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MANAGEMENT ACTIONS IN A WITH-PROFITS FUND

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ABSTRACT

The management of a fund requires a number of decisions as to the fair treatment of policyholders. This paper first considers the difference between the regulatory requirement to treat customers fairly and the longstanding concept within the profession of policyholders' reasonable expectations. The paper then goes on to consider the bearing of risks within the fund, and thus the interactions between the inherited estate and the asset share so often used to guide payouts to customers. Management actions are discussed in normal, and abnormal, times. Lastly, the considerations of distribution of the inherited estate are considered.

KEYWORDS

Treating Customers Fairly; Policyholders' Reasonable Expectations; Inherited Estate; Distribution of Surplus; Management Actions; With-Profits Fund

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1. Introduction

1.1 The profession has a long history of involvement with the fair treatment of customers in a with-profits fund. Several recent papers have addressed the correct assessment of fund liabilities and their presentation, and the move to a new standard of realistic reporting has been both revolutionary, in bringing a scientific recognition of the costs of guarantees and smoothing, and evolutionary, in bringing to audit standard the near universal practice of using asset shares as the starting point for judging claim values. However, given the requirement to treat customers 'fairly', these realistic liabilities can only be assessed in the light of what is 'fair' treatment.

1.2 There has been professional discussion of: what is acceptable, or 'fair'; the management of a fund in terms of the bearing of risk; the uses of the inherited estate; and the balancing of interest between shareholders, existing customers, and new customers. The last professional paper solely

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devoted to fair treatment was Shelley *et al.* (2002), and before that, Brindley (1993). This absence of continued professional debate is unfortunate, and the 2002 paper ended with a call for actuaries to have the opportunity in the future to discuss how policyholders' reasonable expectations (PRE) should be interpreted. The absence of detailed debate and, perhaps more importantly, a detailed definition of PRE may well have encouraged the introduction (by the regulator) of rules and guidance in this area in 2005. I suggest that there is a need for the profession to debate issues in this area on a regular basis, both to share practice and to regain its influence over what is acceptable.

1.3 This paper aims to add to the debate, partly by the device of suggesting certain criteria for acceptable management actions, and partly by focusing on the key question of who bears the risks in a fund. The paper considers asset shares, the inherited estate, the interaction between them, and the management actions which might be fair in various circumstances. The management actions considered are the potential to charge for guarantee costs and to vary the exposure of asset shares to more risky, but rewarding, asset classes. The paper ends by discussing the fairness of the distribution of the inherited estate as a topical management action, given the low level of with-profits new business for the industry as a whole.

2. Current Background

2.1 Recent activity in the industry and by the regulator has focused on developing acceptable methods of managing claim values, and in the practical task of applying such methods. There have been significant shifts in product types and changes in the disclosures made to customers. For example, there are now numerous variants of the simple with-profits bond, and far more detail for customers as to how these products should work. This is a far cry from the situation ten or 20 years ago, when a more paternalist management regime was permissible, and a greater ethos of generalised sharing of fortunes across all products was the norm. The growth of asset share techniques, together with the precision of new products, has made the decisions about claim values far more individual than might have been conceived of some years ago. Indeed, in a broader sense, society has turned against paternalism, in the United Kingdom at least, in favour of more individualistic and precise ownership rights, and the previous methods would not be viable in today's social climate.

2.2 The industry has also seen a number of major fund reconstructions, namely: a series of demutualisations; the attribution of the 'inherited estate' of a number of funds (mainly industrial branch) in the 1990s; and the actual or potential re-attributions of funds (i.e. where profit sharing rights are well documented, but an offer is being made to re-attribute profits in future).

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These all require an assessment of customers' rights as well as how customers should be treated in future.

2.3 To this hive of activity, the regulator added wider disclosure of a firm's discretionary powers in the Principles and Practices of Financial Management (PPFM); rules on fair treatment; and, most importantly, a wider statutory definition of a firm's duties to its customers — Treating Customers Fairly (TCF). The TCF principle in the regulator's rulebook, Principle 6 of the principles for business, itself sits amongst a number of other regulatory provisions which impose obligations on management.

2.4 PRE and TCF are sometimes taken to be synonymous as a firm's obligation under TCF is to "pay due regard to the interests of its customers and treat them fairly". However, these words have a natural English language meaning; there is no reason why the words should be given a specialist technical meaning unless there is further specific authority in the regulator's rulebook for such a meaning. Other rules do have a specialist meaning, such as the rules which link 'fairness' in with-profits payouts with payments falling within a specified range of asset shares.

2.5 Acting consistently with previous representations and meeting expectations may be an important part of fairness, but only a part; ultimately, treating customers fairly is not dependent upon expectations, whether actual or hypothetical. We, as actuaries, use specialist methodologies and models to address obligations under TCF. These methodologies and models may well be discussed or presented in technical language. Since TCF does not have a specialist technical meaning, the key point is that the application of a more technical approach is neither essential nor sufficient to ensure compliance with TCF.

2.6 Ultimately, if there is a dispute, the meaning of TCF will be decided by the courts. With the exception of a single case in which the Court of Appeal accepted, without argument, that the scope of TCF was wider than PRE,[1] TCF has not yet been directly addressed by the courts. I suggest that fairness should be considered, at a fundamental level, in the following terms:

(1) A firm should not perform a contract in a way which undermines an important part of the contractual bargain between the parties, the bargain including the messages given by the disclosures made at the outset and by subsequent action or inaction.
(2) A firm should not exercise its discretion in a way which treats one customer or group of customers differently from the generality of customers for reasons which are capricious, unreasonable, or intended to achieve an improper purpose (e.g. offering poor surrender values to lock a customer into continuing the contract).

