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# TRANSPARENT WITH-PROFITS — FREEDOM WITH PUBLICITY

BY G. D. CLAY, R. FRANKLAND, A. D. HORN,
J. F. HYLANDS, C. M. JOHNSON, R. A. KERRY,
J. R. LISTER AND R. L. LOSEBY

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## ABSTRACT OF THE DISCUSSION

## HELD BY THE INSTITUTE OF ACTUARIES IN MANCHESTER

**Mr R. A. Kerry, F.I.A.** (introducing the paper): The Working Party believes that more disclosure is necessary. Different people have different views about how much disclosure is appropriate: too much, and the customer will not understand the information; too little, and the customer will not have a basis for making an informed decision. Our view is that, with some modest enhancements, the principles which the ABI Raising Standards initiative has set down form a good basis from which to start.

Next, there is the appropriateness of with-profits for a low to medium-risk investor. These investors are mainly passive, they buy the investment and then tend to forget about it. With-profits can give higher returns than you can get on deposits, but without the volatility of direct equity exposure. Decision-making, particularly on timing, is difficult, and the need for some equity exposure is getting more important as the need for self provision increases.

Then there is past performance. For most people who hold their policies until they mature, returns on with-profits investments have been comparable with those on unit trusts. This is illustrated in Figure 2, which shows the with-profits returns compared to those of United Kingdom equity unit trusts for a ten-year period, with the benefits being taken at any time over the past ten years.

The comparison is not perfect. There are quite a few reasons why you might expect the returns to differ, not least of which is the asset mix of the different funds, the charges on them, the tax treatment, which will depend on the individual investor's circumstances, and the charging structure. However, it is the kind of comparison that many people are making, because, from the investors' point of view, these are the alternatives that they have. This figure demonstrates the effect of smoothing on a with-profits investment. The two lines in the middle are the median returns from unit trusts or from with-profits; and, as you might expect, the returns on unit trusts are more volatile.

In the paper the Working Party has written about using 'Raising Standards' as a basis on which to build. There are, fundamentally, two sets of disclosures being proposed. The first is at the point of sale or prior to sale, where the office would have to explain what a with-profits investment is and how it works, what affects how much you get back and how bonuses are determined, what the guarantees are, and what happens if you choose to surrender the policy.

Then, when the policy is in force, there is a requirement for an annual statement, which tells you the current surrender value, last year's surrender value, how much you have paid in or taken out of the contract, and how much you might expect to get back if you have a fixed maturity date or retirement date. Also, significantly, if your office has decided to change its approach to with-profits, it has to inform policyholders. We think that this is a good basis from which to start, but more issues need to be addressed.

These include the actual investment return earned on the with-profits fund, the mix of assets held in that fund, and whether or not miscellaneous profits or losses, for example from guaranteed annuity options, have actually affected the benefits being paid. Policyholders should then be provided with an explanation of how with-profits bonuses have been determined, and how they relate to the office's policy and returns earned.

**Mr P. D. Johnson, F.I.A.:** In the list of information to be supplied to prospective policyholders there is a reference to what is guaranteed. An associated, highly relevant, question is: "If there is a guarantee, who pays for it?" Recent events have highlighted this problem. If the proper answer to that question is: "You do, if you get a guarantee", then it leads to the question of whether the guarantee is worth having anyway. If a company has built up substantial free reserves, at the expense, presumably, of past generations, then it can be argued that one possible way of applying those reserves is to provide a guarantee. On the other hand, if the company has been run on the basis that it has been aiming to maintain equity between generations, and, therefore, has tried not to accumulate large free reserves, then the question is: "How can it possibly operate a guarantee?"

If you are operating a mutual company, then, presumably, you have some kind of duty to maintain equity between different categories of policyholders — at least in prospect. You may not succeed entirely, because what happens in practice may not conform to expectations, but you should not run it on the basis that you expect policyholders in group A to finance benefits to policyholders in group B.

If some people have a guarantee and others do not, then those with a guarantee ought, in principle, to pay for that guarantee. If that means that their bonuses need to be adjusted so that their benefits, after applying a guaranteed annuity rate, say, will be no greater than they would have been if they have not had the guarantee, thereby maintaining equity between the two categories, then it raises the obvious question of: "Why have the guarantee in the first place?" I think that the question needs to be asked, and answered to prospective policyholders: "In so far as guarantees are around, what do they mean, who is paying for them, and what assurance do I have that, in, perhaps, 40 years' time, when the benefits become payable, those guarantees will apply?"

**Mr C. E. Barton, F.I.A.:** At the discussion in London, I asked whether the reference, in ¶1.5, to the smoothing of returns between generations applies to past, present and future members of the fund or, as I think it should, only to current members, according to how long they have been members and how near they are to maturity. In his reply, Mr Clay said that the Working Party viewed inter-generational equity as between different durations in force and different durations to run, but within present policyholders. So, he seemed to agree with me; but, if this is so, the words 'between generations' in the phrase, "both within and between generations", which appears several times in the paper, seem redundant and misleading.

Similarly, the words 'over time' or 'over the long-term' are used several times. These are too vague. I am happier with the phrase "over the time you hold the policy" in ¶D.4.2. Paragraph C.2.2.3, on the other hand, refers to evening out some of the fluctuations in performance over the time you hold the policy, but goes on to refer to the profits earned by the fund over the long term. It is not clear whether this refers to the term of the policy and no longer, as it should.

Paragraph 6.4.2 refers to a buffer and its eventual distribution to policyholders. When is eventually? Paragraph 7.4.6.2 refers to the balance of the smoothing account being distributed to, or recovered from, the class of business with which it is associated. There should be no time lag in this process; otherwise, the wrong policyholders will be affected.

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I do not see why there should be an amorphous smoothing account. If there is to be smoothing, then it should be by means of adjustments to the asset shares of current investors. If, for example, maturity payouts are to be constrained so as not to differ by more than 10% either way from one year to the next, then there should be counterbalancing adjustments, on a clearly defined basis made known at the outset, to the asset shares of those remaining in the fund. This would mean that the change in the asset shares of policies in mid-term would be more than 10%, and more than under unmodified unitisation. There would be no positive or negative smoothing account, and no scope for antiselection.

I question the need for discretion, as set out in the categorical statement in ¶1.5 that: "The most fundamental feature of with-profits is that benefits are subject to discretion". This is asking the investor to buy 'a pig in a poke'.

Paragraphs C.5.1 and C.5.2 refer to making a judgement about how the assets will perform in the future. However, I take it, from ¶C.5.3, that the ultimate total maturity payments will depend on how profits have built up over the years, i.e. over the term of the policy. I am happy with this, but I do not think that these three paragraphs make it sufficiently clear that the view of the future only affects the balance between the annual or regular bonus and terminal bonus, and does not affect the total payout. Contrary to the slogan which we have bandied about in recent years, we cannot at all accurately make financial sense of the future; indeed, we have not done very well in making financial sense of the past. The existence of the so-called inherited estates is evidence of this.

There are several references in the paper to the inherited estate and the possible building up of an inherited estate. Significantly, however, there is no reference to this in Appendices C and D, which are supposed to make everything clear to potential investors.

Paragraph 7.3.2 states that: "The model ... does not incorporate the annual bonus declaration, and, therefore, makes no mention of any shareholder transfer that would result from a 90/10 apportionment." Why should this be? It is very important that policyholders know how much of their money goes to shareholders. Moreover, they should know that, under conventional with-profits business, where the net premium method of valuation is used, and perhaps for other reasons too, the shareholders' take can, in reality, be significantly more than 10%.

**Mr G. D. Clay, F.I.A.**: Regarding the criticism of the paper for lack of clarity, all that I can say is that it would have been simpler if only we did not have to start from here. The problem that the Working Party faced is that there are many different types of product which are described generically as with-profits, and that they vary in quite substantial details. We have tried to produce a paper which distinguishes common features across all with-profits products from those which are idiosyncratic, either to particular companies or to particular product lines of companies. Thus, Mr Barton is right to chide us for being less than precise in our use of language.

The intergenerational point relates mainly to claim values in a year or as between one year and the next, and we do not see major transfers between the much bigger categories that Mr Barton identified, of past, present and future policyholders. However, we do see some transfers occurring at the margin, as some policyholders move from being future to present, or from present to past, policyholders. So, there is some interplay between generations relating to the new business for the year and the claims for the year.

