ABSTRACT OF THE DISCUSSION

HELD BY THE INSTITUTE OF ACTUARIES IN LONDON

**Mr J. R. Lister, F.I.A.:** [Mr Lister introduced the paper at this meeting, and Mr J. F. Hylands, F.F.A. at the sessional meeting held by the Faculty of Actuaries. The two introductions were similar, and so only the amplified version, given by Mr Hylands, is reproduced, and appears in the abstract of the discussion held at the Faculty of Actuaries on pages 445-446 of this part of *B.A.J.*]

**Mr. P. M. Downey, F.I.A.** (opening the discussion)**:** With-profits has been one of the core products offered by the life and pensions industry for over 200 years. Given this long-standing connection with both the industry and the actuarial profession, it is perhaps surprising that relatively few actuarial papers have been produced in recent years which look at the subject in its entirety. Therefore, this report by the Transparency Working Party is to be welcomed. It is particularly timely, given the debate about the appropriateness of with-profits as an investment medium in the increasingly consumer-orientated society in which we now live.

The paper can be broken down into four basic components. It starts by defining precisely what is meant by the term with-profits: "What are the key characteristics that differentiate it from other forms of investment?" It next identifies the criticisms that have been levelled at the product in recent times. It then decides that these criticisms need to be addressed if with-profits is to survive. Finally, it proposes a new framework, centred around the concept of greater transparency, within which with-profits should be operated.

Section 3 looks at the defining characteristics of with-profits. It identifies three items.

*Smoothing*

This seems to me to be the single most important item. The message to the policyholder is that he or she is protected from the full impact of a sharp fall in asset values shortly before the policy matures. Conversely, he or she does not benefit fully from a sharp rise in asset values. This may be achieved by smoothing the investment returns earned on the with-profits fund or by adjusting the unsmoothed asset share at maturity. The key is that the policyholder has a degree of protection from the vagaries of the stock market at the point where he or she is due to access the funds under the policy.

*Guarantees*

Traditionally, with-profits policies have been underpinned by a guaranteed minimum level of benefits, augmented periodically through the declaration of bonuses. I have doubts as to whether this is necessary, or even desirable.

With-profits policies may have been around for over 200 years, but their characteristics have changed enormously over that time. The current version of the contract — with significant guarantees supported by a fund with a high equity backing ratio — has been around for, maybe, only 20 years. This period, as the authors point out, has been one during which investment conditions have been remarkably favourable. I have concerns as to the robustness of such an approach to more turbulent times.

Whilst the public are, no doubt, happy to accept guarantees if they appear to be added to the product for free, it is more debatable that they accord them a value anywhere near their potential cost. Therefore, whether guarantees really have to be an intrinsic feature of with-profits products is questionable.

*Participation in non-investment profits*

The pooling of items such as mortality and expense experience seems reasonable. However, participation in the profits and losses from the general business risks being run by the life office

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is becoming more questionable. I suspect that few with-profits policyholders understand that their retirement or savings funds might be used to provide some of the risk capital behind, say, writing unit-linked business. In the current climate, pressure to keep separate the investor and the 'risk-taker' is likely to grow. The implication is that the wider business risks run by an office should be capable of being supported comfortably by the inherited estate or, in the case of proprietary companies, shareholder capital, without recourse to with-profits asset shares.

Section 5 considers the criticism currently being levelled at with-profits policies. Here, it is important to distinguish criticism aimed specifically at with-profits investment from that where with-profits is being used as a proxy for the life and pensions industry. For example, much of the adverse comment stems ultimately from levying charges at the start of a policy to cover what is perceived to be an excessive level of commission. This, of course, applies equally to unit-linked policies as it does to with-profits ones. It is also less common nowadays, given the emergence, in recent years, of level-loaded contracts.

Where I suspect that problems specific to with-profits have arisen is in exploiting the opaqueness of the with-profits medium to generate inflated expectations by the customer. An example is the practice, in the mid-1980s, of basing projected benefits under new contracts on the continuation of current rates of reversionary and terminal bonus, when the returns required to achieve these were considered by many to be optimistic. Another more recent example is the headline figures appearing in some of the promotional material for with-profits bonds.

I suspect that a significant contributory factor to the unfavourable perception of with-profits investments stems from the practice of comparing the pay-out under a policy maturing this year with that under a similar policy maturing last year. Because of the dropping out from maturity values of high past returns — as, typically, has been the case in recent years — the result can be a fall in maturity values, notwithstanding a reasonable return in the year in question. As the paper points out, the incorrect conclusion that many commentators reach is that part of the return for the year is being held back by the life office.

Investing a significant amount of money with a financial institution entails a degree of trust in the institution. It could be argued that, where the investment is with-profits, the degree of trust has to be somewhat greater. If the consumer is not prepared to place that level of trust in the institution, he or she should consider an alternative form of investment. However, the authors of the paper conclude, probably correctly, that such a view would lead to a steady contraction in the with-profits market. Instead, they propose, in ¶6.1.1, to respond to the criticism by operating with-profits in a transparent manner, in order to demonstrate that consumers are being treated fairly.

This transparency takes two forms: greater disclosure to the consumer, to improve his or her understanding of the product; and the construction of a model for reporting the operation of with-profits business, which breaks down the elements linking investment returns and pay-outs into their constituent parts.

The disclosure to the consumer is proposed to be along the lines already set out as part of the Raising Standards initiative. This, of course, immediately runs into the problem that the underlying operation of a with-profits policy is inherently complex. It does not lend itself to a simple explanation to consumers, many of whom have little, if any, interest in financial matters. In ¶1.10 the authors recognise this conflict between producing something comprehensive, yet also likely to be read and understood. However, there must be some doubt as to whether this goal is, in fact, achievable. When added to the more general information already provided at the point of sale, there is a significant danger of overloading the consumer with information, however laudable the aim.

Increased disclosure to the consumer during the policy term raises the more fundamental issue of selection against the fund. Can the sometimes conflicting aims of smoothing, transparency and portability be reconciled, without either having to remove some of the intrinsic features of a with-profits contract or making the contract too unattractive for the life office to market? Certainly, any attempt to provide information about smoothing at a policy level runs into this problem.

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The second prong of the Working Party's defence of with-profits is the development of a model framework for reporting the operation of a with-profits fund, details of which are set out in Section 7. By revealing the component parts that together make up the return that the policyholder receives, the authors hope to demonstrate to sceptical onlookers that policyholders are being treated fairly.

I found this section of the paper to be an interesting analysis of the inner workings of a typical with-profits fund. I share the authors' view, expressed in ¶9.2.6, that it should be possible to obtain the information required for unitised with-profits business, most of which is relatively recent in duration. However, there may be greater difficulties in building up the various accounts for some conventional lines of business.

The proposal put forward by the Working Party is an innovative one. However, I have three main concerns with it:

(1) There is a risk of selection against the fund. The authors recognise this in Section 9.1, but argue that the benefits from greater transparency outweigh it. I accept that the risk of selection is less when information is provided at a global level rather than at the level of an individual policy. However, it still exists, particularly in relation to the smoothing account.
(2) We need to satisfy ourselves that the model is sufficiently robust to withstand some of the more extreme investment conditions that have existed in the past, and, no doubt, will recur in the future.
(3) Is the form of disclosure proposed simply too complex to achieve its aim? We may consider it transparent, but will the intended audience? I have some doubts in this respect. Yet, is there a simpler alternative, or are we back to the conundrum that with-profits is inherently complex?

The principal charge against with-profits is one of leakage — that not all the return being generated by the with-profits fund is being passed on to policyholders. In theory, of course, this accusation has already been answered through existing disclosure in the key features document and the with-profits guide. However, I agree with the authors that further disclosure is now needed. This should include the return earned on the with-profits fund, preferably as an average over, say, the last three years. In addition, the actual return under a variety of specimen policies should be reconciled with the return earned on the with-profits fund over the same period. Items in the reconciliation would include the deduction for expenses, the impact of smoothing, the transfer to shareholders, any contribution to or from the inherited estate, and any miscellaneous profits or losses allocated to the policy. Each item would be expressed as an addition to, or reduction in, yield. The information would appear in the annual FSA returns. Examination of the figures, over a number of years, should highlight any systematic deductions from, or additions to, the return being earned on the fund, together with their impact.