[1] Equitable Life Assurance Society v Ernst & Young [2003] EWCA Civ 1114.

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(3) A firm treating a group of customers fairly should do so by applying the same criteria to each of them, not necessarily by treating them identically if there are sound reasons (based on the criteria) for treating some differently.
(4) A firm should act to avoid any unfairness between shareholders and customers. Management actions, and any shareholder duties, should be viewed from the customers' side as if they were an independent commercial body to the shareholder, while recognising the shareholders' rights.

2.7 As TCF is wider than PRE, we have, for some while, been in a world where absolute standards apply rather than reasonable expectations. Indeed, reasonable expectations now look close to a minimum requirement. The best approach is to consider fairness from first principles, and then assess whether this accords with the disclosures to customers.

2.8 This directly challenges a discernible theme of previous papers on fair treatment; that changes made gradually are more acceptable than abrupt change, and that this gradual change can manage and develop PRE. That interpretation always had problems — its implied ability to change PRE significantly, provided that there was a long enough period over which so to do. There has also been considerable uncertainty over what constituted good change and bad change. This uncertainty can be illustrated by examining two long-term and two short-term changes within the industry which were taken as meeting PRE, but may not have met TCF:

(1) a transition from the heavily competitive times of the 1980s and 1990s, when it was common to augment claim payouts to preserve, or improve, competitive position — this was presumably with an aim to attract new business, but times have since moved on and such of this new business which remains in force is probably firmly targeted at 100% of asset share;
(2) a steady outsourcing of administration and new business activity, which has made the with-profits fund look less like a profit sharing entity, mainly for the benefit of customers, and more like an investment fund which is managed on an arm's length basis by a wider group;
(3) the recent curtailment of exposure to more risky, but hopefully rewarding, assets (which, in this paper, will be described as the EBR) in a number of funds; and
(4) the recent reduction in the degree of smoothing being offered by funds, often a move from smoothing to prior year payout levels to smoothing deviations from underlying asset share.

2.9 These changes could be taken as a tribute to a PRE management system with wide discretion and a capacity to weather changes and difficulties over the years (the converse of some of the TCF points made

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above). However, they do illustrate serious issues around change imposed on customers which should be questionable under TCF. To analyse these issues, we first need to consider the main areas of scope for management actions (asset shares, the inherited estate, and shareholder resources/benefits) and then assess the management actions which might represent TCF.

3. Asset Shares

3.1 There have been a number of papers on asset shares, and suffice it to say that asset share methodologies are used for the bulk of with-profits liabilities. Asset shares are thus the starting point for a discussion of fair treatment. The taxonomy produced by the regulator under its with-profits review emphasised the differences between:

(1) '*bare asset share*', which represents a roll up at the earned investment rate of premiums less claims costs and expenses;
(2) '*asset share*', which includes permanent augmentations made in the past, often as an increase to investment performance in a year to reflect miscellaneous surplus on non-profit business, surrenders, etc.; and
(3) '*full asset share*', which reflects the firm's softer policies on smoothing, general augmentation and prior one off distributions from the inherited estate.

This paper will use the term 'asset share' to mean the last of these — to stay true to the identification of asset shares as a guide to claim payouts.

3.2 While there is currently considerable weight placed on the use of asset shares, the history necessary for their calculation may be somewhat difficult to justify now. In its second report, the PRE Working Party recommended that actuaries report their interpretation of PRE formally to their boards, and compare current payout levels with the source of profit and the continuance of such profits. The third report of the PRE Working Party stated that the documentation of PRE practice varied greatly, and that the reconciliation of payouts was often not performed. Similarly, Needleman & Roff (1995) reported considerable variation in the formulisation of practice.

3.3 These concerns have been borne out in practice, with many firms having difficulty in proving, to themselves and to their auditors, that their asset shares have been properly calculated. In considering management actions, one must bear in mind this imprecision. Three of the most important issues are:

(1) the degree to which hindsight be used safely in coming to asset shares — for example, what seems an incorrect investment return for the year 1990 in prior work could have been a distribution of miscellaneous surplus or distribution of the inherited estate;
(2) the variety of ways in which profits on non-profit business might be

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credited to with-profits policies — for example the practice of targeting a claim at more than the asset share might have been to capture such profits, and might need developing to capture all profits, including those on surrendering with-profits policies; and

(3) a lack of clarity over which risks have been borne directly by asset shares and which elsewhere. A high EBR is usually borne directly by asset shares, but the cost of guarantees and hedging activity is less universally ascribed to the asset share. There are similar doubts over the level of expenses and mortality being borne and apportioned between and within product lines.

3.4 In one sense, the infancy of the calculation of asset shares was the apogee of the use of discretion and the management of expectations gradually over time. More modern products, those which have grown up in asset shares times, should, in theory, circumscribe to a far greater degree how asset shares are derived. However, these products have faced similar issues over changes to management actions, particularly in abnormal times.

4. The Inherited Estate

4.1 A major influence on who bears the risks, and thus what management actions are to be considered, is the inherited estate. Benjamin, in the debate on Redington's (1981) paper, illustrated this by saying: "Established offices could use their huge carried-forward inherited estates to provide the necessary guarantees." The interaction between asset shares and the inherited estate is important, as risks and rewards must go to one or the other. The reason for maintaining an inherited estate and its place in the rights of the stakeholders to the with-profits fund is fundamental.