**Mr M. R. Kipling, F.I.A.:** I wholeheartedly agree that the investment return on the with-profits fund should be disclosed. It was a recommendation from the profession's Regulation Committee to the PIA the last time that the with-profits guide was revised, but the regulator, on that occasion, declined to take up the challenge. Certainly, I do not think that the profession should ever be seen as wishing to prevent this disclosure.

What is very important is that what is disclosed can be of some use to policyholders, not just to professionals comparing the performance of different companies. The first thing that has to be done is to adjust the overall investment return for the effect of non-profit business, which can, of course, lead to dramatically different overall returns, depending upon its proportion in the fund, so isolating the performance that is actually relevant to with-profits policies. Of course, this is already introducing some artificiality where there is no segregated fund.

Next, within with-profits funds, it may be the practice to allocate specific asset mixes to different product lines. It is important that that is also allowed for, so that, if there is a different asset mix for traditional pensions with heavy guarantees compared with, say, a new generation with-profits bond with hardly any guarantees, for example different equity backing ratios, different returns can be disclosed in order that the true picture can be seen at policyholder level.

Then, to produce something of real use to policyholders, we have to address the question of smoothing and how the actual investment return earned in a year is translated into policyholder benefits. This is not particularly easy, because it is not simply a matter of smoothing the actual returns earned on each policy, so that each gets more or less its total investment return at the end of the day. The point is made in the paper about small funds which grow, or the opposite, large funds which shrink, when either some of 'your' smoothing reserve could go to somebody else the next year or, conversely, you could benefit from departed policyholders' forgone return. This has to be explained, and may not be particularly easy for policyholders to understand or to accept. Thus, there are quite a number of issues that need to be tackled before we can actually arrive at workable disclosure at policyholder level.

**Mr S. A. Robinson, F.I.A.:** One of the concerns that I have is whether people actually read policy documents, given that they also have marketing literature, key features documents, and so on. Has any thought been given to whether IFAs and direct sales forces need further education in how to explain the concept, so that potential policyholders will listen when they are given advice?

**Mr M. Slee, F.I.A.:** When considering the question: "Is the disclosure sufficient?", I ask: "Sufficient to whom?". Do we mean sufficient to the companies, such that, if there are problems in the future, we can say: "We have covered our back; we explained everything; there will be no question of us having mis-sold the policy", or are we saying: "It was sufficient for the policyholder; it actually helped the policyholder."? The two should be compatible. We have to get away from aiming to present sufficient information so that we can say that we are in the clear. We must be considering the policyholders' benefit.

Are we, as a profession, really convinced that we should be selling the with-profits policy? There is a slight edge coming across of: "We are selling it because we have always sold it, so we will carry on selling it". However, are we convinced? If we are not convinced, why are we selling it? If we are convinced, we must know why we are convinced that it is still the right product. That is what we should be explaining.

Concerning smoothing, we talk about it between different classes of policies — possibly quite small classes. The difficulty with this is the attitude of policyholders who say: "I want my share. What is mine?" or, more likely: "I want more than the average." They are not going to be interested in smoothing.

**Mr Clay:** The members of the Working Party found, in our discussions, that we had to distinguish between: on the one hand, prospective costs — what would be a fair charge for a guarantee (or smoothing) prospectively over the life of a new policy, or the remaining life of an existing policy; and, on the other hand, retrospectively, what actually happens when a policy becomes a claim. A company can target on a particular claim value, assuming, say, 10% p.a. future investment return, and everything is clearly fair. However, if, in the last year of the policy the market goes up by 20% or down by 40%, there will inevitably be a large smoothing charge or benefit, purely as a result of events. It is that potentially large smoothing charge that alone is, broadly speaking, what is described as smoothing, whereby some policyholders receive more and others less than their asset share; but only with hindsight can you say that the outcome is not fair.

This comes back to the distinction between: individual fairness, that is individuals wanting their own fair share or more; and group fairness, which is what with-profits is about. Also, this concept of group fairness is of wider relevance than for life assurance.

On the more general point of whether the profession should support the selling of with-profits business, I think that it is important for pension provision that people invest predominantly in equities rather than in fixed-interest for the bulk of their working lives, and also well into retirement, because someone retiring at 65 is quite likely to be receiving a pension in 25 years' time. It is premature to move into fixed-interest assets at age 65.

Relatively unsophisticated investors are rarely able or willing to manage their investments actively. They want a product where all decisions are taken for them. One of the key features of all with-profits funds, in that context, is their 'fire and forget' nature. You pick your fund; you give your premiums to the insurance company; and you forget all about managing those assets. That is a job for the insurance company.

That is one of the key selling points of with-profits. It is not one that goes down well with journalists, who seem to believe that everyone should be an active manager. In contrast, I believe that it is human nature to be averse to taking decisions. Having taken a decision to put money with a particular investment manager or insurance company, the last thing that the vast majority of people wants to do is to think about that investment again.

**Mr A. C. M. Cantor, F.I.A.:** Much of the discussion so far points to with-profits being complicated to explain fully. We have been discussing some fine points, the meaning of which would be lost on 99% of policyholders. If we want additional disclosure to be understood by policyholders, the type of words that we have been using are far too technical; for example, how many policyholders would understand the significance of 'between generations' and 'within generations'? One of the problems with with-profits policies is not the nature of the contract, which is very good, but the fact that, in order to explain it well to policyholders in words that they are going to understand, the explanation has to be so long that they are unlikely to read it, and, even if they do, they might not understand it. This points to whether some simplification of the with-profits concept ought to be introduced.

As an example, investment guarantees have proved to be a problem for many companies recently, and particularly in the 1970s. I suggest that, either the risk could be taken by shareholders, or, for mutual companies, it could be reinsured. The risk for investment guarantees would not need to be discussed in the literature.

So, if insurance companies want to sell the with-profits concept to policyholders, they would be well advised to consider how the contract could be simplified.

Another point for consideration is: "Would the additional disclosure have pointed to Equitable Life getting into trouble?'' There is a good argument that it would not. The real thing that hurt Equitable Life was the change in the law as it was understood by a very large number of people at the time. I did not see in the disclosure proposals anything which said that everything we say is based on our understanding of current law. It is, perhaps, an innocuous phrase, but it ought to be added somewhere. It might not prevent an Equitable Life situation; but at least we would have something to cover our backs.

**Mr R. Calver, F.I.A.:** I recall, long ago, in my LAUTRO days, that, when key features were initially being discussed, the concept was to try to explain the product within two pages. Key features seem to have grown and grown over the past few years, to a point where they are probably unreadable by most members of the public. If we cannot explain the product in two pages, should we be selling it? I say this as a great believer in with-profits products and their value to the public. This is a clear challenge.

I am fully in favour of transparent boxes for the various classes of conventional with-profits policy, but we need to have something that encompasses absolutely everything, otherwise some of the practices could be bordering on the unacceptable.

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**Mr L. D. Borland, F.I.A.:** Regarding the information to be disclosed to customers, I think that the items referred to are quite reasonable. I have seen some statements by an ABI working party which attempt to illustrate this type of information, and I am totally baffled by them, so I think that 'the man on the Clapham omnibus' would also be baffled.

The person in the street does not really want much more information about his or her investment; but does want to be happy that the regulators are being told about the investment performance, charging structure and smoothing methods of individual offices. The regulators should then act as whistleblowers if an office is not doing what it might have promised.

The figures in the paper which are used to illustrate with-profits returns show that a ten-year with-profits policy does give an excellent return. What they do not show, though, is the 30% - 50% of customers who did not survive the ten years, and got a far worse return. We should accept that with-profits is typically a small premium investment, and not comparable to unit trust figures. I doubt whether there were too many monthly premium unit trusts sold in the 1970s and the 1980s, but certainly the charges underlying them would be based on high premium investment, not on typical with-profits premiums.

I suppose that this paper was written because of the adverse publicity that with-profits has been getting in the press for many years. The industry has just brought out its latest with-profits concept, the stakeholder with-profits, which everybody knows is not true with-profits. It is really just smoothed unit-linked. However, the press are starting to knock the new stakeholder with-profits. It is not journalists, but members of this profession, who are criticising the three offices which put their product on the market.

**Mr Clay:** In response to Mr Calver, I have said to anyone who will listen, and to a lot of other people who would not listen, that if you cannot get the information on a postcard it is not worth saying to the vast majority of policyholders. Two sheets of paper is far too much.