**Mr M. Iqbal, F.I.A.:** What our profession and the insurance industry needs to judge is whether the issues addressed by this paper are the right ones, and, if so, whether the proposals go far enough, or, indeed, too far. To put it another way: "Are we in the business of making the minimum concessions necessary to keep the critics at bay, or do we reinvent ourselves to keep in tune with the mood of the 21st century?'' I believe that we should go for the latter. I also believe that the issues relating to existing business and new business are different, and what is proposed might be too complex for new business and, possibly, unnecessary for existing contracts.

The authors refer to the changing climate of opinion. In fact, this change has been afoot for quite a while, if only we had seen it. We can all think of examples from our own experience, and the Equitable Life case is only the latest, and the most public, one. There was a similar judgment in the United States of America in 2000, known as the Harris Trust, which went against John Hancock, so this is an issue of accountability that is common to the western world, not just to the United Kingdom. In the U.K. the press and the judiciary appear to regard the relationship between the insurance company and the policyholder as being akin to that between a trustee and a trust beneficiary, and the long-term fund to be akin to a trust fund. Although

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that is not strictly the case, it is a good discipline to work to. It is also a good legal position to aspire to, and I think that that should be central to what we propose.

Turning now to the detail of what is proposed, I think that the issues relating to existing and new business need to be considered separately.

Taking new business first, I believe that what we need is a complete legal segregation of assets to pre-empt potential Harris Trust type lawsuits in the future. Also, as the authors state, we need to make sure that the charges are limited to those explicitly stated. The model is unnecessarily complicated for new business. It creates an illusion of transparency, when, in fact, all that we have done is to substitute several black boxes for one. The most transparent approach is probably to unitise the fund, keep the smoothing reserve for the new business of that class as part of that segregated fund, and use the smoothing reserve as the mechanism to write up, or write down, the market value to the smoothed unit price. This approach, I believe, is the one adopted by the only with-profits stakeholder currently in the market, although it is not clear to me whether it has gone for legal segregation of assets, rather than for a simple accounting one. If it is the former, then I believe that this should be the prototype for all future with-profits business. The smoothing algorithm, which can change over time, should, if necessary, be available for inspection. I do not see any problem in sharing our algorithm, or smoothing basis, with our customers or the 'interested public'. After all, over the last ten or 15 years, we have started sharing it with our Boards, and that was fairly unknown 15 years ago.

As the authors suggest, there are anti-selection issues, but these cannot be avoided. The right to collapse the unit price to the underlying market value in the event of surrender or switches must be retained and exercised, but the beauty is that you actually have a completely ring-fenced fund. Nobody can argue that management or any other group of people are tucking into it.

The concept of a smoothing reserve will only work for statistical fluctuations in a normal type of distribution. As the authors say, financial options cannot be smoothed out, and must be charged for explicitly. The shareholders or the inherited estate could act as the insurer, but, if it does, then, in order to avoid suggestions of double charging, some of the liabilities should be hedged externally, perhaps on a quota share basis.

Turning now to existing business, my main concern is that, the moment that you start to clarify your approach to smoothing and bonus allocation, you run the risk that it might be contested by a specific group of policyholders. As we found out with the Equitable Life court case, the British system of justice is geared to individual, not collective, interests. Courts are required to focus on petitioners' cases, rather than on wider public issues. Thus, if we are to avoid a Harris Trust type of action being triggered by the proposers, then a Schedule 2C transfer might be necessary to implement it. That may seem to be an unnecessary step.

Therefore, for existing business, the model proposed is unnecessary and expensive. It may also, in many instances, breach policyholders' reasonable expectations (PRE). As an alternative, I would advocate a set of principles that should be mandatory:

(1) The inherited estate or the shareholders' funds should be used as the buffer clearing house, in order to fetter what the company can charge to asset shares. All risks or events that are not normally distributed, including operational risks, should be borne by it. In return, these policyholders would then have no claim to the inherited estate. You cannot have it both ways. Axa Equity and Law and Equitable Life cannot both be wrong.

(2) There should be a clear charge for guarantees given by the inherited estate or shareholders, although I accept that some of the guarantees might be met implicitly, and need not be charged for.

(3) The basis of smoothing and of pooling investment and mortality risks across generations and policyholders should be published in a clear way. This should illustrate circumstances in which pooling would be to the detriment of a particular group. Pooling can never be a completely zero-sum game, because a stationary state does not always apply if you have inflation in the investment return or new business.

(4) Acquisition and maintenance expenses charged to asset shares should be benchmarked, and the information published in sterling terms rather than as a ratio.

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Of these, the first, relating to inherited estate, is the most important. It begs the question about the future of mutuals in the 21st century, but that is a separate debate.

If this approach is adopted, the management of shareholders' funds or the inherited estate will be a matter for the finance director with actuarial support. The policyholders' asset shares would be a matter for the Appointed Actuary. One thing that we have learnt is the Biblical lesson that no man can serve two masters.

**Mr P. W. Wright, F.I.A.:** The origins of this Working Party, as described in Section 2, lay in the desire to ensure that with-profits business had a role to play in the provision of stakeholder pensions. I must admit that I am sceptical about the desirability of this, albeit for reasons unconnected with transparency or value for money. My objection is simply that, ignoring the DSS rebates, three-quarters of the fund accumulated to vesting date must currently be used to provide an annuity.

There is a strong inverse correlation between equity markets and the real and nominal yield on long bonds. Thus, it can be argued that smoothing of the cash sum at vesting is counter-productive to the real wishes of the policyholder, which are probably to smooth the overall benefit available, and smoothing is only of real value for the one-quarter cash element.

A similar objection can be raised for all pension arrangements, except those where the policyholder will be able to receive the bulk of the benefits in the form of a cash lump sum. The argument is stronger where tax legislation prohibits any cash sum, for example additional voluntary contribution (AVC) arrangements. For group policies backing defined benefit schemes, the advisability of using a with-profits approach appears particularly difficult to justify, as the sponsor is not obviously in need of the type of smoothing offered.

Turning to the recommendations of the paper, in general I support the additional disclosure requirements directed at the policyholder. The final sentence of ¶7.4.7.4 is, however, somewhat ambiguous. If it is suggesting that the impact on the investment return of implicitly costed guarantees should be identified separately, then I believe this to be impractical.

My concerns with the paper relate to the disclosures recommended for the regulatory returns. I believe that the problems of selection, if a negative smoothing account was disclosed, would be very great for single premium business. Which independent financial adviser (IFA) could recommend a company that disclosed that it would pay future bonus out of an account which, using the terminology of the paper, was less than 'fair shares' for in-force business? Which IFA could avoid advising policyholders to switch out of a fund with a negative smoothing account if no market value adjustment (MVA) was in place, thus bringing about an active MVA policy and validating the criticism levelled in ¶5.3.2.3?

It is, indeed, these concerns which underlie the problems for both ring-fenced stakeholder business and the new classes of unitised with-profits business, referred to in the paper. Given that the largest class of with-profits business currently sold is single premium bonds, and that the weighting by shareholder profitability is even higher, I think that the industry has to think very hard before it adopts the recommendations of Section 7. The complicated nature of the disclosure regime is unlikely to dispel much criticism of with-profits business.

For example, Sir Howard Davies, in a recent speech, included, as a problem for with-profits business, that policyholders were not aware of the risks associated with early surrender and investment volatility, despite the fact that we have had 'in your face' disclosure of these issues for nearly 13 years.

Most of my concerns arise with the disclosure of a negative smoothing account. However, if a substantial positive account was to arise, it might be very hard, in practice, to enforce the rule that this amount must be distributed to the class of business concerned. If existing policyholders and any shareholders agree to break this rule, on the basis of precedent, it will be very difficult for the FSA or courts to stop it, on the grounds that it might be unfair for hypothetical future policyholders.

**Mr C. M. George, F.I.A.:** I question whether the disclosure in Section 7 helps. I think that,

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internally, for a with-profits office, the answer is clearly 'yes'. For a board of directors, it provides a very clear picture of the operation of the with-profits fund that they should be familiar with. I would then be happy to share the results with the regulators, so as to demonstrate compliance with published descriptions of the way in which the funds work and of their internal operation.