4.2 The size of the inherited estate is now better (or, at least, more widely) identified than ever through the medium of the realistic balance sheet, which forms part of the returns to the regulator and the Companies' Act accounts, albeit somewhat obscured for those closed funds which label it as further planned distributions. The first paper of the PRE Working Party, in 1992, viewed the inherited estate as being the excess after taking account of all liabilities; this is still the common view, even though the calculation has become more sophisticated.

4.3 Although identified in the realistic balance sheet (for the majority of the industry by value), the liabilities themselves can be uncertain or subject to change as:

(1) The valuation of the liability for options and guarantees is performed using market consistent prices. These are often tentative (as no deep market exists of the right form or duration), and, in reality, firms hope to achieve a lower cost from a higher average performance of assets.

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(2) The calculation of various items on the balance sheet assumes management actions which have not been tested in the circumstances under which they are being modelled (and, maybe, does not assume actions which would be taken). For example, the equity/property exposure of funds was altered far more during the equity falls at the beginning of the century than would have been anticipated, as was the scale of smoothing applied to claim values.
(3) The reactions of customers are often assessed approximately. Indeed for the future, different risks, such as the persistency of contracts to option take-up date, and their assumed trend at the time when actions are needed, may become the dominant influence on management action.
(4) The legal form of certain guaranteed annuity rate (GAR) guarantees has been challenged in the courts recently, and future court challenges are possible.
(5) The goodwill built up by a longstanding fund through its administration systems, marketing connections with distribution outlets, and its brand and recognition value is usually ignored.

4.4 Therefore, there may be material hidden value within the balance sheet, balanced by untested management actions, extrapolated derivative prices, and speculative reactions by customers which have been assumed for the future. This, together with the known inaccuracies of asset shares, needs to be borne in mind in considering management actions.

5. Uses of the Inherited Estate

5.1 Previous professional discussion of the uses of the inherited estate has often been in general terms; less focused on the allocation of the costs of bearing the risks identified or what limit should be placed on the risk taking. The risk appetite of the fund, or the wider firm, is rarely mentioned.

5.2 The sources of typical inherited estates were summarised in Smaller *et al.* (1996). They were mainly created across the mid 1900s, as firms were slow to recognise the durability of excellent equity returns, and had difficulties in developing systems to reward customers with such performance in claim values, both in terms of recognition (asset shares methods) or practical administration (final bonus systems). Deliberate underpayment of early claims, at least compared to asset share, was also significant. The end result has been a variety of sizes of the inherited estate which:
(1) augmented claims in the competitive 1980s and 1990s;
(2) coped with considerable mis-selling costs in the 1990s/2000s;
(3) enabled high EBRs and higher smoothing costs and guarantee costs (though somewhat capriciously if the crystallised risks of such high EBRs, in the form of guarantees, subsequently fell on asset shares); and

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(4) did not look excessive across the industry at end 2005, after recovery from an equity market decline, but would have looked so in 1999, and were beginning to look so again, as the existing portfolios ran down with new business below replacement level, until the most recent equity market decline.

5.3 Typical descriptions from PPFMs of the application of an inherited estate are given below, with some discussion of the imprecision which arises.

5.3.1 *Allowing a high exposure to more risky, and hopefully more rewarding, assets such as equities.* This could mean the inherited estate meeting the downside of such exposure — i.e. meeting some or all of smoothing and guarantee costs. Alternatively, it could mean simply covering the required regulatory solvency reserves, with a real cost to the inherited estate only in disaster.

5.3.2 *Meeting costs which could not reasonably be met by asset shares, such as expense overruns, the tax on shareholder transfers, or mis-selling compensation. In extremis*, these items may represent under-priced premium rates, sheltering shareholders from unwelcome tax changes, or problems with the fund's manager.

5.3.3 *Financing wider TCF actions which give better terms to customers than their contractual ones, such as a top up promise for endowments covering mortgages or more user-friendly forms of a basic contractual GAR right.* This may become unbalanced and harmful to the other customers if the inherited estate is overly weakened or redirected in this way.

5.3.4 *Smoothing claim values.* Although this was, typically, intended (and perceived) to be neutral, so that there is no long-term impact on the inherited estate, the shift to a low inflation environment has meant that, for some years now, maturity values have been projected to fall year on year. Smoothing has looked asymmetric, and thus costly, for some time, if the smoothing is from the prior year payout level, while there is this bias downwards in year to year asset shares. This effect was sharpened by the introduction of the realistic balance sheet, which uses a lower, risk free, forecast of mean asset return. The inherited estate has borne (and will, in some cases, continue to bear) the real cost from smoothing.

5.3.5 *Meeting the risks of writing new business into the future.* The capital concerned has, of course, typically been brought forward from earlier generations of policies and has helped to write today's existing business. However, it is questionable whether one could ever justify underpaying today's claims, compared to asset share, to finance new business. This is the implication of a sample statement in Section 7 of the second PRE Working Party report, namely: "Payouts may deviate from smoothed asset share, either by an addition to improve the Company's competitive position or a deduction to finance future growth."

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5.4 The risk appetite of the fund would seem central to these debates, as any statement about bearing a risk is deficient unless the limit of appetite can also be cited. 'Discretion' over risk appetite, in the sense of no defined risk appetite, is no longer possible, given the regulatory requirement that management both holds and identifies what it believes is adequate capital for the risks. One is talking of the risk appetite of the board, which is entirely not (except by serendipity) the regulatory underpin of a 99.5% risk of ruin on a one-year closure basis. Such a risk appetite is, in reality, likely to be a band of acceptable or available capital; it is likely to involve boundaries each side of a spot calculation before action is taken in response to an improving or deteriorating capital situation.