Underlying the Working Party's proposals are two questions: "What do we tell the policyholders?", and: "What do we tell the regulators to show that the transparent (or perhaps not so transparent) boxes are, in fact, being operated fairly?" We should make sure that there is no relatively small, but very black, box somewhere, into which we sweep all the bits that we do not want to talk about.

We started by saying that it is not possible to explain all the details of how the fund works in a way that 90% of policyholders can understand. However, we believe that, if we can keep the lawyers off our backs, we can explain to about 98% of policyholders all that they want to know on a piece of paper that is small enough that they are actually prepared to read it.

Hence, any suggestion that we should include information in order to protect ourselves is self-defeating. It has to be more effective to include a message on all types of marketing material: "These are the key points; if you want more information, here is the website address or the contact phone number".

In answer to queries about the appendices, these are Raising Standards material and do not come from the Working Party.

**Mr P. A. C. Seymour, F.I.A.:** I started in unit-linked in the 1970s, and was part of a number of working parties that looked into the cost of guarantees. What we discovered was that the cost of guarantees was so high that the customers did not want to pay for them, so we stopped offering them. It was quite straightforward. In that sense, I feel that with-profits actuaries have not yet really come to grips with that issue.

I would not want to be the Appointed Actuary of a company offering smoothing to its customers. I just might accept it if I were in Company A, with a huge amount of reserves already to hand, but, if this system is to work, it must surely be possible that you can do it from scratch. I just say: "You are damned if you do, and you are damned if you do not", basically, because if you over reserve and finish up like Company A, with large reserves, you get damned for that, and if you do what the Equitable Life did, and make a virtue out of distributing all the money as you go, then you are surely going to come unstuck.

Should the profession continue to support issuing this type of 'fund' with smoothing? Is it possible, in such volatile markets as we have now, to run this smoothing account in a public way? I think that it is impossible.

**Mr J. Goford, F.I.A.:** I am a firm supporter of the characteristics of with-profits, including the exercise of discretion, and support the fact that these are available to the public.

I have borne three principles in mind that have served me well in the past:

(1) Start with the customer, because life is a lot easier if you do.
(2) The owners of capital should price the use of that capital to get a return commensurate with risks.
(3) Deals should be two-sided.

Where do those principles lead? They lead to a three-part conversation with the customer along the following lines:

(1) Establish that the customer has a long-term need to accumulate capital, and wishes to do so by investing in equities and property.
(2) Establish that the customer, nevertheless, has some aversion to risk, and, with some prompting, the customer might be able to express the risks that he or she would like to avoid, such as:
    — "I would like, at least, to get my money back''; or
    — "I want to avoid the risk of the value of my investment falling suddenly just before I retire''; or
    — "I want to avoid the risk of too low annuity rates when I retire.''

    Given some refinement of these statements, and being aware of the riskiness of the underlying investments chosen by the customer, these benefits can be priced and provisions established.
(3) Establish how the customer would like to pay for the avoidance of risk: "Would you like to pay:
    — by paying a level regular amount?
    — by a regular charge to your investment?
    — by forgoing some investment performance significantly above expectations?''

    The value of all these ways of paying can be assessed and provisions established.

    So, by unbundling smoothing into the benefit of limiting the downside and the price of limiting the upside, we are able to offer the guarantee benefit that suits the customer and allow, as one of many choices, what appears to be a novel way of paying: namely, by giving up some upside.

That can be the end of the story so far as the customer is concerned.

Coming inside the company, the benefits and contributions could be matched, as far as possible, with derivatives or, as we have in with-profits funds, just backed with much capital.

Now we can begin to see some of the USPs of life companies compared to other providers:

— much capital;
— much cheap capital;
— capital to cover guarantee benefits that cannot be matched by derivatives;
— in particular, the ability to offer long-term guarantees where prices are relatively cheap;
— the expertise to bundle benefits like accumulations and guarantees; and
— the wonderful USP of the expertise of the Appointed Actuary, using his or her discretion to balance the benefit of limiting the downside and the price of limiting the upside. So, Mr or Mrs Customer, you do not even have to decide what guarantee you want or how to pay, the Appointed Actuary will do it for you. That is what we call with-profits.

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These USPs are to be exploited in the quest for customers achieving their needs, but we have two Achilles' heels. One is the automatic granting of guarantees that customers do not need. The other is excessive expenses. Both of those are eating away at our cheap capital base, but both are avoidable.

My other point is that there is not only the issue of transparency of finance, but the issue of transparency of governance. I quote here: "There is a concern about the role of the Appointed Actuary, and the tension between his responsibility to protect the interests of policyholders and his duties to the Board of Directors.'' This is a direct quotation from the paper just circulated in advance of the FSA meeting on with-profits to be held in June 2001, and is more evidence that the perception is that the Appointed Actuary does protect the interests of policyholders — he or she does not just inform the board of his or her interpretation of PRE, or the implications of the company's actions on PRE, but protects the interests of policyholders.

If we are going to satisfy that perception, we need to demonstrate that it is so. In demutualisations, there is plenty of demonstration of doing the best deal for policyholders, because the directors working for the owners coincidentally happen to work for the policyholders at the same time. However, we need to increase the demonstrations, in other reconstructions and in the day-to-day running of the fund, that the Appointed Actuary is protecting the interests of policyholders. At present, the reconstruction certificate, the visible manifestation of the Appointed Actuary's work and that of the independent actuary, carry only the weak double negative statement of: "Policyholders have not been disadvantaged.'' Could we envisage certificates saying: "I have protected the interests of policyholders'', or even: "I have negotiated the best deal for policyholders that I can.''

If we are to demonstrate that we are fulfilling the perception, I suggest that logic leads us to splitting the role of the Appointed Actuary into that of a 'solvency actuary', responsible for advising the board on solvency and surplus distribution, and a 'policyholder actuary', whose role is to protect the interests of policyholders, and negotiate — and I mean negotiate, not advise — for the best deal for policyholders day-to-day.

We must follow this perception of the role of protecting policyholders' interests, which includes negotiating, and this is now firmly out of the bag and needs to be embraced positively, with a proposed structure that demonstrates transparency of the governance of the fund. The paper's proposal for the demonstration of the transparency of the finances is most welcome.

**Mr Kerry** (continuing his introduction of the paper)**:** I now move on to the structure of the model that the Working Party is proposing, and how it might work. (See also Section 7.) The reason why we have developed the model is that, with all this disclosure that the policyholders may, potentially, be getting, is it still enough? Smoothing, as part of its concept, also involves some sharing of risks and benefits between policyholders, but what you tell an individual does not necessarily demonstrate to that individual that what they are getting is fair, and, in particular, it does not demonstrate if there is any systematic underpayment of benefits to policyholders as a whole. Hence, the Working Party decided that there was a need for a model of how a fund operates, in order to demonstrate fairness to policyholders as a group.

It begins with the basic asset share model, with which we are fairly familiar. It works on the basis that there is no smoothing going on in the asset shares at this point, but shows all the cash flows that go into a normal asset share calculation. In essence, our proposals for a fund model start to separate out the impact of smoothing and guarantees from this.

We start by looking at smoothing, which is one of the key benefits that with-profits has to offer policyholders, but which is not particularly easily explained, either to an individual or demonstrated in aggregate. A smoothing account collects any differences between the actual claim amount paid to policyholders and the unsmoothed asset share, but also, if you are making any explicit smoothing transfers during the lifetime of the policy, to accumulate those in a reserve.

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One of the key points is that this smoothing account can only be distributed to those policyholders with whom it is connected. It is not something that the shareholder can tuck aside and use for something else. It has to go back to the policyholders. This requires an office to define its smoothing policy, not only in terms of the benefits to policyholders, but also how it is going to smooth within and between generations. Because there is a range of models which apply in practice, this model is a template to try to encompass all of them, rather than a prescriptive: "This is the way we think to go forward."

The way that the smoothing will work is that, if there are no explicit smoothing transfers, what you will see is the difference between claim amounts and asset shares going backwards and forwards in any individual year. If those were the only smoothing flows, then we would expect the smoothing account to fluctuate around a zero balance, according to the rules of the particular office.

If there are some explicit transfers during the lifetime of the policy, then you would expect to see a positive balance being carried on the smoothing account for that class of business. That money is there to support the smoothing of the payouts to policyholders at the end of the day.