However, the shareholder share of profits for UWP business written on a 90/10 basis has been neatly glossed over in Section 7. Part of being open and transparent is the disclosure of the value of the shareholders' share, so that prospective policyholders can judge whether it is reasonable, relative to the risk that the shareholders are taking. I am not sure why the Working Party did not address this issue, but it does seem to be a somewhat significant oversight in what, otherwise, I believe to be an excellent paper.

Should the disclosure go wider than the company and the regulators? At this stage I believe the answer to be 'no'. Consider IFAs and IFA offices. Best advice could well mean that small problems, such as a negative smoothing account, as has already been identified, could soon become a major crisis for some offices. Best advice would lead to reduced new business and even increased switches away, so that the people who would then suffer would be the small consumers and those without advice. I am not sure that this is what we would want.

I asked myself: "Will the wider disclosure actually assist consumers?'' Undoubtedly, for the well-informed, the answer must be 'yes'. Personally, I would make very good use of it. For other consumers, however, I think that the answer is much less clear, and may well be 'no'. Consider the services provided by some organisations at one end of the with-profits spectrum, such as the small friendly societies serving affinity groups. These organisations could suffer heavily by being forced into the changes proposed in this paper for very little benefit. For them, the essence of with-profits business is trust. Ownership of the organisation by the members means that there is no competition with shareholders, or no conflict with shareholders. The service offered by the traditional with-profits business is a long-term savings contract with an equity content, and the heavy smoothing of traditional with-profits business assists in removing the timing risks that are normally associated with virtually every other form of equity exposure. Expenses for some organisations in this group are surprisingly modest. Whatever happens, I would be very sad if this paper contributed significantly to the demise of such organisations.

**Mr D. I. W. Reynolds, F.I.A.:** I hope that with-profits survives, but it will not survive without change. This paper does not convince me. I hope that there is time to develop it. It fails for me because the proposals fail to meet three tests:

(1) Will the common man or woman be better able to understand with-profits?
(2) What will be the impact on mutual offices?
(3) Are the different contexts of with-profits provided by mortgage endowments, pensions accumulation, annuities and bonds properly considered?

The authors acknowledge that the general public will not follow these proposals. They depend upon what they term the 'special publics' to support and communicate the proposals. That is a vain hope for what is still quite technical and dependent upon interpretation. More important, and needing more work both by the profession and by individual life insurance companies, is what the companies tell their policyholders, year in and year out, through the life of these long-term contracts. That means better communication, and that means getting rid of terms like 'reversionary bonus', 'inherited estate', and even 'with-profits'.

Can mutuals survive if with-profits disappears? I believe so, but they need to separate the benefits of membership from the smoothing of investment returns. Some building societies have started to provide membership 'dividends' or 'bonuses'. These are separate from having provided better contractual returns on deposit accounts or lower mortgage rates. Developments along these lines within mutuals might also help clarify the use of the inherited estate within proprietary companies.

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I started by saying that I hope that with-profits survives, but it needs, not only transparency, but also some more radical thought.

Consider, first, mortgage endowments. As currently designed, these fix a premium and give a variable pay-out. Should we not reverse the process, and go back to how with-profits operated in the 19th century; fix the payouts and, if the investment return is good, reduce the premiums? That is not a very original idea, but it would still need transparency to support it. Mr Wright has already said that there is no great benefit (and may even be a cost) in smoothing investment performance during the accumulation phase of pension contracts. I am glad to find somebody else who agrees with me, that this may be a Pyrrhic victory to have gained with-profits for stakeholder pensions. So, I have no wish to see with-profits survive in the pensions accumulation phase.

However, with-profits annuities are quite a different matter. They are an ideal means by which a pensioner can continue to be invested in equities, and yet be insured against the risk of longevity. Draw-down schemes are inherently dangerous, because pound-cost averaging works in reverse, and the longevity risk remains with the individual.

There is no discussion in the paper on how with-profits annuities might work. I suspect that they provide quite different problems, as they are drawing down and taking money out of the fund rather than accumulating it.

The one class of contract that the paper deals with is unitised with-profits bonds. As single premium contracts, proposals could be made which are more understandable by the common man or woman.

This is a vital issue for us to debate, but we need more than technical actuarial work. We need some lateral thinking, possibly in the names and contexts that we call things, but, most of all, in how the proposals can be communicated to the public.

**Mr N. H. Taylor, F.I.A.:** As a long-time advocate of providing more information, I welcome both the ABI's Raising Standards scheme, and this paper.

The comments made in the press, by politicians, by the Consumers Association, even from the top of the FSA, show a lack of understanding. Though with-profits business has been around for almost 250 years, we have never bothered to explain it. I empathise with the specific criticisms mentioned in the paper and how to address them. Simply put, we need to make more information available.

Mistrust, deceit and incompetence are the descriptions best fitted to how the life assurance industry is seen, and, by implication, our profession also. In addition, we have seen the management of two large mutual offices, both dominated by actuaries, described as arrogant. Maybe it is as well that both we and the ABI got our act together before the real problems arose, and started looking into this subject.

Even where a legal necessity, policyholders' circulations are not good. Look at that from Standard Life in connection with its demutualisation vote — unforthcoming. Look at the Axa Sun Life case — totally incomprehensible. Although I am involved in the transfer business, I struggled through the 100 or so pages, but there was nothing new after the introductory pages. Even then some important information was not included.

Turning to the proposed model, I support the concept, in principle. However, I leave it to others to make detailed comments. It certainly took me quite some time to work out the flow chart. From the point of view of mergers, it will almost certainly make life easier to secure PRE or with-profits funds than at present.

What is important is that the information on the model should be available publicly. I differ from some of the previous speakers on that. Maybe it should go into the bonus parts of the annual FSA returns. If so, it should be enforced, however difficult that is practically, on all conventional with-profits business. So, my answer to the question in the title of Section 8: "What level of disclosure is appropriate?'' is simply 'full'. Do not hide anything. If we hide anything, we will still be accused of mistrust and lack of integrity.

I have been fascinated by the lack of understanding of with-profits business, particularly by

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stockbrokers and IFAs with whom I have come into contact. There seems to be a view, similar to that seemingly held by many journalists and politicians, that life assurance funds are an amorphous mass of money, from which the directors, advised by some technical boffin called an actuary, distribute at will. Any connection with investment returns and market movements is totally lacking. If these people cannot understand, then I believe that the ABI's simplified guide is too difficult. The real examination question is to explain with-profits to a policyholder briefly, and without the use of jargon.

I believe that it would be wise to keep the detailed guide, and, possibly, even develop it, but preface it with a short, and much simpler, version. I think, to some extent, that I am in line with Mr Reynolds here. I also believe that any guide should stand alone, with no reference to other documents, such as key features documents. We must be careful not repeat the farce of with-profits guides. Has any policyholder ever read one of these?

I am interested that the Working Party would like to give some more information than the ABI in the annual statement, which I support. What worries me about the proposed annual statements is that they will show surrender values or transfer values, not asset shares (or what we now apparently call fair shares). This is nonsense. I have heard all the excuses about not quoting asset shares, but these can be summed up as all that they would do would be to make life harder for the life offices. Too bad!

While surrender values and transfer values are useful pieces of information, they do not represent the underlying value of the policies, and they may well mislead policyholders. In addition, projected maturity values should use asset shares as the starting point. I am not sure where the FSA guidelines have got on this. We have to face the fact that the underlying theory suggested in the paper is all asset share based.

I totally agree with a comment in the paper that life offices should have a detailed written record of how they manage with-profits business. Any office involved in a transfer of business has that included in the Scheme of Transfer. These documents are in the public domain, and policyholders will, at the very least, be given a summary.

I believe that, in order to regain trust, integrity and competence as the hallmarks of both our profession and the life assurance industry, we need to simplify the basic information, but be even more open in making detailed information available than the proposals made in the paper and by the ABI.

**Mr I. G. Maidens, F.I.A.:** I welcome the Working Party report and am generally supportive of the recommendations contained within it. I am particularly supportive of the recommendation, in ¶6.2.5, that companies should disclose the investment return earned on the assets backing with-profits policies each year.

A handful of companies already provide information on investment performance in their with-profits guides. The vast majority do not. I believe that the fact that this information is not currently in the public domain is one of the main reasons why industry observers in the media and elsewhere find it particularly difficult to understand the level of, and movements in, payouts on with-profits policies.