5.5 Firms regularly used to portray themselves as strong to new customers — i.e. professing a risk appetite which they at least met. The actuary may find committing to a more precise risk appetite a concern, in the sense of being held to the same articulation or to the same methodology of risk appetite for all time. While this is understandable, it is not credible under today's management standards to avoid articulating such an appetite. However, while capital management still needs some time to bed down — after a plethora of recent regulatory changes — it is, at present, rare to find a scientific description of the rationale for the size of the inherited estate in a PPFM.

5.6 Debates over ownership of the inherited estate are not part of this paper, but, as management actions likely to be considered or approved often depend on the size of the inherited estate, similar questions arise. Indeed, uncertainty over the 'ownership', and thus use, of this capital is likely to place actuaries in stressful situations if they have to serve two masters (shareholder and customers) who are more at odds than is common. This is not just a proprietary fund issue, as, within a mutual, there may well be similar issues where the firm is torn between a longer-term future writing non-profit business and the existing with-profits policies.

5.7 This question over the available capital goes beyond the inherited estate to the wider resources of the shareholder. It is common to see funds run as ring-fenced pools of assets and liabilities, with the shareholder on risk for the with-profits fund only, for the unavoidable liability if the fund fails to meet TCF and/or its guarantees. For a proprietary fund, the shareholder can be viewed either as an agent of the customers, with limited exposure to risks, or as a manager enjoying various sources of income as below, but consequentially a number of duties, as follows:

(1) the profit sharing rights for conventional and some unitised business, or the percentage management charge on many modern unitised with-profits contracts;
(2) the income recognised in the first report of the PRE Working Party from the use of a separate shareholder company to provide services to a fund at a fee; the practice of charging tax on profits to the fund rather

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than to the transfer to shareholders; and the switching of future non-profit business from the with-profits fund to a shareholder entity — potentially a transfer of goodwill;

(3) to which could be added the ability to write new business using the capital of the with-profits fund, thus gaining a further 10% profit share, and the synergies flowing to the shareholder of running such a business alongside other shareholder-owned businesses, so that new developments or, indeed, mis-selling episodes can be part financed by the inherited estate; and

(4) the degree to which profits taken for sharing are one way — how should losses in the form of deductions to the face value of the units be treated in coming to the 10% share of total profits? This is an area where the regulator has recently introduced rules which balance the treatment of profits and losses.

5.8 Embedded value methods capture the expected cost of burn through to the shareholder, when its 10% share of profits becomes a 100% share of losses. However, certain costs may fall naturally to the shareholder. If the shareholder aims to make a profit on the other avenues noted above — for example it charges an arm's length fee on administration costs — then surely the shareholder places himself in the position of a third party supplier with the duties over errors which that implies. A more general role for the shareholder is referred to in Section 11, when considering the tail of the run off of a closed fund.

5.9 It remains true that the shareholder's choice of management actions will affect the degree to which risks impact the shareholder's share of profits, any defined support assets held outside a with-profits fund, and the wider shareholder capital. Even if the shareholder is more an agent for the fund, the risk appetite used by the shareholder for the fund should be aligned with representations to customers of the particular fund. It would be perverse to run customer interests on differing standards of rigour and documentation of risk assessment compared to other entities within the shareholders' group.

6. Dealings between Inherited Estate, Asset Shares and New Business

6.1 The inherited estate (and any further assets outside the with-profits fund which are on risk) is a significant player in any discussion of possible management actions. The nexus of the particular EBR pursued, the resultant costs, and who bears the risk and enjoys the rewards, is usually whether there is a charge for guarantees levied on asset shares and/or an explicit hedging programme in place as guarantees are granted. The Needleman & Roff (1995) paper identified that a third of firms made a deduction from

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asset shares for the cost of guarantees (and/or the cost of capital, which, economically, is likely to have been the same thing), implying that, in 1995, two thirds were relying on the inherited estate (or had no exact plan for guarantees).

6.2 A plan for charging for the cost of guarantees requires a good estimate of cost. At present it would seem natural to reference the market. The mix of guarantees, extending over the life of the portfolio, could be hedged to a greater or lesser degree or, at the least, priced to estimated market positions. Some risks, persistency and longevity, are less open to hedging. Wilkie *et al.* (2003) identified the likely results which one might have seen for GARs, and touched on why such pricing was uncommon. One reason for uncertainty, though not perhaps a credible reason with hindsight, is that the complexity and long time period over which guarantees extend go beyond any liquid market in derivatives, making assessment both judgemental and difficult.

6.3 The guarantees involved include a number of hard guarantees (minimum amounts on maturity, spot guarantees on bonds, guaranteed annuity or cash options) and soft guarantees (smoothing, mortgage promises). Soft guarantees, in particular, are more likely to be funded from the inherited estate as they are discretionary, and may often apply to particular product classes — such as mortgage endowments.

6.4 It was the practice, until recent years, to offer these guarantees without hedging the risk. Hedging would have crystallised the risk in a way similar to an explicit charge. Indeed, traditionally there has been the reverse of hedging — an extreme equity bias in the management of the fund, as (using realistic balance sheet terms) the costs of guarantees and smoothing were traditionally matched with the same asset mix as asset shares. This equity gearing compared to guarantee costs made the equity falls in the early years of this century more painful. The result was volatility in the size of the inherited estate, and doubt over its capacity to meet various costs.

6.5 It may be that the cult of the equity held such sway that such risks were, and perhaps still are, considered worth taking. However, this paper contends that, whatever the background, there should be management plans for dealing with these issues, where a 'plan', in this context, is effectively a blueprint to ensure that reasonable quality decisions are made at the right time. The portrayal to customers of a product with both the benefits of guarantees and high exposure to volatile assets, yet no risk, is likely to be unsupportable in the longer term. Regrettably, one suspects that it was not unknown.