There is one disadvantage. If the smoothing account became very negative, it may not actually be possible to bring it back to a balance because of the effect of guarantees. This leads to the guarantee account coming in. This is a separate account which is there to accumulate any explicit charges made for guaranteed benefits. These may be risk benefits, such as life cover or morbidity cover, but may also be for an investment guarantee, the key point being that you are making an explicit charge on the asset shares to provide those guarantees. If you are not making an explicit charge on the asset shares, then it needs to be managed through the asset mix of the asset share account and through the smoothing account. Ultimately, if the amount that you have been charging for the guarantees proves not be sufficient to meet those guarantees, then you have to have some capital somewhere to call on.

In terms of this structure, although the Working Party identified that the smoothing account should go back to the policyholders, we have not identified explicitly who should own or benefit from the capital account or the guarantee account. In most cases this may be provided by either the inherited estate or the shareholders, but, if a policyholder class does benefit from those, then we do believe that the policyholders should be told about that, because they are bearing some risks that they should be aware of.

One of the by-products of this model is that you can start to look at the capital of the company on a risk-based approach. Does it have enough money in the guarantee account and the capital account to meet its guarantees?

Then there are any payouts and any explicit charges made on an exit. Disclosing the flows into all of those accounts would certainly help demonstrate that the class is being operated fairly. We have also suggested that the smoothing flow be separated between smoothing flows happening on surrenders and those happening on maturities, deaths and other payments, to demonstrate whether there is any systematic under or overpayment in any one of those categories.

Any growth in the smoothing account, guarantee account or capital account would also become visible, so it will be disclosed in these accounts if an office was accumulating some money to build an estate. Alternatively, any distribution of existing inherited estate would be disclosed. We have not shown shareholders' transfers on Figure 4 for clarity, but if you have a 90/10 fund, where shareholders' profit transfer is based on the bonus, that could also be incorporated. The office would have to be clear where that is being paid from in different circumstances.

If we adopt this model, there are quite a number of implications which we spent a considerable amount of time discussing. If all business is covered by this model, then you will have the visibility of an inherited estate. A point which has been raised before is that it may not be possible to squeeze all existing business into this model because of the existing policyholders' expectations, in which case you might have to operate some 'non-transparent' classes alongside it.

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If you are building up an estate, then that will become visible through the guarantee account and the smoothing account. If the guarantee account is unattributed to policyholders, that will also be visible. If there is an estate in the smoothing account, then it is clear who it is going to go back to. Also, by separating the smoothing flows between surrenders and other exits, you identify the surplus which is arising through surrenders, and also, when you identify the guarantee and capital accounts, you identify who is actually providing the guarantees, who is on risk for them, and who should be benefiting from the charges.

One topic that we discussed at length in the Working Party was the effect that this might have on possible selection against the fund, and we came to the conclusion that this is a possibility. This could be selection either against other policyholders in the fund or against the office, depending on the circumstances. However, for some types of policy this kind of risk already exists, or will shortly exist when new rules for benefit projections come into force. Ultimately, it will probably require more active management of market value reductions and surrender value bases.

One thing that is not disclosed through this model is the balance on the smoothing account for an individual policyholder. Obviously, if that happened, the individual would have all the information that he or she needed to be able to select against the remaining policyholders in the fund. If that is the case, and if with-profits is going to work, then that information is not something which needs to be made readily available. If you wanted to get your absolute unsmoothed asset share at all points in time, the unit-linked option is available.

Is this model workable? Can we make it work in practice? Do we think that it answers many of the criticisms that are being made about with-profits at the moment? In the paper it is suggested that the information on the working of this model is included in the returns to the FSA. Are there any problems with that, and can they be overcome? If so, how?

**Mr Kipling:** I welcome the model that the Working Party has put together. My office has attempted to build such a model at a theoretical level, and is to begin to implement it at a practical level for the new series of pensions products that we launched in April 2001. There is a distinct advantage that we can start, as it were, from square one, without having to model any history.

Our product has a number of particular features. This is not an unusual claim, as I am sure that you can take the total number of with-profits life offices and multiply by at least five to get the number of different with-profits structures that are currently around. Anyway, for our product we are able to model, for each policy, both the actual asset share and the smoothed asset share. The difference between the progression of the one and the progression of the other can represent a transfer from the actual aggregate asset share account to the smoothed asset account each month.

That will probably be how we will operate our model. Of course, the movement back the other way will depend on how the in-force volumes change within the model. Therefore, the aggregate picture does not look quite the same as the individual picture.

We find the model, in general, quite illuminating. It certainly is quite useful to run it through a number of different future investment scenarios of the more pathological types to see exactly what happens, to see, for example, how many years it takes to get a very negative smoothing account back to positive. We can then see what that implies for our particular rules about when market value adjustments (MVAs) are imposed and when they are not, and how much capital strain there could be in those situations.

It does tend to suggest to us that we need fairly flexible rules about MVAs rather than rigid ones. This is something that we already have, so we would not really have any problems with greater disclosure of the mechanics of this smoothing mechanism. We have also built things like shareholder participation into our model.

There are a number of problems, at a practical level, that we can see with the proposals. The first of these is how often to crank the model through? Do you crank it through with investment returns daily or monthly, for example? If you calculate your prices daily and your terminal

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bonuses or your asset shares monthly, you may want to do it with one or the other of those frequencies, but can you actually value your investment portfolio monthly. This will probably not be for property assets, other than in a fairly approximate way. So, there will be practical issues of this nature which will have to be resolved.

If you do not make an explicit smoothing transfer, it could be quite a number of years before you actually have anything very much in your smoothing account. You really need quite a number of policies to mature before anything meaningful transfers one way or the other. There are also some questions to be answered about how smoothing would be presented, particularly how negative smoothing accounts would actually appear in public.

Would one, in fact, link them to the capital account, such that the capital account tipped into the smoothing account to make sure that it was never negative? However, these can be answered — and, in our limited experience, the model is certainly workable on a ground up basis.

**Mr Goford:** In the guarantee account, would you envisage doing a risk-based calculation of the adequacy of that account and publishing that too?

**Mr Kerry:** It is not something that we discussed at great length. We certainly were aware that it gave the possibility, and that it will depend on how the regulation of solvency develops.

**Mr Clay:** Is the question really about the guarantee account? I think that it is really about the adequacy of the capital account.

Commenting on Mr Kipling's remarks, I emphasise that the Working Party sees a difference between the smoothing account, which gradually builds up a balance as claims occur, and therefore could go negative quite easily, but would normally be very small in amount, and the smoothing exposure, which is, essentially, the difference between Mr Kipling's smoothed and unsmoothed shares, or, in other companies, the difference between the fund including terminal bonus accumulated across all policies and the unsmoothed aggregate asset shares across those policies.

The smoothing exposure can be quite large, because of what happened in the market overnight. In the discussions which took place in London and Edinburgh there was a degree of confusion. Speakers discussed the negative smoothing account balance as though it were the size of negative that might appear as the smoothing exposure.

**Mr Cantor:** What bases are you recommending for working out all these calculations? Are they solvency-type bases, or market value-type bases, or a third type?

**Mr Clay:** "I am not sure that I understood the question'' is the only possible answer. The Working Party believes that all accounting will, very shortly, be based on market values, and that assets are already counted at market values. The E.C. solvency regulations are being reviewed, and our references to risk-based capital indicate how our proposals might assist if solvency requirements become risk-based.

**Mr R. Betteridge, F.I.A.:** I had some difficulty in reading some of the information to be given to the average policyholder. There has been reference, earlier, to 90/10 splits. I suggest that only 10% of policyholders would understand these, and that, for the remaining 90%, it would float on over their heads or into their wastepaper bins.

These draft documents appear to have been prepared by a committee of experts, and have not been vetted by the people who have to understand them. We have gone to a lot of trouble, but we are still unlikely to get the message across to the average policyholder.

Also concerning average policyholders, are they likely to be able to understand the question of selection against the office? I have grave doubts as to whether they would. They might be egged on by financial journalists, who seem to know even less about it than the average policyholder.

Who are we aiming disclosure at? Is it the existing policyholder or is it the potential new policyholder? We, the ABI, or whoever is responsible, ought to say: "We want to target this group of people so that they will better understand with-profits."

**The President (Mr P. N. S. Clark, F.I.A.)**: I think that Mr Betteridge highlighted, very significantly, the issue that there are various different audiences here: policyholders, advisers, and those such as the Consumers' Association and the regulator.