Over the last seven or eight years my firm has been responsible for running the asset share survey referred to in the Acknowledgements section. In addition to this regular survey, we have also conducted much research, in recent years, into the assumptions underlying the calculation of with-profits asset shares and bonus rates. In particular, over 30 companies have provided us with the investment returns earned on their with-profits assets and applied to asset shares, and the mix of investments backing their with-profits policies over a period back to 1960.

Using this information and other publicly available data, we have been able to calculate estimated asset shares for the participating companies. Our conclusions from this research are that, contrary to the belief of many observers, who suspect what might be termed manipulations or deliberate holding back of surplus to build up estates, the range of differences in policy payouts from company to company can be almost entirely explained by differences in investment performance.

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I use 1999 as an example. Excluding a few outliers, we have data for 30 companies. These companies had equity backing ratios, by which I mean the proportion of U.K. equities, overseas equities and property backing with-profits business, ranging between 52% and 86%. This is quite a wide range, so differences in the investment returns achieved would be expected, particularly in a year like 1999, when, according to the Barclays Capital Indices, the total return on U.K. equities was about 24%, while the total return on U.K. fixed-interest was about −4%.

In practice, the gross investment returns earned by these companies on their with-profits assets ranged between 11% and 22%, with an average of 16% — a very wide range. All other things being equal, the difference in the returns in this one year alone could have accounted for a difference of 10% in payouts on policies maturing in early 2000.

Perhaps more startlingly, 12 of the participating companies had equity backing ratios in the range 80% to 85% at the end of 1999. Consumers, or their advisers, observing these equity backing ratios, might reasonably have expected that these companies would produce broadly similar unsmoothed investment returns. In practice, the investment returns ranged between 11% and 20%, with an average of 17%, a much wider range than would have been expected. I believe that, if information on each company's investment performance on the assets underlying with-profits policies was in the public domain, it would, on its own, go a very long way to making with-profits more understandable to consumers, and would remove much of the suspicion about the existence of what some observers described as manipulation. If nothing else, I would encourage companies to make these data available publicly for at least, say, the last ten years.

**Mr C. D. Pullan. F.I.A.:** The problem of disclosure and with-profits is not new. It was over 170 years ago that a life office declined to offer with-profits policies, because of the fear that investors would demand to inspect its books to ensure that they received a fair return. It was not until after the Second World War that the investment return became the major contributor to bonuses.

In more recent times, the Securities and Investments Board (SIB) recognised the problems of disclosure for with-profits policies, and, in 1990, introduced the with-profits guide. I find it a little disappointing that the paper does not mention this initiative, and yet, in ¶1.3(h), suggests that regulatory changes (e.g. illustration bases) may be a candidate for a change in public perception.

It is worth recalling that, back in 1988, the SIB broke the mould of using current bonus rates for illustrations by specifying rates of investment return, because there was no basis for the calculation of the level of expenses, and so they were forced to prescribe a standard level of expenses. Since then, changes have been made to reduce the rates of return in line with market expectations, and to move to own expenses.

Just imagine the problem if current bonus rates had been used in August 1990 for a ten-year policy. From Figure 2, this would have meant a 15% return, whereas the actual return achieved by the year 2000 was under 10%. This is a major problem with this table, in that it addresses only the position at maturity, but not on earlier surrender. There is a public perception that, while with-profits may give reasonable values at the end of the term, it gives less value at early cessation. Is not the existence of a substantial market in traded endowments evidence of this? Of course, an alternative perception is that the market overvalues existing with-profits policies.

I find the ideas in this paper very interesting, and well worth further investigation; but it has to be accepted that it is only an attempt to scratch at part of the problem. Conventional with-profits barely gets a mention, except in ¶7.1, where it states that, on practical grounds, some companies will never provide disclosure for CWP business. This is a pity, since, for the next ten years, managing expectations in an era of declining payouts for with-profits policies will be a major issue.

Referring again to the with-profits guide, back in 1988 the Personal Investment Authority tried to encourage more disclosure in this area, and issued guidance which stated that, in order to explain the relative importance of underlying investment returns, information on rates of return on net assets attributable to with-profits business may be included, together with how these have

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been taken into account in determining bonus policy. It also stated that firms were encouraged to indicate how the net return to policyholders is split between the return on assets and allocations from miscellaneous sources. It would be helpful to indicate the likely future potential for allocations from miscellaneous sources. So, these ideas are around somewhere, and exist in regulatory guidance.

One area where much more needs to be done on the model is on surrender values, to demonstrate whether they are reasonable value for money, especially where market value adjusters have been used.

Paragraph 8.7.I is intriguing, in that it links the last 50 years to inherited estates. What it reveals is that our knowledge of the development of with-profits, despite its age, is limited, and initiatives like this, which track the fund in some detail, should prove to be very useful.

**Professor A. D. Wilkie, C.B.E., F.F.A., F.I.A.:** This paper seems to me to be a very good start, but (and this is the reverse of the usual criticism) the paper has no formulae. It does seem to me that offices implementing these ideas will need formulae, or equivalent words, and should put these into the full explanation, which, I think, should be in the statutory returns, so that at least the 'special publics' can see them.

I also see that there is no reference to what happens overseas, either in the U.S.A. or in the European Union. In other states of the E.U., the way in which profits are distributed is often prescribed, and therefore transparent. I do not know whether it is a good way of doing it, but it is, at least, a known way, though, of course, it varies a lot from country to country, and in many countries all policies are with-profits, including term assurances and annuities.

There is no mention of the words 'analysis of surplus', but this is really what is going to be needed in order to work out the different elements.

It is also not mentioned that, essentially, the investments need to be unitised. An earlier speaker said it might be a good idea to, in effect, publish the unit prices of these internal units. That means units for U.K. shares; overseas shares; possibly separate funds for fixed-interest, chopped up by duration, etc.

There need to be explicit charges for guarantees, and Hare *et al.* (1999), which is quoted, explains a number of methods of doing that. It seems to me that one needs to charge the expected value for the guarantees, then set up a 1% or 1‰ quantile reserve, and then charge the policyholder an extra rate of interest, maybe 1% or 2%, on this extra reserve. I think that that is implicit in the paper.

The smoothing formulae will need to be explicit. I think that there is a surplus arrow in Figure 4. The diagonal arrow going from the asset share directly to the smoothing reserve is not needed. Of course, the smoothing formula needs to be able to be changed from time to time.

I am not worried about low surrender values for what are, essentially, fixed long-term contracts. If people want easy cash, then they should choose unit-linked policies rather than something with guarantees which is intended to run for, perhaps, ten, 20, 25 or 40 years. I can see that there are problems with pensions policies, where people may want a spread of possible retirement dates. However, for ordinary endowment policies, I think that it is a mistake to worry about surrender values too much.

When the smoothing account is in surplus, this is not very different from the free reserves being larger than usual; and when it is in deficit, this is not very different from the free reserves having got a bit smaller. However, one way of avoiding anti-selection might be to charge slightly higher premiums (a sort of entry premium) when the smoothing reserve is in surplus, and a slightly lower premium when it is in deficit, quite explicitly. This is a sort of smoothing adjustment, but you cannot charge so much as to negate the smoothing entirely.

A big advantage of this whole system is that, if you have explicit formulae all the way through, it is very much easier to use stochastic simulation — and, as you can imagine, I am in favour of that — and simulation is, in any case, desirable to test the whole system. You need to see whether the formulae that you have put forward are robust in a variety of different circumstances.

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**Mr C. J. Hairs, F.I.A.:** The future of with-profits rests on making its operation transparent. I feel, however, that one vital aspect of the contract is missing from the proposals in the paper. Having seen the criticisms of the paper's proposals in the weekend press, I wonder if it is the missing element that needs to be added. For while this admirably clearly written paper's proposals would result in setting out what is going on, it does not, perhaps, make it clear why what is going on is necessary. I refer here to what it is that makes with-profits work — the secret magic of a savings vehicle, which allows premiums to be invested in equities, and yet which gives significant protection via smoothing on top of a base of guarantees.