6.6 Similarly, the writing of new business also requires a plan which balances the interests of existing and new customers. New business represents a natural use of the inherited estate on a going concern basis, but also a transmission of capital to future generations. Therefore, it represents the deferral of distributions from the inherited estate to existing policies, and

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thus potentially lowers prospects for the existing policies. Deferral has long been seen as consistent with TCF, as new business was universally seen as beneficial — for spreading expenses and providing investment freedom.

6.7 This view of new business is less obviously true where the fund has outsourced its administration, and has a plan for guarantee costs which does not rely on passing the burden to new customers (the historical giving and receiving of guarantees noted by Squires in the discussion of Wilkie (1987). A view that new business shares risks usefully is now far more challenging to support. Product design is no longer evolutionary over long periods, an incremental process which produced products capable of easily blending into an existing fund. New products are now generally more aligned to those from other competitor sectors (banking, asset management) rather than from the existing book of products in the fund. They are also more explicitly described to customers, as noted in Shelley *et al.* (2002): "For new business greater transparency means significantly reduced discretion."

6.8 The industry underwent a significant and highly worrying equity market fall at the start of this century, and was ill-prepared for abnormal times such as those. We are now suffering such market falls again, and we hope that we are far better prepared. In viewing what is fair, it is therefore useful to think through actions which might be acceptable in normal market times, in abnormal times, and when times revert back to normal. It is then worth considering how any of these actions might change when there has been a distribution of the inherited estate, and so capital and claims have become even more interlinked.

7. Management Actions in Normal Times

7.1 What, therefore, is a credible plan for meeting the costs of guarantees, setting the EBR, setting annual bonus rates, and financing new business? Incremental change in the management of payouts does not have automatic merit in itself. Ideally, the starting point would be from the plans and the risk appetite current at the outset of the policies. Setting management plans at this point ensures the most consistent disclosures to new customers, an unbiased assessment of the risk rather than a subsequent assessment biased by how that risk has performed, and thus proper consideration of new business compared to the risk appetite and capacity of the existing fund. Subsequent consideration of altering the plans would then be viewed against the original plan.

7.2 If no such plans exist now, plausible plans should be created, given the disclosures to customers and the projections of benefits at the time of new business. Although this will be difficult, given the range of products and disclosures which typically make up a fund, this attempt at reconstruction does try to judge what has, effectively, been offered to customers. The

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alternative, of reacting to where the fund is now, leads to a management reaction which:

(1) may bear little resemblance to the original proposition to customers, and may open the fund to challenges over mis-selling;
(2) will be set after a number of risks have crystallised, as, almost by definition, favourable times do not need difficult decisions, so the starting point is one of stress; and
(3) may mean delay and confusion over what are often urgent decisions, as the fund lacks a blueprint for action.

7.3 An analysis of guarantee charging systems is useful in this context. This is not to undervalue the traditional forms of managing guarantee costs — the EBR, annual bonus rates, and perhaps the smoothing regime, all of which can have an equal or greater effect — for which, as they are not cost-free, similar considerations arise; but recognise that guarantee charges often represent a clear crystallisation of who bears the risks.

7.4 The two plans common in the industry to meet guarantee costs are either to charge for the expected value of guarantees from the outset or to plan to meet such guarantees from the inherited estate, while at the same time using the investment and annual bonus policy to moderate such costs. This latter plan sounds more plausible, with a real world view of investment returns than with a market consistent view. It makes assumptions about the cost of what is, in effect, partial dynamic hedging, and carries with it the necessity for a sub plan as to when to reduce exposure to risky assets. In the competitive world of the 1990s, competing over bonuses and EBR, adherence to such a sub plan was not easy, nor, perhaps, well explained to customers.

7.5 A plan using dynamic hedging may incur a similar cost to that of an explicit hedge, due to the costs and dangers of asset purchases and sales. In this case it is less important whether asset shares bear an explicit charge for the cost of guarantees or to see investment returns which bear implicit hedging costs. Disclosure to customers should recognise the impact of the plan — noting either the explicit costs of hedging or the implicit costs of selling equities on falls. As noted, some risks, persistency and longevity, are less capable of being hedged. Management plans typically do not distinguish the reason for the change in guarantee costs when attributing cost to asset share or to the inherited estate. It may be fairer for the inherited estate to bear the risks which are essentially unhedgeable, and thus of uncertain cost for new and existing customers.

7.6 This paper holds that clarity over who bears which risks is paramount. The firm may plan to make no charge to asset share. However, whether a charge is contemplated or not, considering the ways in which one should structure and review an explicit guarantee charge to asset share illuminates the risk sharing and, more importantly, defines the risks introduced by new business. These charges could be prospective (a planned

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regular future charge on asset shares), retrospective (an immediate cut in the existing accrued asset shares), or a charge on claims (targeting 97% of asset share at claim, for example), with the last having elements of both prospective and retrospective charging. Fairness needs to be considered for each type of charging regime.

7.7 Logically, a prospective charge should be set at a level which accords with the costs of the guarantees at outset — if asset share is to meet all such costs — given the desired future progress of the fund's investment and bonus policy. The cost would be the time value of the guarantee, although this can be materially altered by the precise planned investment and bonus policy, and whether it is assessed on real world or on market consistent bases. The question then arises whether it is fair to review such a charge over the course of the fund's progress.