In response to an earlier comment that what needed to happen was that the regulators should be persuaded that what was going on was correct, it should be said that the Consumers' Association was not convinced that persuading the regulators was sufficient in the inherited estate case, because it felt that discussion with the regulator was not open to a wider audience. What is called the 'special publics' is an issue that we have to address.

**Mr Clay:** I will amplify a part of that. First, a simple one; the Raising Standards material in the appendices to the paper, which we did not write, will go through some Crystal Mark or Plain English process before it is let loose on policyholders. To the extent that it reflects insurance companies talking to themselves, that should get smoked out.

The complexity of with-profits led to a distinction between a simple and a more complete version of the facts to be given to new with-profits policyholders. Everyone gets the simple version; but the company does not have to give them the more complicated one. However, I do take the point that the simple one really is not very simple.

The principle is appropriate disclosure at the point of sale. The company then gives an annual statement of how the policy is evolving, which should be simple arithmetic for a unitised with-profits product. We have to keep the words simple to go with it. The process gradually builds up an understanding. The company can steer that understanding slightly one way or the other over time.

Now consider in-force policies. Even when they are of a relatively simple type, the company must assume that the policyholder starts with zero knowledge, and also must recognise that it does not have a new policyholder who is naturally quite interested. So, it will be a challenge to bring existing policyholders to the same degree of understanding that a new policyholder obtains as a result of the sales process. That is an issue that is recognised.

The anti-selection point is probably not an issue when markets are relatively benign. However, I wonder how long a broker bond would have survived in 1974. The current issue is mainly the anti-selection opportunities for those selling single premium investment bonds. There could be a major exposure. If the market collapses, everyone will be trying to surrender if there are no MVR provisions. So, it is the 1% or 2% outliers in the scenarios that one tests that probably have very painful experiences in them.

**Mr J. J. Mason, F.I.A.:** The feeling that I have is that with-profits actuaries are fiddling while with-profits Rome burns.

As a consumer, I find with-profits incredibly complex. An earlier speaker said that, if it is that complex to explain, are we really doing the right thing by seeking to shore up a product which many people believe has lost credibility?

I give two examples from my own personal experience. I hold three with-profits policies which I took out some years ago, because my then employer, an insurance company, offered me a discount. I am now within a few years of the maturity date. I feel somewhat locked in, because I have to wait the full 25 years before I receive the proceeds. The nature of the product has changed somewhat since I took it out. Then terminal bonus was a relatively small proportion of the total return. Now, a significant proportion of the proceeds — probably 25% or more — will comprise terminal bonus. What, if any, terminal bonus will I get in seven or eight years' time?

I also hold a unit-linked personal pension. Recently, I was considering whether to pay a single contribution. I thought about it, and I quickly came to the conclusion not to. The reason

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why is that I could not face the form filling and the inevitable key features and the rest of the literature that I would receive.

**Mr W. J. Martin, F.F.A.:** We are generally right in not being especially worried about anti-selection from policyholders directly. However, I can easily envisage, in two years' time, the creation of a website listing the largest smoothing reserves. In that sense, especially in a stakeholder environment, where there is likely to be less advice and we have a mis-buying rather than a mis-selling culture, I can see that such information could be misused in a way that, as a profession, we do not really have an easy way to influence.

On whether the product can be so complicated as to invalidate its worth, use of the product does not equate with, nor require, deep understanding. People do have, and have had, sufficient disclosure.

Identifying the 'special publics' is a good idea, because they are those who are complaining about with-profits. As with any product, if you have a kitemark, that is what most policyholders want. I agree that it is not what the FSA, or the Consumers' Association, or journalists want.

**Mr M. J. Field, F.I.A.:** My firm is heavily involved in the small self-administered scheme (SSAS) and self-invested pension plan (SIPP) market. There is no very active market for funds within SSASs and SIPPs to be invested in with-profits policies on a single premium basis, mainly because the funds within these schemes have a tendency to lie on cash deposit. Members of these schemes may be wealthier than average, but, from an investment point of view, they are, in most cases, quite unsophisticated financially. Many are not willing to invest directly in equities or even managed funds, but they find the concept of with-profits to be familiar and acceptable. As a result, large amounts of fund moneys are invested in with-profits policies. As long as these funds yield a few per cent more than by leaving the money on deposit, then the members are happy. Our usual advice is to spread the funds around the with-profits market.

This investment strategy appears to me to be acceptable for SSASs and SIPPs, and I am happy to recommend with-profits policies in these circumstances. We have done so for many years, and have never had any complaints. Many of the policyholders have had windfalls on demutualisation, with which they are delighted, but this feature is, unfortunately, now coming to an end.

Having said that, we never recommended Equitable Life for with-profits policies with SSASs and SIPPs, because Equitable Life refused to give a guarantee on their funds at a certain date (apart from death or retirement).

I am a firm believer in with-profits policies for this particular market. It is an active market, and I hope that it has a long-term future.

**Dr T. S. Bunch, F.I.A.:** I agree with Mr Kipling that, in the case of new products, there is really no problem in making this model workable. It is straightforward enough to design a product and systems to fit in with it. The problem that I have is with some of the existing business, and particularly some of the older conventional with-profits business, in terms of the ideal position. In practice, one can probably develop an approximate approach based on model points, and many companies, in fact, have done this sort of thing or are doing it at the moment. It may require a certain amount of effort, but I do not think that we should be put off by that.

However, I question whether the accuracy of such calculations is really sufficient for disclosure in FSA returns in terms of the way that the valuation is currently carried out, with individual policies valued very precisely by formulae. I see the industry being some way from being able to do this, for some of the older with-profits business, to the kind of standard that is, perhaps, required, or has been required, for regulatory returns in the past.

**Mr Clay:** Dr Bunch's point relates to the accounting concept of materiality. Actuaries have tended to assume that the FSA returns have to be done to the nearest £1,000, which is unnecessary for a fund of £50 billion. Nonetheless, that is what we have to do. For accountants preparing the Companies Act returns, materiality is always relevant. In that context, a model can probably be driven down to within around 1% accuracy on the liabilities, and that should be accepted for the purpose. The traditional actuarial view applies, in that it is the trend in certain numbers that is more important than their absolute size. If there is uncertainty relating to a large enough number relative to the company's totality, I think that the model would be refined very rapidly. So, I take the point that, particularly for older products, it is necessary to use a model which, by definition, will not be perfectly accurate. If we can persuade the regulators to accept the concept of materiality, I think that it should be possible to build appropriately accurate models without undue effort.

I now comment on the kitemarking idea. The Working Party tried to encompass the whole range of with-profits products. It has been suggested that with-profits is the wrong name. There has been a lot of publicity recently for the with-losses aspect; but, going forward, many unitised with-profits products share only in investment profits. Would 'smoothed unit price' be a more appropriate name? If we have a new with-profits product, I suggest that it should have a range of standard characteristics — call them the kitemark features — which should enable the product to be described briefly. I am not sure what characteristics should be in the kitemark. That was not part of the brief for the Working Party. I think that it is for the industry to decide what are the key features of the products and how to market them. Can the whole industry agree on what is the basic product?

Part of the problem is that, for some years, the insurance industry has been marketing products as 'different', 'better', etc., when they are actually 99% common. Unfortunately, emphasising the differences has created a chaotic situation, and, as a consequence, a lot of non-understanding.

**Mr J. Goford:** With-profits has changed tremendously since it started. It used to be a way of distributing mortality profits, and now it is a way of distributing investment profits. It is constantly changing, and we need to think through the next phase. It could do with some support from the Appointed Actuary, so that there is somebody who the policyholders see inside the fund, who is not only making sure that the policyholder is not disadvantaged, but is actually prepared to say: "I am doing the best that I can for the policyholder".

If the position of the Appointed Actuary is such that that is too much in conflict with the role of maintaining solvency and equitable distribution, then we should have a 'policyholder actuary' sitting in the company. That would help to give with-profits a new lease of life.

**Mr Johnson:** There are a number of references in the paper to the inherited estate and to the possibility that some proprietary companies might seek to build up the inherited estate primarily for the benefit of shareholders.