This feature — this secret — is, in its essentials, very simple, and not, in fact, magical. It is that the with-profits contracts, properly managed, themselves produce capital. Because they produce capital, they share in the considerable risks of the business; and so they are justified, on grounds of simple financial equity, in receiving their share of the rewards.

A with-profits policy does not generally generate capital immediately the first premium is paid. It is by distributing only part of the investment return on premiums, in the form of guaranteed bonuses, that each policy's asset share (for those policies that stay in force long enough) comes to exceed the prudential reserves necessary to cover its share of the guarantees. After that point, the contract's contribution to capital tends to increase, until, at the end of the day, there is a return of that capital, on a smoothed basis, in the form of terminal bonus. For a reasonably well-established book of with-profits business, the class of with-profits policies, as a whole, in a with-profits office provides the major part of that business's working capital.

Communicating this mechanism is, I believe, essential in showing why boards, advised by their actuaries, have to be cautious in setting levels of annual bonus; why they have to avoid locking themselves irrevocably into explicit distribution formulae; and why ultimate levels of terminal bonus need to be quite high. Indeed, the higher the amount of terminal bonus, that is of capital generated, the greater the prospect of the fund being able to earn profits.

In making any reference to the term 'capital' in disclosure material, it would be essential to make clear that there are differences between permanent shareholder-provided capital and some of the attributes of this policyholder-provided capital, which is ultimately temporary, and may not be available to cover all contingencies. However, I believe that the similarities are sufficiently powerful to allow use of the term, which, I would hope, would command understanding.

To show this capital at the level of the with-profits bonus class, you could divide the asset-share account box in Figure 4 into two parts. One part would correspond to the reserve necessary to provide for guarantees, with the balance being the aggregate contribution to risk-bearing capacity or capital. This second part can then be shown to have a linkage with the capital account box.

The authors may feel that this is an extra degree of complexity, which would take transparency beyond the threshold of what is acceptable. If so, I should like to see this developed and debated, and I hope that they would be wrong. Policyholders' provision to the fund of risk-bearing capacity is a key facet of with-profits, and vital, I believe, to understanding why a board takes the decisions that it does.

**Mr C. E. Barton, F.I.A.:** Bearing in mind that this paper places such stress on the need for clarity, I would like to ask whether the reference, in ¶1.5, to the smoothing of returns between generations, applies to the three broad categories of past, present and future members of the fund, or whether it applies only to current members, according to how long they have been members and how near they are to maturity. I have long maintained that the operation of with-profits business, if it is to be legitimately viable, should be based upon the latter principle, that is smoothing within the body of existing policyholders. It is not practicable, and if it were it would not be equitable, to attempt to smooth the known past with the unknown future. The criticism implied by my question applies to the reference, in ¶3.3.2, to smoothing between generations of policy. It also lies at the heart of the debate on the so-called inherited estate.

In ¶3.3.3 it is suggested that, in certain circumstances, transfers between generations of policy should be viewed as a contribution to, or distribution from, the inherited estate. Surely

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this reference to a contribution to the inherited estate is contrary to what I thought was accepted within the profession; that the creation or increase of inherited estate should be avoided in future.

In Section 6.3 the paper attempts to refute the criticism of ¶5.3.9.1, that 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. Whilst Section 6.3 shows that, for the examples chosen, average returns under with-profits policies have, in general, been at least as good as those under unit trusts, this applies to policies which have run their full term. A valid and complete comparison between with-profits assurances and unit trusts needs to include the consideration of policies which are not maintained for the full term. This is probably the major source of the iniquitous inherited estate. In general, the paper does not place nearly enough emphasis on prematurely discontinued policies.

Mr Pullan made this point. Professor Wilkie was less worried about surrender values. The current situation may be all right, provided that policyholders understand the situation. In the past they certainly have not been led to understand it.

**Mr P. D. Needleman, F.I.A.:** [Mr Needleman also spoke in the discussion on the paper at the sessional meeting held by the Faculty of Actuaries, and an amplified version of what he said in this discussion appears in the abstract of that discussion on pages 450-451 of this part of *B.A.J.*]

**Mr M. J. Wadsworth, F.I.A.:** My comment relates primarily to Section 7.4.8, the capital account. Two qualitatively different structures both operate under the 'with-profits' label. This helps to create a good deal of the confusion in the market place. The first structure is about providing life companies with capital-at-risk, historically mutuals, but, to some extent, proprietary companies as well, and receiving a return for participating in the capital-at-risk. The second structure is simply about smoothing out or underpinning investment returns.

These have quite different risk profiles. The first, the capital-at-risk, represents a potentially very high risk to the investor, rather like a single company shareholding. This is seldom made clear to would-be investors. It is certainly higher than participating in, say, a unit-linked equity or managed fund. The second, the smoothed or underpinned investment fund, has, typically, a much lower risk profile, sitting somewhere between an equity and a bond or deposit-based fund. Nearly all with-profits funds seem to be sold by analogy with the second risk profile. The first area of risk is not brought to the attention of customers, but with consequences that we have seen over recent months.

The problem is compounded, because the structures are combined in varying proportions, and customers generally end up with a higher risk exposure than they would expect. This has been true of customers in both mutuals and proprietary companies, but has particular significance in mutuals, as recent events have demonstrated.

I believe that the labelling of funds should give an unambiguous message as to their nature, and that this is a point that the FSA should act on. 'With-profits' should be understood to mean 'with-profits or losses' of the company, or a defined part of it. On the other hand, 'smoothed investment funds', whatever the methodology of smoothing, that have no exposure to genuine profits or losses of the company, such as the funds referred to in ¶3.5.4, should not be referred to as with-profits funds.

It is not enough to deal with this confusion by supplying more detail to customers. The current ambiguity must be removed by a change of terminology if customers are to understand what they are buying. My guess is that few customers will want to supply capital-at-risk, however apparently remote the risks are, particularly after the events of the last few months. If this is the case, it, of course, raises some interesting questions as to the future of the few remaining mutuals.

**Mr S. A. Carne, F.I.A.:** Recently I had occasion to ask someone what he thought his greatest

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business skill was. He said that, when he was firing on all cylinders, he could solve a complex commercial problem and present the solution in terms which were so simple and so straightforward that every sensible person accepted his proposals instantly. I then asked him if he was recognised for having this skill. He looked at me as if I was stupid, and said: "Of course not. Once you have made the solution seem blindingly obvious, no one is ever going to admit to thinking that there was a problem in the first place.'' I hope that the authors will understand that I mean this as a very great compliment, indeed, when I say that I thought their paper read like a statement of the blindingly obvious.

If the result of this work is, as the authors suggest, that with-profits policies survive for a thousand years or more, future historians of the actuarial profession will doubtless look back at this paper and say: "It must have been a quiet month.'' or even: "Did you say *eight* authors?'' Therein lies both the greatest strength and the greatest weakness of this paper. When these ideas are implemented, people are bound to ask why it was not done sooner. The answer (indicated in the paper) that it was not possible (for technological reasons, I presume) to do so more than ten years ago will simply invite the question: "So, why was it not done nine years ago?''

The true answer — that the idea was not thought of before; that this is one of the first great actuarial discoveries of the 21st century — is likely only to attract more disrepute for the industry — the very opposite of the authors' intentions.

The ideas in this paper deserve to be implemented. Indeed, they cry out to be implemented, but they cry out to be implemented quietly. By all means let the press and other commentators express pleasure at the decision to be more transparent, but the temptation to trumpet the ideas as a great invention is one that I recommend we resist at all costs. If transparency is presented as a management choice, it will attract praise. If it is presented as a new invention, I fear that it will be used as an excuse to criticise.

That leads me to my second point. For too long we have thought of the actuarial profession as being almost synonymous with the life assurance industry. The industry's successes were the profession's successes, and its failures were our failures. That ceased to be a sensible line to take when the industry started to populate the senior positions with more and more people from outside our profession. Ironically, the most recent big failure within the industry was in one of the few remaining companies whose management was dominated by actuaries, but, whilst the management decisions may have been *taken* by actuaries, they were not actuarial decisions.

**Mr J. Roberts, F.I.A.** (in a written contribution that was read to the meeting)**:** I am seriously concerned by a number of aspects of this paper. The Working Party was tasked, according to ¶2.1.3, with: "preparing proposals for the transparent operation of with-profits business'', and was asked to present: "an initial report that focuses on the use of with-profits for stakeholder pensions.'' Yet, in ¶2.1.4, the Working Party have felt the need to restate their terms of reference to: "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 accepted as a suitable investment medium.''