7.8 A review may well be justified when there is a significantly altered assessment of the future — a material revision to long-term views of the economy and the asset performance. The review should, however, keep faith with the original logic of the charge. If the original charge were designed to meet the time value of the option, as might be expected, then a review when the option is in the money should try to exclude such likely crystallised costs. Application of hindsight could confuse the review of expected time value with the current estimate of the outcome, an outcome for which the original option charges for the guarantee were appropriate. Any such review must also consider the current roll forward of past charges less past costs, not in the sense of again confusing time value and actual costs, but to balance views of the future and the environment of the past.

7.9 A retrospective charge — an immediate resetting of current asset shares — may represent an explicit 'pay as you go' style of charging guarantee costs across surviving policies in the year of the guarantee payment. There is still a need to assess the likely level of average charge to inform disclosures to customers. More fundamentally, the fairness of this explicit form of loss sharing needs to be considered when no offsetting profit income is likely. Firms may previously have relied on miscellaneous profits from other sources to cover the (miscellaneous) losses on guarantees. However, in today's environment, such miscellaneous profit is far reduced, due to outsourcing and to better treatment of early claims. It would seem fair, if properly disclosed, to apply such losses up to the limit of such past profits which have augmented asset share. However, cutting into bare asset share is more questionable, given the typical disclosures made to customers — that highlight the roll up of asset share and may mention additional 'profits', and possibly 'losses', more briefly.

7.10 The last method, charging by targeting a percentage of asset shares at claim, can likewise be set to recoup the time value of the guarantee costs. Its structure is less geared than the 'pay as you go' style, as charges are taken whatever the market is doing, but are more geared than a regular annual

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charge from outset. Any review of such an existing percentage target has the same difficulty as an annual charge in distinguishing between:

(1) the risks which have crystallised, i.e. that part of the charge which is now assessed to be less than hoped for, as either asset shares are lower or charges are not possible on policies whose guarantees are biting; it would not be fair if this led to a review, as it is merely one of the risks to the wider fund of such a method; and
(2) the risks which justify alteration when following the same methodology as the regular prospective charge.

7.11 A review, or introduction, of charges which result, not from reasonable differences in assessment, but from shock at the scale of the problem, or from confusion as to how costs are to be met, may well be unfair, unless the firm finds itself in relatively extreme circumstances, where, for example, minimum capital requirements are threatened. At other times, when markets and other experiences are well within tolerances, abrupt changes in the plan for meeting guarantees would seem unfair. This applies equally for other 'shocks' more in the command of the fund, such as the writing of large volumes of new business with guarantee costs which strain the fund, or investing in acquisitions which include material goodwill.

7.12 Introducing higher charges for higher benefits, such as improved EBR or annual bonus rates, would normally be more acceptable. However, one would need to test that these benefits were not, in reality, a reinstatement of a long standing expectation, and the firm must have seriously considered the pros and cons of the benefits versus the costs, and the disclosures made to customers.

7.13 *Disclosure to Customers*

7.13.1 It is important to consider whether the long-term plan maintained to cope with guarantee costs, and the likely impact on claim values, were communicated to new and existing customers in a clear and coherent way. If disclosure is weak, or placed well away from the promotion of rewards, then relying on the efficacy of, and the protection afforded by, such disclosure is unfair. The regulatory rules or industry good practice of the time will also be relevant in determining what amounts to effective disclosure.

7.13.2 Projections given to customers, regulatory constraints apart, should include the assessed costs of guarantees and any other charges for such risks, however labelled. Costs must be included clearly in projections if there are actual charges being made now to asset shares, or if there are guarantee costs on claims in the immediate future which are unlikely to be avoidable. More scientifically, the assessed costs which the realistic reporters, at least, have from their stochastic calculations should be included to give a fair picture to customers.

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7.13.3 Firms may argue that, in some, or indeed all, of the deterministic projection scenarios, the guarantees would not bite. The defence is dubious and potentially misleading to customers. An offer of a benefit which ignored the realistic assessment of its cost in communicating with the customer must be perverse.

8. Management Actions in Abnormal Times

8.1 A plan for managing risks will only be fully tested when the risks crystallise to some degree. Plans which cope with moderate changes in the environment may come under pressure from changes which one could honestly call abnormal — such as the equity falls early this century or the current credit and equity turmoil. The question is whether it is fair to revise, perhaps radically, plans in the light of such events. Again, one can look at charges for guarantees, the EBR, annual bonus rates, and the interaction with the inherited estate. Section 9 considers the more radical changes of hypothecation and unitisation.

8.2 Fairness may require a firm to deliver to a customer more than required by the strict terms of the customers' contract. Conversely, an action proposed by the firm can be fair and take proper account of customers' interests even if that involves delivering less than customers might have expected, given different circumstances. However, if a firm's actions mean that it will deliver less than customers expected, the firm must test its legal power to alter its practices in the way proposed, and consistency with the firm's previous disclosures to its customers, together with the firm's previous action (or lack of action) in relation to the same issue.

8.3 *Guarantee Costs, Bonuses and EBR*

8.3.1 When a fund faces problems, the reasons can be difficult to identify: was the plan flawed; has the environment changed unexpectedly; or was there a lack of planning? I suggest that a starting point for judging whether a change in approach is justifiable is that any abrupt changes to practices, for example moving from charging costs to the inherited estate to cutting existing asset shares, would be unacceptable in normal times. Therefore, the degree to which exceptional circumstances can fairly justify action which impacts on claim values/asset shares depends on whether such circumstances should have been planned for — were they reasonably foreseeable?

8.3.2 Differential charging for guarantees between groups of policies may be fair if underpinned by longstanding practice. The introduction of differential charging raises at least two concerns. First, is the charge appropriate for the risk? Second, does the differential charge apply to policies which previously received the same annual and final bonus? Such a change

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needs careful review in the same way as a move to a differential investment mix.