One feature that has emerged over the years, from the transaction of with-profits business by proprietary insurance companies, has been the concept of having a 90/10 split, that is that the declared profits will be shared 90% to the policyholders and 10% to the shareholders, although some offices may have different figures. This might be relevant information to disclose to a prospective policyholder; that in the company there are shareholders, and that it has long been the custom for them to have 10% of the distributed profits. This might appear quite reassuring to a prospective policyholder, who might think: "This, at least, gives some correspondence of interest between the shareholders and the policyholders, because it is in the interest of the shareholders to see that the company maximises its profits for distribution to them." However, because of the discretion in the emergence of the surplus, there is the possibility that there may be quite a substantial accumulation of the inherited estate. Is there any way of giving an assurance to a prospective policyholder that there will not come a time when the shareholders decide that it will be a good idea to have, let us say, 50% of the inherited estate, and persuade the policyholders at the time to vote for this by giving them an unexpected windfall?

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**Mr R. Graham, F.I.A.:** The paper and the proposed model are impressive and well structured, but, I believe, do not answer the problems facing the profession and the industry. In particular, enhancing the level of disclosure (whilst welcome in itself) suggests that the main problem lies with a lack of disclosure, which, I suggest, misunderstands the true concern.

Superficially, there are three key features of a with-profits contract: the smoothing, the guarantees, and the actuary's (or life office's) discretion in determining bonuses and policy values.

However, I contend that the smoothing element is not an intrinsic part of the with-profits contract, as it is quite possible to create a smoothed unit-linked fund (indeed, this is what some new stakeholder contracts appear to be).

By contrast, the guarantees contained in the contract are its essential aspect. However, the true cost of the guarantees would, typically, be too expensive for the consumer, if not for the fact that the actuary and the life office retain discretion over policy values. In other words, the existence of discretion is merely the 'flip side' of having a guarantee. As such, there is only one essential feature, namely the guarantees, with their associated need for discretion over policy values. Indeed, any actuary concerned with the financial control (pricing or reserving) for with-profits contracts will agree that the guarantees determine the essential feature of the contract (as opposed to a unit-linked policy), whilst actuarial discretion and smoothing barely feature, if at all.

The with-profits system has generally worked well for a very long time, and we need to ask ourselves what has happened now to create a climate of concern for such a tried and tested product. Consumerism and a general concern for an individual's rights probably do play a role, and greater disclosure might assist with that. However, these are incidental issues to the main area of concern. The essence of with-profits is a 'contract of trust' between the investor and the life office. The investor values the guarantees, and accepts, perhaps reluctantly, the need for life office discretion. However, this can only work where the life office acts, and is perceived to act, reasonably in the policyholder's interests.

In the days when the actuary was 'king of the life office', this system worked well, as, by and large, the policyholder's interests were generally looked after. Bonuses were perceived to be fair, and there was little, if any, suspicion of financial shenanigans. However, this (or at least its perception) has changed in recent years, and I believe that this is the true cause of investor malcontent.

It started about ten years ago, when one life office persuaded the DTI to allow it to distribute a portion of its so-called orphan estate outside of the standard 90/10 agreement and on terms which favoured the shareholders. More recently, we have seen one life office persuade the courts that it is reasonable for it to 'throw a bone' to its policyholders in return for the shareholders being paid a substantially larger portion than that which they traditionally received. It might be technically correct, but the fact that the company pursued it so diligently suggests a duality of interest that runs contrary to the policyholders' interests.

The debacle at the U.K.'s oldest life office, where perceived mismanagement meant that the life office failed to safeguard the policyholders' interests, has not helped. However, the concept of one set of policyholders paying for another group, to redress the life office's mistake, highlights the scope for an unreasonable use of the investors' funds.

More generally, using with-profits funds to make good mistakes, such as pensions mis-selling, leads to mistrust. Policyholders accept the pooling of risk for losses that arise from the normal running of the business (e.g. investments, mortality, etc.), but would not expect to have to bale out the life office from its own mistakes.

Most recently (and I regard this as very worrying), a very large life office is proposing to use its with-profits fund to subsidise guarantees on its stakeholder plan. If the financial winds blow the wrong way, this will presumably mean that bonuses, or at least the financial strength for other members, will be impaired. If the policyholders have a 'majority interest' in the with-profits fund, who authorised the life office to play this essentially one-way bet against their foreseeable interests? Crucially, a with-profits contract is regarded and sold as a 'lower risk' stock market product. However, is there now a material additional risk imposed, not by the structure of the product, but by the risks taken on by the life office? In my opinion, it is this abuse, or perceived abuse, of with-profits funds that lies at the heart of the current investor disquiet.

If we acknowledge that a with-profits contract is essentially a long-term bond between the investor and the life office, then, just as the investor accepts some measure of penalty for 'breaking the contact early', so must the life office be held to its perceived and actual bond of trust that existed at the outset.

How can anyone reasonably invest in a with-profits fund now, if the life office directors might decide, next year, to use the funds in a manner that runs contrary to policyholders' interests? In perception, at least, if not in reality, one might argue that the life office is using the funds other than for the long-term benefit of the policyholders.

If breaking the contract of trust is indeed the problem, no amount of additional disclosure can cure it. Instead, we need to find measures (perhaps, as someone suggested, a 'policyholder actuary' with statutory powers) that will curb the abuse, or perceived abuse, of the policyholders' legitimate interests.

**Mr Kipling:** Mr Goford has suggested that there should be a policyholder interest actuary. I do not think that it has yet come to that. However, the perception that the current position of the Appointed Actuary is weak does need to be addressed. External peer review is one development worth progressing.

We also have the new regulations which, we expect, may well come into force from November 2001. These will emphasise the role of the Appointed Actuary to advise on matters that are in the policyholders' interests, and the onus on directors to take this advice into account in making their decisions. We may also expect the FSA to make fairly regular inspection visits, very much on the lines of the PIA's periodic inspection visits, during which they will quiz directors as to what account they have taken of the advice given by the Appointed Actuary. Directors will have to have fairly good reasons for not having done so. The Appointed Actuary's position is, therefore, strengthened.

It will be disappointing if the Eleanor Linton review of with-profits was actually to come to some different conclusion before this new regime has had a good chance to bed in.

**Mr Seymour:** On the theme that we actuaries could be even more publicly in defence of policyholders' interests — in what I said earlier is an unworkable system — if we do that and it goes wrong: "It will be the worst for us'', is all that I can say. I am amazed at how sanguine some speakers appear to be.

**Mr Clay:** Mr Mason commented that the level of terminal bonuses is much higher now than 20 years ago. Companies have planned a particular level of terminal bonus prospectively. Stock markets have done rather better than anticipated. Should companies have held that back by leaving terminal bonus unaltered, and, instead, had a uniform annual reversionary bonus to distribute the benefit over the lifetime of the in force policies, that would not have been very fair for those going out. So, they increased the terminal bonus to pay fair claims to those leaving. The industry earned roughly 20% p.a. through the 1970s and 1980s. It has been earning, perhaps, 10% p.a. through the 1990s. That step change in the average return must somehow feed through into claim values, and, in practice, can do so only via a change in the level of terminal bonuses.

**The President (Mr P. N. S. Clark, F.I.A.):** I give my own thanks to the Working Party for the second time.

There is a tremendous challenge here. I noticed the word that kept on coming out was communication. It was certainly something which, as you know, I majored on in my Presidential Address, and also when I spoke at the annual dinner here a few months ago. The sort of discussion that we have just had underlines that need to communicate, and to communicate effectively. I could well have an interesting debate with Mr Graham about the level of abuse that has been involved in certain transactions, but part of that is down to an issue of communication and understanding what is actually going on.

Mention has been made about the FSA review under Eleanor Linton. Some of the comments were published only last week. I was a little disappointed that there was no mention of the actuarial profession, as such, in it. We are in discussion with the FSA on this, and there is a big challenge for the profession to communicate the issues effectively.

Thank you, particularly to those who have spoken in this discussion. I ask you to join me in showing appreciation for the Working Party in stimulating this debate.

## WRITTEN CONTRIBUTIONS

**Mr C. E. Barton, F.I.A.:** In my remarks at the meeting I suggested a possible pre-defined basis for smoothing, so that maturity payouts do not differ by more than a specified percentage (I gave 10% as an example) either way from one year to the next. If such a system were operated, the upper and lower limits should probably not be the same, i.e. not plus $x$% and minus $x$%, but plus $x$% and minus $y$%. Since the purpose would be to avoid a sharp fall in payouts, the value of $y$ should first be decided upon, and $x$ should then be determined, so that the expected value of capping the payouts to plus $x$% is equitably counterbalanced by the expected value of applying the limit of $y$% to any fall in the payout. Similarly for policies not yet due to mature, there should be an equitable balance between the expected gains and losses arising from the application of the upper and lower limits for the change in payouts under policies currently maturing. As to how the value of $x$ should be determined, perhaps this could be done by a process of simulation, based on an unbiased judgement of the probability distribution of the change in payouts if there were no smoothing.