This apparent transformation of the Working Party, from a professional body scrupulously and impartially examining the features of with-profits, into a lobby group for with-profits life offices, is regrettable. I have observed, in the past, that the profession had been too close to the ABI, but had hoped and thought that the profession had managed to divorce itself from that association. I am disappointed to see that the profession is, once again, prepared to show itself as a mere adjunct of the U.K. life industry; the technical division of the ABI.

Having decided to switch its brief from the use of with-profits to the advocacy of with-profits, the lobbying tendencies of the Working Party would seem to have dominated its thinking and presentation, with the result that the technical aspects of the paper are deficient. Figure 2, for example, makes the inappropriate comparison between the returns on with-profits contracts and those on U.K. equity unit trusts. It says that the asset mix of the two products is "not entirely comparable''. This is an understatement of some degree. In ¶6.3.3.3, it says:

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"Returns on unit trusts are more variable..." and: "Average returns show less volatility for with-profits policies than for unit trusts." These conclusions jump from the particular to the general all too carelessly. Of course, U.K. equity unit trusts will be more volatile than portfolios of mixed assets that make up the average with-profits fund. Surely, a comparison with unit-linked balanced managed funds would have been more appropriate? Also, the products themselves are fundamentally different. The unit trust investor has access to the full current value of his or her funds throughout the term. If the with-profits policyholder discontinues before maturity, he or she will usually receive substantially less than the amount invested in the early years, and, in later years, forfeits at least part of the terminal bonus.

The bias of the Working Party is also shown in its embracing of the ABI's Raising Standards initiative. This is a trade body initiative that has been subject to considerable criticism, is not yet implemented, and is unlikely to be universally adopted; indeed, it is quite possible that it falls foul of the Competition Act 1998. It was an obvious danger that, by simply accepting Raising Standards as given, without any form of critical scrutiny, it would find itself effectively promoting this trade initiative. The Working Party was persuaded, deciding, in ¶2.1.4, to develop its proposals on the assumption that the Raising Standards proposals would be adopted by any company writing with-profits new business on a transparent basis. Thus, it transformed itself into an agent of the ABI.

This is a major issue for the profession that I thought had been killed off, and is now resurrected. Most actuaries are not involved with with-profits companies. It should be easy for those actuaries to decide whether they are happy for our profession to align itself with such a heavily criticised product. For those who are involved with with-profits providers, it is for them to consider whether they are debtors to their profession or mere servants of their employers.

**Mr P. J. Twyman, F.I.A.:** My points turn around the arrogance of the profession, and the way that it approaches various subjects. Can you imagine the absurdity of the Appointed Actuary formulating a method to do something, and then reporting that he or she had done it? Why not have the auditors, who have credibility and responsibility for other financial issues, provide an opinion as to whether or not the principles have been followed through? Do not let us report on ourselves to ourselves.

My criticism of the paper is that it is totally inward looking. I think that it is high time that we actually turned it round and looked at it the other way. We should look from the customer's point of view rather than from the point of view of the profession.

We have several bald statements that speak of anti-selection against the office. I ask you, how often has the office selected against the customer? Probably 99.9% of the time.

**Mr R. A. Rae, F.I.A.:** In ¶3.2 the authors mention smoothing, guarantees and profits participation as being three characteristics of with-profits business. I should like to add a fourth; namely, that, in the U.K., this class of business typically involves a high asset/liability mismatch, with equity backing ratios of 65% to 75%, or even higher. This would be in contrast with mainland Europe, where, typically, the equity backing ratio is less than 30%.

Paragraph 5.3.1 notes that the customers are not aware of the extent of the equity backing behind these contracts. They are probably not aware that they are also investing in equity derivatives, either. These, typically, involve the fund implicitly writing equity put options between its different generations of policyholders to provide guarantees. In particular, the terminal bonus pot of mature policies is used to provide expensive protection on newer, less mature, business, with no terminal bonus cushion. The paper, Hare *et al.* (2000), developed a model which, according to their assumptions, showed the use of equity puts as equivalent to a 1% p.a. charge; or, to put it another way, by keeping this risk within the fund, the fund managers are hoping to enhance investment returns by writing these puts. The suggested model is very useful in disaggregating or categorising these various risks within the with-profits business, and in highlighting this phenomenon. The authors mention, in ¶3.4.3, how this risk can be managed implicitly through restrictions and explicitly through charges.

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Paragraph 3.4.5 describes implicit management as being through asset allocation, which presumably means matching, or by leaving the risk to be met from the underlying asset shares. To me, this option to leave the liability risk within the asset share liabilities is exactly what we want to avoid. It is this ambiguity that leads to a lack of transparency. Separation of the risk from the asset share account enables the liability to be properly analysed and priced. In this way, life offices may avoid some of the issues that we have experienced, such as guaranteed annuity options, where past recognition and corresponding pricing of the risk has not been addressed fully.

The paper does not address ownership of the bonus smoothing and guaranteed accounts, but I should like to look at this in the context of stakeholder unitised with-profits plans, where a closed system is required to demonstrate the capital charges of 1% p.a. As demonstrated by Hare *et al.* (2000), depending on the equity backing ratio, the capital required for the guarantee account could be a significant proportion of the asset share, 20% on average for an 80% equity backing ratio. I cannot see how it can be fair to accumulate this capital within a closed system for a growing class of business, as needed by stakeholders. I also cannot see how the asset share account can write derivatives unless the practice is capable of being clearly explained to policyholders. Possibly, the asset share account could buy and own the guaranteed account and have its assets marked to market. Consequently, the risk needs to be passed on commercial terms to the guaranteed account outside of the closed system, by writing a derivative on arms length terms with shareholders or inherited estates. If this is based on servicing the capital needed to back the risk, the life office will be open to the charge that it is circumventing the 1% cap leakage. The best way to demonstrate the cost would be to use arm's length derivative pricing. Once you do this, the risk becomes explicit, and the next logical step is to think about whether to take a trading position in these derivatives or whether to pass some, or all, of this risk to the open market. A similar position applies to bonus smoothing accounts.

I also mention that the bonus smoothing account looks very similar to the way that South African companies run their smoothed bonus plans, and I would be interested to know whether there are any lessons that can be learnt in the light of their experience. All in all, I see the smoothed bonus account and the capital account as being exactly the same things, risk accounts.

Concerning the regulatory and fiduciary aspects, the paper implies that this arrangement would exist within the existing regulatory framework. I would see this fitting within a fair value accounting regulatory framework, with the asset share account having a liability equal to the mark to market of the assets as with unit-linked business, and, if the guaranteed accounts and bonus smoothing accounts are not hedged, then I would expect them to mark to market their positions and see sufficient risk-based capital to support the retained risk.

I would even go further, to suggest that the asset share account could be held in trust like a unit trust, with the life company being the fund manager and the risk manager.

Reference

Hare, D. J. P., Dickson, J. A., McDade, P. A. P., Morrison, D., Priestley, R. P. & Wilson, G. J. (2000). A market-based approach to pricing with-profits guarantees. *B.A.J.* **6**, 143-213 and 721-735.

**Mr C. G. Thomson, F.F.A.:** [Mr Thomson also spoke in the discussion on the paper at the sessional meeting held by the Faculty of Actuaries, and what he said in each discussion appears in the abstract of that discussion on pages 456-458 of this part of *B.A.J.*]

**Mr P. J. Nowell, F.I.A.** (closing the discussion)**:** The paper is important, not just for the profession, but, more importantly, for the savings public. As the paper says, with-profits has served the long-term saver very well for a very long period. It fills the gap between very conservative cash style investments and exposed equity type investments, which can, as recent market movements — both by markets and by sectors — have shown, produce some nasty surprises.

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As various speakers have said, there has been a series of criticisms of the way in which with-profits has been operated, some of which are more justifiable than they should be. Some of these are criticisms of savings contracts in general; but, even so, the relatively complex nature of with-profits, which is evident from some of the figures, has been 'hiding' some adverse features rather more easily than otherwise.

