan grows at 5% a year	£0000.00
If your plan grows at 7% a year	£0000.00
If your plan grows at 9% a year	£0000.00

How to contact us

If you have any questions at any time, you can phone us, or send a fax or e-mail, or you can write to us:
Call us on *0000 000 0000* during the following times:
Monday to Friday 0 am — 0 pm
Saturday 0 am — 0 pm

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APPENDIX F

RAISING STANDARDS — A SPECIMEN YEARLY STATEMENT

Dear [Customer Name]

Policy Number XXXXXXXXX
Annual Policy Valuation as at 3 June 2010
Statement period: 4 June 2009 to 3 June 2010

F.1 *Statement*

F.1.1 Here is your statement of your [Lifestyle Saver]. It shows what your plan is worth now (line 2), the payments into your plan (line 3.a) the amounts withdrawn from your plan (line 4) and what you might get [when your plan matures on 3 June 2015] (lines 8.a-d). Please keep this statement with your policy document.

Plan value		£	£
1.	Last year's fund value on 3 June 2009		13,000
2.	Current fund value on 3 June 2010		16,600
3.	Your plan has increased due to:		
3.a	Payments into your plan		3,000
3.b	Change in bonuses accrued (but not vested)		1,600
	Benefits provided by your plan during the year		
4.	Amounts withdrawn		1,000
5.	Life cover provided	16,160	
6.	Ill health cover provided	0	

Benefits you might get			
7.	If you die	16,766	
8.	When your plan matures on dd.mm.2015		
8.a	Guaranteed benefit		12,320
8.b	If your plan grows at 4% a year		19,700
8.c	If your plan grows at 6% a year		21,600
8.d	If your plan grows at 8% a year		23,800
9.	If you surrendered your policy now		16,268

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F.1.2 The surrender value (line 9) is less than the current fund value (line 2), [firstly,] because of the explicit penalty of 2% of the fund value, [and secondly, because, to reflect market conditions, we are currently applying a Market Reduction Factor of yy% to protect policyholders who remain invested in the with-profits fund].

F.1.3 The benefits you might get (lines 8.a-d) will depend on how our investments grow and the future payments you make into your plan. The values quoted give an idea of the amount you might get if you made no further contributions to your plan, and did not withdraw any of your savings. Please read the full notes on page [n].

F.2 *Bonuses Added to Your Plan in the Last Year*

Over the year, the **guaranteed** value of your plan (line 6.a) has increased as follows:

	£
Sum assured payable on 3 June 2015	8,000
Existing bonus at 3 June 2009	4,000
Bonus added during the year	320
Guaranteed value payable on dd,mm,2015	12,320

F.2.1 [The statement should include a paragraph that relates the regular bonus decision to the company's regular bonus policy for that class of business. An example follows.]
The regular bonus we have added for the year is 2.0% of the sum assured, plus 4.0% of the existing bonus. This reflects our policy of paying in guaranteed benefits 50% of the investment return received smoothed over time. The remainder of the investment return is retained within the fund to pay final bonuses and provide a smooth progression of the fund value from one year to the next. Your current fund value (line 2) reflects the total investment return that has been credited to the fund.

F.2.2 [The statement should include a paragraph on the outlook for future regular bonuses].
The outlook is for future investment returns lower than has actually been achieved for this class of business in recent years. If this turns out to be the case, then we expect that future regular bonus rates will be lower than we have declared this year. Any reduction in regular bonus rates will be gradual in accordance with our bonus policy [company may wish to elaborate].

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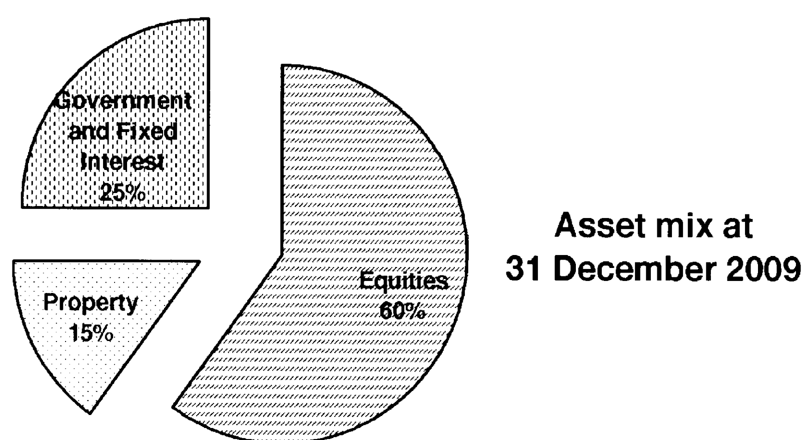
F.2.3 The actual return we achieve is dependent on the assets we hold in the class. The actual return achieved for this class of business during 2009 was 11%. The with-profits fund your plan is invested in currently holds:



F.3 *Charges made Against your Plan*

[Where there has been a miscellaneous item of profit or loss, including an expense overrun, the company should comment on whether this has affected the bonus rates and the value of a policyholders' investment. This should refer back to the description of with-profits given at the point of sale. For example].
There have been no additional profits or losses from miscellaneous sources credited to this class of business during 2009.

F.4 *Notes for Actuaries on the Information included in the Yearly Statement*

1. The fund values shown include any accrued final bonuses.
2. The investment return shown is the actual return achieved on the class of business, rather than the investment return credited to the policyholders' own asset share.
3. The paragraphs explaining the regular bonus decision and the prospects for future regular bonuses need to be written in the context of the bonus policy and circumstances for that particular class of business.

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F.5 *How to Contact Us*

If you have any questions at any time, you can phone us on 0000 000 0000 or send a fax to 0000 000 0000 between 0 a.m. and 0 p.m. Monday to Friday, or 0 a.m. and 0 p.m. on Saturday. Alternatively you can write to us at:

EVERYMAN INSURANCE
HEAD OFFICE
ANYTOWN
ANYWHERE
XX1 1XX

Or email us at customerservices@everyman.co.uk

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