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Briefing note

A new dawn – how improved with-profits management can defeat the dark side of excessive regulation

With-profits business has been a major part of the UK life insurance market for many generations. It remains a critical component of many insurers' existing and new business despite regular ill-informed criticism and reports of its imminent demise.

> In this briefing note we describe how an integrated review of your approach to with-profits business can result in improved positive outcomes for customers and your organisation.

In our opinion well-designed and well-managed with-profits offerings can and should continue to provide customers with good value investment vehicles that are appropriate for their needs. Indeed, recent developments such as pensions freedoms and the forthcoming Lifetime ISA (LISA) offer exciting opportunities for insurers to grow their with-profits business. However continued regulatory developments, most recently the publication of TR16/2, have increased the complexity and potential cost of managing this business.

In this briefing note we describe how an integrated review of your approach to with-profits business can result in improved positive outcomes for customers and your organisation. For many in the industry, trying to provide good customer outcomes, while meeting the ever-growing regulatory requirements, can feel like being an under-powered rebel in Star Wars fighting the irresistible force of the Empire. Life insurance, and with-profits business in particular, is obviously not as exciting as an instalment from that saga, but even Jedis sometimes needed to review their overall strategy and approach to overcoming the Dark Side.

Before considering this integrated review, we outline the opportunities open to insurers, and the difficulties in balancing conflicting pressures in the management of with-profits business.

The dawn of new opportunities

There are several reasons why we consider that with-profits can play an increased role in meeting customers' needs in the future.

First, the introduction of pensions freedoms has not yet led to any really innovative offerings in the at-retirement market. In our view the continued successful sales of with-profits bonds is evidence that for many individuals there are considerable attractions in investing in a smoothed investment vehicle. There is room for an innovative offering aligned to customer needs after the vesting of their pension accumulation contract.

Second, the increased amounts available to be invested in ISAs, and the new LISA, should allow insurers to offer savings contracts that are materially different from the cash or fund based products available from banks or fund managers. With low interest rates on deposits, and continued high volatility in financial markets, insurers offering a smoothed investment offering can make a coherent proposition to customers.

> There has always been a conflict between the need to maintain a fund's financial strength while ensuring that payouts to customers leaving the fund are as high as possible.

Finally, several specialist with-profits providers and administrators have demonstrated their ability to stream-line administration and implement new requirements at low cost. For such organisations there are opportunities to take on the business of smaller, less efficient with-profits funds, for the mutual benefit of all customers.

The need for balance in With-Profits Management

The following paragraphs illustrate the various internal conflicts and issues facing the management of with-profits business:

Financial strength v policy pay-outs

There has always been a conflict between the need to maintain a fund's financial strength while ensuring that payouts to customers leaving the fund are as high as possible. Insurers can feel that they are like Odysseus navigating between the Scylla of the Prudential Regulation Authority (PRA) and the Charybdis of the Financial Conduct Authority (FCA). Odysseus chose to sacrifice some of his companions to Scylla rather than risk losing his whole crew and ship to Charybdis – do insurers need to adopt a similar tactic for the overall benefit of the fund?

Complex financials v desire for simplicity

The financial management of with-profits business is by its nature complex, with the degree of complexity depending on all of:

- the nature of the underlying guarantees
- the approach taken to smoothing
- the financial strength of the fund
- its rate of growth, or of run-off
- its status within the overall insurance company

Most people experienced in with-profits recognise these complexities, and appreciate that each fund, and indeed each line of business within each fund, needs to be considered individually to ensure its specific characteristics are recognised. However there is an increasing desire by the regulators and commentators for simplicity.

For example the 'draft Handbook guidance' set out in TR16/02 would require regular statements to be issued that may oversimplify the actual management of the business. Achieving this apparent simplicity while remaining financially sophisticated will be a challenge.

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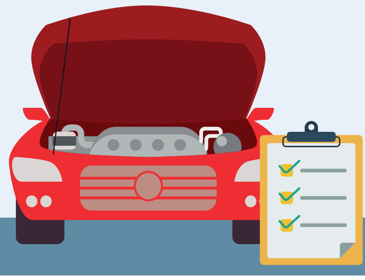
> A further conflict is between the historical reliance on principles and judgement, that has been core to with-profits management, and the increasingly prescriptive and voluminous body of regulation.

Long-term business v constant change

Many of the existing with-profits contracts were designed within a different economic and regulatory environment, and were considered appropriate for their time. However the significant changes in the environment can add to the complexity of management.

For example in several places within TR16/02 it appears that the FCA does not regard simple adherence to a policy's original terms and conditions to be sufficient to demonstrate satisfactory customer outcomes. It almost appears as if the FCA, if it were in charge of the motor industry, would require all manufacturers to replace a customer's engine for free each time improvements in performance and fuel efficiency were introduced on new models – while also updating the sat-nav and installing a DAB radio.



Historic reliance on principles v increasing regulatory guidance

A further conflict is between the historical reliance on principles and judgement, that has been core to with-profits management, and the increasingly prescriptive and voluminous body of regulation. Many insurers might have felt that they were giving full attention to the FCA's requirements by assiduously adhering to the detail of COBS20, following their Principles and Practices of Financial Managements and receiving input from their With-Profits Actuary and With-Profits Committee.

Despite this good governance, in TR16/02 the FCA has not only introduced the concept of 'non-Handbook Guidance', but also stresses the continued importance of points made in earlier publications including:

- the Dear CEO letter of 24 August 2004
- the Insurance Sector Briefing of May 2007
- the With-profits regime review report of June 2010

This development raises two difficulties.

First, it can be challenging to ensure that all the requirements or suggestions scattered across these (and other) publications are understood by those responsible for the management of the with-profits business. It would be far better if there was one coherent and complete set of requirements.