8.3.3 A particular form of differential charging arises between claims at guarantee dates and other claims — paying a higher percentage of asset shares to maturities than to surrenders. If carried out to recoup guarantee costs, it is likely to be most objectionable — one is charging the very policies not enjoying the guarantee — and, of course, it brings the risk of a failure to comply with regulatory requirements and the decision in Equitable v Hyman. (A description of this case can be found in Section 3.1 of Shelley *et al.*, 2002.)

8.3.4 Specific points arise on annual bonus levels and the EBR. Changes to annual bonus rates may represent a change from what was indicated and planned for at the outset, particularly if it appears that the cuts are not a reasoned response to changed circumstances. Annual bonuses are often set under the firm's view of its long-term aim for annual bonuses, and either its explicit bonus earning power assessment for each product, or the level of risk free interest rates in the market. Abrupt changes to these bonuses may be a sound mitigation of risks, but can such a change be fair if the fund is strong and the assessment of future asset performance is favourable?

8.3.5 An example would be a firm offering a high annual bonus — seen particularly in the 1990s, with sales backed by a very high first year bonus — later cutting such bonus to zero to maintain a desired equity exposure. The question becomes twofold: is this reversal of the implicit proposition for the original contract justified if one looked solely at those products; and is this change justified by the state of the overall fund? The answer will depend on the fund's history, but, at first sight, such a cut looks unfair.

8.3.6 Similarly, a firm could reasonably have a high EBR, and a decision rule to sell such equities rapidly on a fall. This could be well modelled through the medium of the realistic balance sheet, and disclosed to customers in a general sense; perhaps: "We adjust our asset mix to reflect the balance of guarantees and our views on investment markets." At some point, however, this need to sell equities on a fall may become so imminent that the maintenance of the EBR, and the portrayal of a high EBR to new customers, could be taken as reckless or misleading to customers — and thus unfair.

8.4 *Capital Resources*

8.4.1 In deciding on the fair reaction to whatever position has been reached, a key factor is whether the fund is near the extreme position of a potential breach of minimum regulatory capital requirements. This should be distinguished from the less extreme position in which (absent management action) the firm is likely to fall or remain below the level of capital which the firm itself thinks that it needs to run its business. A firm should manage its business with an eye to maintaining its inherited estate, and/or resources

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external to the fund, at an economic capital (EC) level. The EC referred to is the individual capital assessment (ICA) at the fund's risk appetite and not at any regulatory minimum. Where the EC is driven purely with regard to the risks across all existing policies, then failure to maintain EC may imply a rising risk of being unable to treat one or other group of customers fairly. The achievement of fairness across all policies may, therefore, justify actions (to maintain capital) which might otherwise be unfair. In particular, fairness does not entitle customers to have benefits which the firm, including shareholder assets, is practically incapable of delivering.

8.4.2 However, management actions to restore or to meet a particular EC, rather than basic regulatory solvency, are not automatically fair. A firm's EC can be high for many reasons: because the firm is anticipating large volumes of new business, because the firm wants to be far stronger than its competitors; because the firm is exposed to particular control/operational risks; or because the firm takes on a high degree of business risk via non-profit risks or low reassurance programmes.

8.4.3 Resource to meet costs is not just a decision between the inherited estate and asset share. Subordinated internal support or external debt is sometimes in place to enable a higher exposure to equities within asset shares, and so the debt should usually suffer some of the consequences of such exposure. The TCF obligation clearly means the rights of shareholders, and debt holders (usually also the shareholders) should not be advanced at the expense of the customers. The alternative is to allow higher risks to be taken, but then, in practice, to allow the costs of the risks on crystallisation to fall to customers.

8.4.4 Similarly, it should be a starting point to question whether other resources, such as any shareholders' one ninth transfer or their fixed charge on unitised with-profits policies, or any shareholder funds, should be brought into play. The shareholder normally enjoys a profit share rather than anything described as a fee for risk management. However, the shareholder, as the manager of the fund, should have a good plan in place to deal with foreseeable events, and often will be charging arm's length fees for administration, which, in itself, brings more explicit duties of good risk management.

8.4.5 Fairness may not be an issue once all the circumstances are taken into account. For example, capital adequacy may be under threat with no other shareholder resources available, or the firm may have radically altered its view of the relative attractions of different asset classes. In such cases, it may be fair to overturn past disclosures of particular asset mixes — of the 'we are strong and invest highly in equities' variety; but, in any situation of stress, it is preferable to allocate the costs to the shareholders or to the inherited estate than to asset share, unless a plan which naturally charges costs to asset share has been disclosed to customers — in the written marketing material and in the projections of possible returns.

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9. Radical Changes Resulting from Abnormal Times

9.1 Radical changes may be contemplated, though not necessarily possible, when the fund has reached a position where:

(1) some guarantees are so heavily in the money that it makes little difference to those products if their asset shares are in a normal, risky, asset mix;
(2) the fund's resources mean that a very risk adverse investment strategy is needed; or
(3) the fund's resources mean that a normal, risky, investment strategy can only be regained by radical contract change.

9.2 The first is often called hypothecation; the second is akin to the classic end game for a fund, namely matched bond investments; and the last can take various forms, but includes unitisation. It is worth considering each of these in turn, as they raise strong, and difficult, TCF questions.

9.3 *Hypothecation*

9.3.1 Hypothecation is used to describe the sub-division of investment policy by product line or within product line — typically a high or even 100% bond weighting for products with guarantees heavily in the money. The effect is usually to reduce the capital requirements materially, and sometimes, to a smaller degree, the cost of guarantees recognised in the balance sheet, by holding assets with lower volatility. At the extreme, 100% bonds to match the guarantees, the products have been effectively converted to non-profit. While customers may not appreciate the implications, particularly if portrayed as part and parcel of matching assets to the remaining term of the policy, a conversion has effectively been achieved which would normally require a business transfer or other court process and significant review and oversight.