However, it would need to be appreciated that, if the amount of the payouts under policies maturing at any one time in future were very large in relation to the funds of the policies due to mature at a later date, the gearing would be such that it would be unreasonable, and perhaps quite impractical, to adjust the asset shares of the continuing policies by the large amount which would be required. It might be possible to meet such a situation by arranging, in advance, some form of reinsurance, but otherwise there should be a provision, made known at the outset, that, in these circumstances, the values of $x$ and $y$ could be increased so as to reduce the extent of the cross-insurance (there would be no cross-subsidy) between maturing and continuing policies, which would otherwise be entailed. Perhaps there should be provision that, in extreme circumstances, the system of adjusting payouts/asset shares should cease altogether. This would mean that policies maturing after the modification, suspension or cessation of the arrangement would not be insulated, either as much or at all, from a large change, up or down, in payouts, but there would be no inequity, provided that there were a balance between the expected values of gains and losses, that is to say that the value of the guarantees would be paid for by those benefiting from them, and those financing the guarantees would gain or lose according to the extent to which experience differed from the assumptions made when setting up the arrangement.

Thus, quite apart from these considerable complications arising from an uneven distribution of maturity dates, the possible system would mean, as I indicated in the discussion, that, whilst policies maturing shortly after a large change in market values would, to some extent, be insulated from it, unless or until the change in market values were reversed, the payouts under policies maturing later would be subject to more change than if the system had not operated at all. Risk would be decreased for one set of policyholders, but increased for others. I am not at all sure that this would be attractive to potential investors, even if they could comprehend it.

I have attempted to explore, by no means exhaustively, a possible theoretical basis of smoothing which I very much doubt is a runner, but this does not mean that the arbitrary exercise of discretion is any better; it is subject to similar shortcomings, which are less transparent and probably less equitable.

**The members of the Working Party subsequently wrote in response to contributions made in the discussions in London, Edinburgh and Manchester:**

1 The Working Party wishes to thank all those who contributed to the discussions on the transparency of with-profits at the sessional meetings at London, Edinburgh and Manchester. These comments reflect a number of themes to which we will respond generically. We believe that it is significant that the substantial balance of comment was in favour of greater openness.

2 The first theme is the relationship between our proposals and the ABI's Raising Standards Initiative.

2.1 Recognising this development in the industry, we used Raising Standards (RS) terminology as a basis for our work. However, the Working Party did not seek to endorse or to criticise RS, but used it as a start for developing its own proposals. A number of its proposals go beyond what is required by RS, but we do not believe that accreditation under Raising Standards is a prerequisite for improving the transparency of with-profits.

2.2 There were a number of critical comments about the with-profits summaries in Appendices C and D. These summaries are taken directly from the Raising Standards manual, and the Working Party shares the concern that they may be too long to hold the interest of most policyholders.

3 The second theme relates to our comparison of the returns achieved on with-profits policies with those achieved on U.K. equity unit trusts. The key purpose of this comparison was to demonstrate that the with-profits returns have been similar to the returns on other types of equity-based investment, and that with-profits has delivered smoothing of stock-market volatility. Criticism frequently levelled at with-profits contracts is that returns are worse than for unit trusts, and that the charges for smoothing and guarantees are high; our limited research indicates that there is evidence to refute this. We hope that this will prompt more extensive and refined research.

3.1 We recognise that there are a number of differences between a regular premium life policy and regular saving in a unit trust, but, to use a well worn analogy, the majority of consumers are not in the least interested in the detail of how a car's engine works. Significant differences between with-profits and U.K. equity unit trusts include the asset mix of the underlying funds, tax (the returns shown for unit trusts were gross), charging structures, and the capital support required. Despite all these differences, the returns delivered to investors are similar, which is what matters for the consumer.

3.2 Since the paper was finalised, we have completed similar research, comparing with-profits policies with U.K. balanced managed unit trusts, albeit for a shorter period. This comparison supports the same conclusion that with-profits returns are both smoother than, and comparable to, those delivered by U.K. unit trusts. These are shown in Figure A.

4 The third theme relates to the range of applicability of the reporting model set out in Section 7, and divides into two strands. There is a significant range of variations between with-profits funds, but the fundamental features are the element of discretion in the benefits paid to policyholders and the sharing of experience within a group of policyholders. The latter characteristic means that fairness is necessarily a group concept rather than an individual one. Hence, the model is designed to be able to demonstrate that benefits paid to policyholders, as a class, are fair.

4.1 The template proposed is not product specific and neither is it envisaged as changing policyholders' reasonable expectations (PRE); the Working Party believes that it can be applied to all products, including regular and single premiums, life, pension and annuity business, and both conventional and unitised with-profits business. Whatever products are included in the class of business, the future application of bonus and smoothing policies will need to reflect the PRE generated by the way that the business has been managed.

4.2 The Working Party recognises that implementing the proposed model is a significant task for each class of business, because of the need to quantify asset shares and the amount of any smoothing and guarantee accounts.

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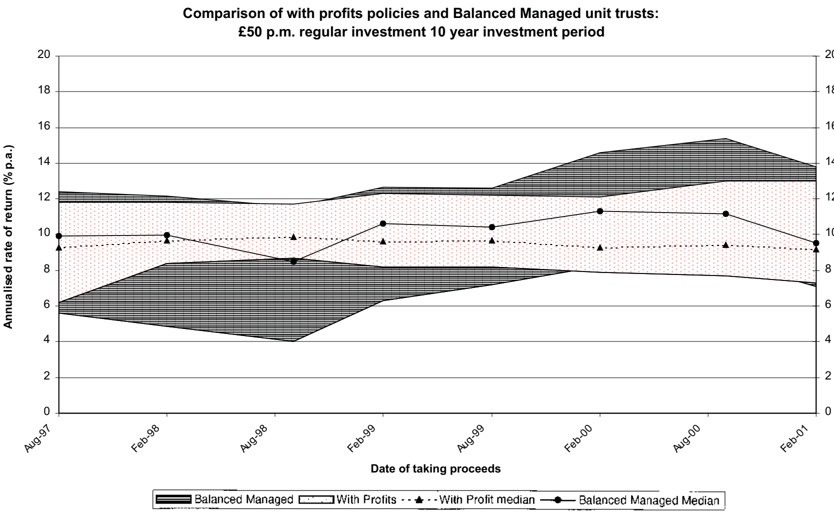


Figure A. Comparison of with-profits policies and balanced managed unit trusts; £50 p.m. regular investment, ten-year investment period

4.2.1 One possible approach for existing business is as follows:

(a) The guarantee account would presumably be established as the accumulated value of the explicit guarantee charges that have been deducted from (or are now ascribed to) the current in-force business, less any calls that have been made on that account to support guarantees (e.g. on with-profits annuities and partial withdrawals).

(b) If a company has had a fund reconstruction in the relatively recent past, it may be able to establish, with reasonable accuracy, the amount of the smoothing account balance for each class of business at that date and the amount of the transfers to or from the account(s) in each subsequent year. If so, these amounts can be rolled up at the rate of return earned on the fund to give the current smoothing account balance(s).

(c) Otherwise, the company will presumably have to assume a zero smoothing account balance.

(d) A deterministic projection on a best estimate basis will identify the extent, if any, to which the office's smoothing approach will cause claim values to exceed asset shares. The amount of such excess would presumably be set aside in the smoothing account. The excess of that amount over the balance determined in either (b) or (c), as appropriate, would be a charge on the inherited estate, which would probably be regarded as an irrevocable transfer, although, conceptually, it might be possible to structure it as a loan.

(e) A stochastic projection across the whole business would identify the quantum of capital required to provide a desired probability of failure to meet PRE during the projection period, or, alternatively, the probability of such failure that is implicit in the current level of capital in the business.

4.3 The principles of the model are applicable to a 90/10 fund or a mutual, and not just to a proprietary 'charges less expenses' structure.

4.3.1 The application of the model to a 90/10 fund was discussed at length by the Working Party, which concluded that the shareholders' transfer would be a charge on the asset share account (for the regular bonuses) and on both the asset share and smoothing accounts (for final

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bonuses), except to the extent that the transfer is supported by an inherited estate. This complication was left out of the fund model diagram for clarity.