The odd thing about with-profits is the high level of broad understanding of the contract which comes from the savings public, which is mentioned in the paper. Despite this broad understanding, there is little depth to it. Ask any searching question, and most of the public will not know the answer or, worse still, will give the wrong answer. Perhaps there is a similarity here with the increased complexity of many of the physical things that we buy, compared with their relative simplicity to use.

Cars, for instance, are the best example. They are relatively easy to drive, very much like they used to be; and yet they are becoming more and more complex under the bonnet. These days, engine management systems are so complex that some firms only allow immediate access to top up oil and water, and leave the rest of the engine compartment as a sealed black box.

The paper is not proposing that the mechanism of with-profits should be left as a black box. Far from it. Instead, it proposes that there should be a mechanic's manual, which describes, in detail, how the fund will be operated, and a user's manual for the owner of the policy.

As one speaker said, I think that the area where the paper does not fully develop its transparency ideals is in the area of the cost of smoothing and guarantees. Whilst there is an arbitrary charge being made for regulatory capital or guarantees, there will be a suspicion that money will leak out to shareholders. The profession could do a lot to remove this criticism, by producing ways of costing the guarantees and smoothing.

The advantage of with-profits is that it gives long-term and broad guarantees. These are not easily replicated by traditional short-term options, despite what some merchant banks would say. However, the techniques being developed by the profession and other financial engineers enable the fair cost of these guarantees to be calculated, and, therefore, are able to be checked by someone else.

This would seem to me to close off the last area of non-transparency in with-profits, together with the ways which the Working Party is suggesting. Clearly, these calculations would only make sense to an expert mechanic rather than to the user. However, if the way in which the charges have been calculated were open to external scrutiny, the transparency objective could be met more fully. Work in this area would also help to avoid companies giving guarantees or bonus rates which cannot be afforded, which is obviously the other side of the coin.

I now turn to, and attempt to sum up, the comments made by other speakers. Overall, it was good to see a constructive approach to the problem rather than other, less constructive, approaches. There was quite a discussion about the anti-selection risk of disclosure, and, in particular, centring around the problems associated with a negative bonus smoothing account. The opener, Mr Wright and Mr George were concerned that this would happen. Mr Needleman suggested that the bonus smoothing account should not be allowed to go negative. There were interesting implications of this. Mr Twyman did not agree. He said that it was more common for companies to disadvantage the customer rather than the other way round, although some broker dealer type funds have done the opposite over time.

Were the proposals too complicated to disclose? Mr Iqbal, Mr Reynolds and Mr Needleman thought that there was some danger of that. Mr George made the interesting suggestion that the mechanics should be disclosed to the regulator, but not to others. I think that that has passed its 'sell by' date. There is more demand now for disclosure to everyone. Mr Taylor very much agreed, and said that, essentially, we should disclose everything.

Were the proposals workable in the long term, and, in particular, in extreme conditions? Mr Iqbal, the opener and Mr Thomson, in their different ways, thought that there might be problems associated with extreme conditions, and, therefore, there needed to be careful thought given to exactly what was said, in order not to mislead people.

In terms of leakage, the opener thought that the proposals helped to allay these fears,

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because they showed the various flows of capital and checked that the money was not leaking. With the exception of the cost of guarantees, that is true.

In terms of smoothing for annuity purchases, Mr Wright made the interesting point that it was all very well smoothing investment returns up to the point of retirement, but, if you have to buy a fixed annuity at a particular rate of interest on a particular day, most of the benefit has gone away, and indeed, to the extent that there is correlation between the equity returns and the bond returns, it may be working in the wrong direction. Mr Reynolds made the point that that problem goes away if you buy a with-profits annuity with a with-profits contract. There is a continuity there. Certainly, the issue of with-profits helps to solve that problem post-retirement.

Mr Reynolds also raised the issue of mutual offices, where there is some confusion, perhaps, in whether the return you are getting comes from an effective ownership dividend and the underlying bonuses, and so an additional bit of disclosure would be to try to separate those out to make it clear what you are getting for what, and, indeed, this might help the whole mutuality debate.

I do not think that anybody suggested that we should not publish investment returns. Indeed, perhaps it is long after it should have been done. Several offices already do this. In fact, there has been a survey, which covers most of the industry, that covers non-linked funds, that is, including non-profit and also with-profits. I think that, if those sort of figures are published going forward, the results would have to be audited historically, particularly for with-profits funds. I think that it is important that, going forward, there is a common measurement basis for this measurement, so as to avoid any confusion. There was a great deal of agreement on this subject.

Turning to issues around surrender values and miscellaneous surpluses, Mr Pullan, in particular, was asking for more clarity and disclosure in this area for the avoidance of doubt, and in the spirit of disclosure on maturity amounts. Mr Needleman suggested that more should be done to make it clear what expense disclosure should be based on, so there is no doubt in the policyholder's mind about what he is getting.

Mr Hairs raised the point that, as well as paying the shareholders for the level of guarantees, there is an element of co-insurance or self-insurance through the build up of the terminal bonus cushion. That is one of the reasons why with-profits funds in this country can invest a great deal in equities, much more than elsewhere. This is a vital part of the whole process, and needs to be explained in any disclosure.

On the issue of: "Is the level of disclosure proposed enough?" there was, in reply, a mixture of views: "Yes, maybe too much;" or: "No, do more." Generally, the feeling was that it might be complicated, but, if with-profits is going to survive, it must be disclosed.

The other question was: "Is it workable?" I think, broadly speaking, that most people thought that it was. The bonus smoothing account might be a problem. There was certainly a series of suggestions for the development of improvements.

This seems to have been a constructive debate on a very good paper. The key thing is to try to maintain a constructive approach, and to carry on doing so, even if there is criticism in the press. Mr Hairs summed it up very well: transparency is essential to the survival of with-profits. It would be sad if a good concept was killed off on the altar of simplicity, and I hope that these ideas will be developed to a successful conclusion in the coming months.

**Mr G. D. Clay, F.I.A.** (replying)**:** From the Working Party's perspective, when it was set up in November 1999 it seemed a relatively routine actuarial Working Party, albeit with a potentially commercial objective: the preservation or promotion of a with-profits option for stakeholder pensions. Despite one comment from the floor, I believe that we felt that this was desirable in the national interest, and not merely in the insurance industry's interest.

Over the last two years or so, since we started this exercise, an ever-increasing number of column inches has been filled with criticism of with-profits, in particular, and of life assurance products, in general. Over that period it has even become a topic of conversation on the golf course for the first time.

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One of the points in the paper on which there seems to be a degree of misunderstanding is that we want the transfers to or from the smoothing account to be shown separately in respect of surrenders and in respect of all other claims. If, in future, companies underpay surrender values in order to overpay maturity values, that will become very apparent. I suspect that this is a valid criticism of what used to happen many years ago, rather than what is currently happening on unitised with-profits. In that connection, I would refer to the remarks about traded endowment policies. So far as I know, the market is confined to endowment assurances, not unitised with-profits.

In choosing to make the comparison between with-profits products and unit trusts rather than unit-linked policies, we looked for published data that could be shown to be neutral. It is obviously not the ideal comparison, but we felt that it was the best one possible. If we had compared with-profits with unit-linked policies, I think that we might have been accused of favouring with-profits, because the insurance industry is perceived, in some quarters, not to have the best investment managers around, so that the performance for unit-linked would probably be worse than for the corresponding unit trust.

Responding to Mr Barton's comment, our view of intergenerational equity is very much 'different durations in force' and 'different durations to run', but within present policyholders. We believe that, if a company plans to build up the inherited estate, this would need to be disclosed and the charges shown in the marketing material at point of sale.

Another comment was that the industry may have created a hook for itself by comparing claim values every year with those applying to corresponding policies in the previous year. What, perhaps, might usefully be drawn to people's attention is that, despite something like a zero return on the life fund last year, most companies have declared bonuses this year which have increased the fund by something between 5% and 10% over the last year. So, despite a poor investment return, the face value of the benefits has been increased. That should be apparent from the annual statements that the policyholders will receive over the next few months.

I think that the Working Party has been criticised because the paper had to seek to cover the full spectrum of with-profits product types, and, therefore, the proposals in the paper (and also in the Raising Standards appendices) are necessarily somewhat generic. We hope that each office would be able to be much clearer in describing its own particular products.