Second, the additional prescription that the FCA appears to want can have adverse knock-on effects on customers. One example is the FCA's desire to see with-profit funds operating within narrower target pay-out bands when expressed as a percentage of asset share. Enforcing this could result in firms being required to change their investment strategy to the detriment of expected future payouts. It is also counter to one of the core attractions of with-profits business to customers, namely smoothing payouts on similar policies from year to year.

> The FCA understandably stresses the need to ensure that with-profits business is being managed efficiently and at low cost.

Value for money v demonstrating compliance

Finally, the FCA understandably stresses the need to ensure that with-profits business is being managed efficiently and at low cost. However there are clearly potential additional costs in meeting the FCA's requirements.

For example, adopting a narrower target range for payouts is likely to require additional stochastic modelling which smaller funds (who did not need to adopt the Realistic Balance Sheet regime) are not normally equipped to do. In addition, even apparently simple exercises such as stronger governance, improving regular customer communications and carrying out benchmarking studies will cost money.

This could put the continued viability of smaller with-profits businesses in doubt.

An integrated approach

In order to address these conflicts, and to seek to benefit from the opportunities a holistic review of a firm's with-profits business is needed. The following diagram outlines our recommended approach:

STAGE 1

WITH -PROFITS WITHIN OVERALL CORPORATE STRATEGY

- How key is With-profits?
- How much is required to be spent on managing this business?
- What strategic options are open to us?

STAGE 2

COMPARISON TO FCA REQUIREMENTS?

- Governance
- Investments
- Expenses
- Smoothing

STAGE 3

ASSESSING THE MERITS OF MAKING ANY CHANGES

- Costs/benefits
- Practicalities
- Availability of alternatives

STAGE 4

IMPLEMENTATION AND FURTHER REVIEW

- Investments realigned
- Administration improved
- Governance in place

The diagram above includes just some of the various decision points and additional considerations needed at each stage.

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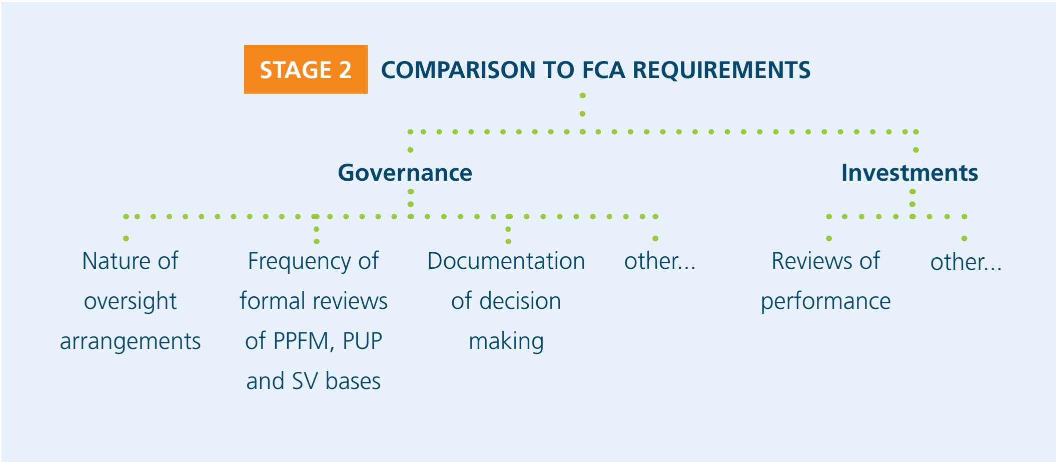
> Recognising your current strength with this business may encourage the active pursuit of funds who are in a less fortunate position.

For example the following illustrates some of the additional steps that could be needed during Stage 2:



In addition, all aspects of with-profits management need to be looked at together rather than in isolation.

For example a review of the investment strategy to seek maximised customer outcomes also needs to consider:

- the impact of any change on the cost of the guarantees and smoothing policy
- the stated risk appetite and capital position of the fund
- the effect of any run-off plan already in place
- the governance issues around any potential widening of the asset mix
- the ability to include any new asset classes in financial models and Solvency II reporting requirements

For a mutual, the need to consider the ongoing issues around Project Chrysalis is a further influence on the optimum strategy

Companies going through a review of this nature may find that the ever-increasing overheads involved in with-profits business mean that their corporate objectives (and improved customer outcomes) are best met by seeking to make a fundamental change to the business. The subsequent options available include:

- full disposal of the business to a specialist provider
- outsourcing all or part of the management, administration or oversight of the business
- seeking a conversion of the business into a non-profit nature, through either a Part VII transfer or a s425 restructuring.

Conversely, recognising your current strength with this business may encourage the active pursuit of funds who are in a less fortunate position.

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> We can assist companies with all aspects of their with-profits business, from a full review as outlined above, to specific tasks such as reviews of the investment strategy and governance.

How we can help

Our consultants have worked on with-profits business across a wide variety of organisations, including restructurings of large funds within proprietary companies, designing and implementing mergers, carrying out With-Profit Actuary roles, disposing of large illiquid assets from closed funds, and building and implementing stochastic models.

We can assist companies with all aspects of their with-profits business, from a full review as outlined above, to specific tasks such as reviews of the investment strategy and governance.

We can supply regular support to carry out periodic reviews of areas such as surrender and paid-up basis which can avoid the risk of 'corporate knowledge' being lost if key internal staff leave or retire.

In addition our independence means that we can provide fresh insight into current practice, and strengthen the independence of the oversight function.

Please contact your Barnett Waddingham consultant if you would like to discuss any of the above topics in more detail. Alternatively contact us via the following:

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