4.3.2 For a mutual, the concern relates to who is entitled to the profits or losses on the guarantee account. If there is only one class of business, then the risk is borne by the class on which the charges are levied, and hence there is no specific need for a separate guarantee account. Alternatively, where there is more than one class of business, then at least one of these classes is entitled to the profits, or losses, on the guarantee account and such policyholders should be informed that they are bearing this risk (see ¶7.4.7.6).

5 The fourth theme relates to the Working Party's proposals for disclosure. There are two strands to this: recommendations for additional information to be disclosed to policyholders; and, in order to demonstrate group fairness, disclosure to the regulators of the working of the proposed model.

5.1 There was general support for our proposed disclosure to policyholders of the investment return earned on the fund, the asset mix, and the impact on bonuses of miscellaneous profits or losses.

5.1.1 We recognise that there is a balance to be struck between providing additional information that may well influence PRE and retaining sufficient discretion to continue to be able to respond to changing circumstances. Companies will need to be clear about the extent of the discretion that they have retained, and then ensure that communications with policyholders are clear and reflect the way in which the fund is being managed, while retaining for the company sufficient flexibility to respond appropriately to future unknown circumstances.

5.1.2 Current literature generally does not give much prominence to the point that with-profits also means with-losses. Perhaps we should have given more emphasis to the recommendation, in ¶6.2.5, that companies should indicate that, where policyholders benefit from a source of profit, they may also be affected by losses from the same source. If such losses are likely to be large on the rare occasions when they occur, this should be specifically mentioned.

5.2 There was considerable criticism of our proposal that the revenue accounts and balance sheets of each class of transparent with-profits business be disclosed in the returns to the regulators.

5.2.1 We recognised, in the paper, that all but the most inquiring consumers would find this information too much to digest readily (see ¶8.1). However, we believe that publication of this information is necessary, so that companies can demonstrate that payments being made to policyholders, as a class, are fair.

5.2.2 Considerable concern was expressed that this level of disclosure would lead to increased anti-selection against the fund. This was discussed at length in Section 9.1, and, while the possibility exists that this disclosure will lead to increased selection against the class (that is against the other policyholders in the class), such adverse selection is likely to increase, anyway, as a result of other changes in disclosure that will be mandatory. Indeed, the policyholder currently prepared to put in the effort can combine the information in an existing business projection (which is theoretically based on the asset share) and in a surrender value quotation to determine whether he or she is gaining or losing, as an individual, by leaving early.

5.2.3 We also recognise that this increased disclosure may encourage, or indeed force, offices to use market value reductions (MVRs) more actively.

6 The fifth theme relates to the impact of the smoothing account, particularly when the balance on this account is negative. How frequently this will happen will depend on the specifics of how a particular fund is operated. The template for the model has been drawn to cover two different sets of circumstances.

6.1 The first option is where the are no explicit smoothing transfers. Here the smoothing flows on claims (¶7.4.6.2) should fluctuate broadly equally in both directions, and therefore average at zero over time. Consequently, the balance on the smoothing account would also be expected to average zero, with a negative balance occurring as often as a positive one. In ¶9.1.1 we identified that a significant negative smoothing account could lead to a reduction in new

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business, and commented, in ¶9.1.2, that an office would have to monitor exits more closely and be more active with its MVR policy. In practice, a fund that operates on this basis would be likely to provide less smoothing of policy benefits than the majority of existing with-profits funds.

6.2 In the second option there are explicit smoothing transfers. These consist of regular deductions from asset shares that accumulate in the smoothing account. In any prospective analysis, these would be expected to be returned to policyholders on claim. The smoothing account will need to accumulate the explicit smoothing transfers to support subsequent claim values, and hence the balance on the smoothing account will tend to become, and then remain, positive in all but extreme circumstances.

6.3 Under either option, the current balance of the smoothing account would need to be managed on a defined basis that, in the absence of new business, would eliminate it over the lifetime of the in-force business.

6.3.1 Thus, the smoothing flows each year will comprise one element that runs down the current balance, positive or negative, and a second factor reflecting the random variation between asset shares (augmented for the release of the smoothing balance) and the smoothed claim values.

6.3.2 When a class is closed to new business, this structure will ensure that the smoothing account is distributed to that class of business.

6.3.3 While a class is open to new business, this structure allows a pre-defined measure of smoothing between generations of policyholders.

6.4 Whichever approach is adopted, the office will need to be clear about the principles that it uses to manage the smoothing account. We have stated, in the paper, that the smoothing account should only be distributed to the class of business to which it is attached — in essence, it belongs to those policyholders. Whether this is just the current generation, or whether the office could use it to smooth benefits to future generations, would depend on PRE.

6.5 The industry has been criticised for overpaying maturity values for competitive reasons, particularly when claim values have been declining. If this criticism is valid, continuation of such an asymmetric smoothing practice would be apparent under the proposed model, so it is to be expected that offices will become much more disciplined in the operation of their varied approaches to smoothing.

7 There was some criticism, most notably from Mr Barton, relating to our comments about smoothing between generations. A fundamental problem in discussing this issue is the lack of a clear definition in actuarial literature or practice of what is meant by a generation. On reflection, we believe that we should have been more explicit, and also that it would be worthwhile for the profession to develop a consensus meaning. We therefore offer some basic analysis.

7.1 The Working Party notes that, in one sense, the current generation comprises all in-force policies, and that it evolves from year to year as a result of the addition of new business and the payment of claims. On this approach, there are future generations and past generations, but it is not clear whether there is more than one of each. In any event, the boundaries between generations are blurred.

7.2 Normal industry practice has been to group policies bought in different months in the same year (which may be any specified 12-month period, and not a calendar year), so that they receive identical bonus rates. Hence, identical policies issued in different months of a year will provide the same benefits, even though the underlying asset shares differ, perhaps substantially for single premium policies. So, if a generation of policyholders is considered to be all those who bought their policy in a particular month, with-profits has always provided smoothing between generations. The Working Party does not consider this to be a workable definition of a generation, but it believes that the analysis is useful.

7.3 A similar, but potentially more practical, definition might be to regard each year of issue as a generation. However, if there were to be no smoothing between such generations of policyholders who bought policies in successive years, then either:

(a) the office would create a tontine, where the accumulated effect of smoothing for policyholders who left early would have to be spread over the diminishing group of remaining policyholders; or
(b) the office would have to pay exactly the asset share to all policyholders, in effect operating an unsmoothed managed fund with yearly unit pricing.

Again, this does not seem to be a useful definition of a generation.

7.4 Similar considerations apply to the definition of a generation as policies which become claims in a particular year (or month). Again, this does not seem to provide a useful definition of a generation.

7.5 The Working Party suggests that the most useful definition of a generation of policies is those becoming claims in a limited period of years, or, in rare and clearly stated circumstances, those issued in a limited period of years, with the boundaries of the period being defined by reference to significant changes in financial conditions. Self evidently, any such changes can be identified only in hindsight.

7.6 In this context, the Working Party believes that the underlying concern about smoothing between generations relates to any consistent underpayment to claiming policyholders over several years in order to accumulate an estate. While the model that we are proposing does not prevent the occurrence of such systematic underpayment, it would make the growth of the smoothing account visible. However, the smoothing account is for the benefit of the relevant class of policyholders, and so there would be no increase in the inherited estate. An increase in the inherited estate could occur only if the company made transfers to the capital account, in which case it would have to disclose the scale of such planned transfers in its sales literature.

8 The paper is less prescriptive about the ownership of the guarantee and capital accounts. This is mainly because it is possible for companies to have different structures, but also because the explicit charges that flow into the guarantee account are in return for explicit benefits, for example there may be an explicit charge for life cover benefits.

9 Finally, there were comments that with-profits needs discretion only because of the existence of guarantees, although it was also remarked that guarantees can be provided using traded financial instruments.

9.1.1 The Working Party suggests that the nature of the guarantees on with-profits policies, whereby the amount of the guarantee can increase at a variable rate over time, and the guarantee applies on death as well as at a specific future date, are such that discretion is essential. It is needed to manage both the rate at which the guarantees increase and the mix of the assets in the fund, so as to keep the risk, and hence cost, of providing those guarantees (whether charged for explicitly or not) to an acceptable level.

9.1.2 The Working Party believes that discretion is also needed to operate the smoothing that is a key feature of with-profits, essentially because we have no confidence that a formulaic approach can cover all possible eventualities over the 50 plus years for which a with-profits life assurance can continue.

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