I would plead for efforts to be made to make sure that the with-profits concept does survive. I believe that it does meet a significant customer desire, both economically and, perhaps more importantly, without the need for active customer management. Yes, there are probably better investment strategies; and yes, the financially aware can initiate them and, more importantly, maintain them, without the benefit of hindsight, but how many of us present this evening can claim to manage our personal investments that effectively? I know that I cannot. I believe that the profession's objective should be to promote the investment vehicle that delivers the best investment return possible, acknowledging that that is not necessarily the best possible investment return. I do not believe that the theoretical optimum is achievable for the vast bulk of the investing population, and, for that reason, I believe that with-profits ought to survive, and I hope that it will continue to flourish.

**The President (Mr. P. N. S. Clark, F.I.A.):** This is a very timely paper, with a number of external audiences expressing their views, some fairly forcefully. There is clearly work that needs to be done. A number of speakers talked about the need for communication. Mr Taylor mentioned something close to my own heart — that there is a need to make clear what this concept is and what it is not. Some spoke about the public interest. Mr Roberts expressed the feeling that the profession had gone into the pocket of the ABI. I challenge that. I think that it is quite significant that we have representatives here from the Consumers Association, the FSA, and the ABI. I believe that our challenge during this year is to work with each of these organisations in the public interest, to get something that is clear and that is worthwhile. If it is not, then we, as a profession, should be standing up against it.

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This paper will be one of the contributions that we are making — a very significant contribution, I believe — to this ongoing debate.

It has been a good debate. It has been the practice run for two further discussions, so there is opportunity to consider these issues further, both in Edinburgh and then, in May, in Manchester. The column inches in the press demonstrate the importance of this topic. It is right that we, as a profession, play our full part in that ongoing debate.

So, I thank the all members of the Working Party for their contributions, and all the speakers, and I ask you to join me in showing your appreciation for those who have worked so hard on this.

## WRITTEN CONTRIBUTIONS

**Mr C. J. Hairs, F.I.A.:** Transparency is, I agree, a vital development, but neither the profession nor the industry should suppose that, once an extra dimension of disclosure has been put in place, say in accordance with the paper's recommendations, including the model in Figure 4, that that will be the end of it. There will almost certainly be continuing demands for disclosure, at least until we are able to drill down through the various pooling mechanisms, so as to be able to explain and justify payouts to the individual policyholder in terms closely related to the very particular circumstances and timings of the individual policy.

Management of with-profits business is based heavily on pooling, which includes smoothing, and the charging of (and profit distribution from) guarantees and options, mortality and morbidity, expenses and tax. These can all be operated at high levels, in the sense that charges for pooling are set at average levels for the group or some sub-group; or they can be operated at lower levels, where charges are much more specific to the individual situation. Under a transparency regime, broader-brush approaches to pooling that offices may have operated in the past may not prove to be robust (in the sense of pooling charges being self-evidently fair at the individual level).

There is no single approach to smoothing, but different approaches can be characterised by how they behave in practice. One attribute relates to whether there is a smoothing profit or loss to a policy at the point of payment of a premium, that is whether, and the extent to which, smoothed attributed value differs from the unsmoothed value of the asset share that is generated. Under high-level smoothing approaches, for example where smoothed and unsmoothed values are the same for all policies within the bonus class concerned, the chance is high of smoothing profits or losses at point of payment of a premium. This, I believe, is the source of the threat referred to in ¶9.1.1.

Lower level smoothing approaches are, I believe, feasible, under which, at the ultimate, smoothed and unsmoothed values of the asset share developed from the premium, at point of payment of a premium, are identical. Such a smoothing approach would be based on the premise that current market prices represent the best balance anyone can strike in terms of future upside or downside potential. Such a smoothing approach would, I believe, eliminate the scope for anti-selection at entry, the more dangerous form of anti-selection, as I read the paper. As well as avoiding the anti-selection threat, such a form of smoothing would be robust in a transparency era, in the sense of the ability to explain the process in fair terms at the level of the individual policyholder.

A good number of proprietary with-profits offices have a strict 90/10 basis of profit-sharing, and, as I recall, rather more on an 'at least 90/not more than 10' basis. Such a way of splitting profits has its origin in the mists of life assurance time, but was clearly always a rough-and-ready sharing basis, which felt right much of the time. I doubt, however, whether this historic basis would seriously stack up as fair, in principle, to both policyholders and shareholders these days, when set against the respective roles of the two parties. If (in line with my comments in the discussion) we can extend the recommended approach to transparency by incorporating a display of the contribution of policyholders to risk-bearing or working capital alongside the contribution

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of shareholders or inherited estate, the additional insight should facilitate moves towards evidently fairer bases of profit-sharing, and hence more efficient allocation of capital within the industry.

The paper refers to how certain risks associated with with-profits business are increasingly being borne by shareholders or the unattributed estate alone, that is that policyholders are being freed of such risks. I believe that such approaches can work, but that policyholders should expect to see a full market charge made for any risks in which they are not sharing. Having said that, I believe that an approach where all risks of the with-profits business are borne by all risk-bearers, collectively, may prove to be more satisfactory in the long term, facilitating, as it does (within a more transparent regime), a sense of community of interest between policyholders and shareholders.

What if, in future, an office wishes, for an existing bonus class, to shift the level at which smoothing or other forms of pooling are operated? To what extent would it be proper for an office to make such a change for an existing class of with-profits business? I would hope and trust that transparency will not impede the proper ability of a board to exercise discretion to make such a change, subject to suitable transitional arrangements (spreading the impact over a number of years) and disclosure.

I do not underestimate the transitional challenge of implementing the lower levels of pooling that I have referred to for existing business. If policy history according to date of premium payment, let alone availability of proper pooling charges every day, is incomplete, then the challenge will be great. Even when the information is available, the costs will be significant, and will need to be weighed against the benefits. Approximate methods would doubtless be needed, at least for the purposes of building up a suitable history, but such approximations would, I think, be acceptable.

**Mr P. A. Harlow, F.I.A.:** I applaud the various efforts that the authors make in the paper to promote the public acceptance of endowments. Like them, I consider endowments excellent (albeit complex) vehicles for long-term savings. However, I would like to mention, from personal experience, one issue concerning information for policyholders.

Recently, I thought it prudent to inquire how my own low-cost endowment policies were performing, being 15 years into a 25-year term. I wanted, not a surrender value, but a projected maturity value, based on actual past performance (the equity market having performed well for a decade), to assist with future financial planning.

I obtained a valuation, but it was extremely unhelpful — in fact, merely a projected roll-up of the premiums at annual rates of 5%, 7% and 9%, deducting expenses and mortality charges. These calculations were ones which any actuary could easily perform for himself or herself, and the results were very condescendingly presented. I was most disappointed by such a feeble response from the life offices in question, whose only comment was that: (a) the valuation basis was a standard one prescribed by the Personal Investment Authority (PIA); and (b) the PIA did not allow them to publish any other sort of valuation.

Whilst it is true, as you suggest in ¶9.3.3, that it might be onerous to create an infrastructure just to send out policy valuations on an ongoing basis, it is also quite reasonable for policyholders to ask for realistic updates every five years or so. We can hardly, as a profession, propound the wisdom of 'making financial sense of the future', and then deny the public the right to forward planning of investments held on their behalf; or do we just blame the regulators?

**Mr I. J. Kenna, A.I.A.:** There is only one thing wrong with this paper. It is just not true. I refer to ¶D.3:

> "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."

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In fact, the policyholders' premiums or contributions, plus any other cash from dividends, rents, interest and other forms of profit, less tax are used to pay other policyholders' claims and to meet expenses. Only the balance, usually positive, goes into the fund to be invested. Some of this balance is invested in company shares. This amount, over all funds, usually exceeds the amount of net new issues of company shares. Buying pressure is therefore generated, pushing up the prices of company shares. When the policy becomes a claim, the proceeds are paid out of incoming cash.

As a result, the actual value of the fund is tested only in a sellers' market. Not surprisingly, payouts are good, being based on the theoretical value of the fund. The good payouts induce more people to take out policies, and so on.

There are only two flaws in the edifice:

(1) What happens when outgo from the fund exceeds income, making disinvestment necessary?

(2) What happens when company share prices have become obviously disproportionate to company profits?

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