9.3.2 The statement that guarantees are heavily in the money itself needs clarification. It does not mean that asset share at a risk free roll up would equal the guarantee, or even if the best estimate real world roll up would equal asset share. It is only when asset performance has minimal impact on the particular maturity claims that material hypothecation would be acceptable. Thus, a test in current investment conditions might be that the non-bond portion of the asset share would need to deliver very high, perhaps 10% p.a., returns to affect the outcome.

9.3.3 On the merits of hypothecation, the first comment must be that the industry has, to a remarkable degree, previously avoided an investment mix which is tailored to each product type. Common, though not universal, practice has been for all asset shares to enjoy the same investment return, driven by the return on the total asset portfolio.

9.3.4 The firm may reasonably wish to hypothecate to relieve its risk, as

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captured by its capital requirements. To go further and achieve a material improvement of the balance sheet itself, from a materially lower liability for the cost of guarantees post hypothecation than pre hypothecation, would seem very questionable. In the context of a business transfer scheme, one might well view this as a reduction in benefits. An improvement to the outcome for other products, because of hypothecation for the high guarantee product in stress, would be a mitigating factor.

9.3.5 The reduction of the capital strain of these high guarantee products is an acceptable purpose for the change if the strain impedes the usage of capital for more productive risk taking elsewhere. However, in extreme 100% bond cases (or unitisation), the products may, by default, lose some of the benefit from any subsequent distribution of the inherited estate. Consider the picture if, just before or just after hypothecation, the inherited estate was completely distributed as a percentage of asset share. Just before, the product receives an enhancement which could undermine the decision to hypothecate (or unitise). Just after, while there may remain an asset share to be enhanced, there could be a quasi non-profit product no longer run on asset share lines in any real sense.

9.3.6 Policies claiming at non-guarantee dates have lost potential investment performance (and risk) from a switch to bonds, but, of course, are not identifiable at outset. Two actions can mitigate this.

(1) The surrender values are realigned to a discounted value of the guarantee, rather than asset share — normally bringing higher values from enjoying a discounted guarantee rather than no guarantee.
(2) Customers are given the explicit option to transfer, at full value, including the cost of the guarantee, to another product with a more open investment mix — a solution close to unitisation if the level of guarantee is moderated at the same time.

9.3.7 Hypothecation may be potentially disadvantageous to more than those customers who surrender without a guarantee applying. It is open to construction as circumventing the guarantee offered to customers, contrary to Equitable v Hyman (see Shelley *et al.*, 2002). The circumvention may arise if a product offering a mix of assets underpinned by a guarantee is transformed to a product with a defensive asset match which ensures that guarantees do not bite. One should remain aware of the danger in this situation if the policy guarantees concerned are not firmly 'in the money'.

9.3.8 It was noted above that using capital release to effect a beneficial customer change elsewhere, such as reducing the EBR on some products to increase the EBR on others, was more acceptable — far more acceptable than merely reducing the EBR on some products. A more complex, but common, situation is the real effective starting EBR for sub sections of the portfolio, when one takes account of the interactions with the inherited estate. Take a portfolio which is equally split between pension policies with

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heavily in the money guarantees and endowments still with final bonus being paid. There is a uniform 25% EBR across both sets of asset share. If equities go up the endowment asset shares rise, but it is only pension transfers which benefit from the pension asset share EBR. The majority of the equity rise attributed to pension policies thus feeds the inherited estate, and conversely, when equities fall, the pension EBR induces a fall in the inherited estate. While the transition of value to the endowments through the inherited estate may be somewhat asymmetrical, it may be the fall in equities which triggers a more immediate impact on the endowment asset shares, such as a charge. Hypothecation needs to recognise that the endowments, in many ways, already have a '50%' EBR.

9.4 *Natural Movement to Bonds*

Notwithstanding statements to customers, it has seemed almost standard theory that a with-profits fund should become invested more and more in bonds as it shrinks. This move to a 100% bond strategy has less to do with any intrinsic problem of guarantees versus asset share in a smaller fund, but more to do with the smaller scale of such a fund which may militate against the sharing of outcomes — adverse as well as favourable — between cohorts of asset shares. However, it is not inconceivable that a shareholder could stand behind a more risky asset mix, or the fund, itself, could come to the view that a partially hedged asset mix would be sustainable. What is certain is that, while the fund needs to be managed across many years, particularly via the aggregate asset mix, major changes in segregated asset mix can prove to be irreversible, and should, for this reason, be sceptically reviewed.

9.5 *Unitisation*

9.5.1 Unitisation, the conversion to a property linked fund, should be treated as a special case of this part of the interaction of guarantee versus EBR versus charges. The process is likely to be subject to a more formal court process, though it can arise as a switching offer to an existing fund.

9.5.2 However, the change is effectively a wish on the firm's part that it had started with a different portfolio of products. The change is fundamental, and, moreover, removes the crucial part of the contract — the guarantee. The principal object may be to shift investment risk (or opportunity) back to customers. This is normally to make the fund tractable again, but the question of whose interest this is in, and who gains, is paramount.

9.5.3 In this case, there are the same conflicts affecting whether customers are getting full value within the conversion. A customer would reasonably wish to share in the release of the cost of guarantees, in the capital tied up partially to meet those guarantees, and in the balance of the inherited estate. The transaction is likely to need the level of review called for by a business transfer scheme or, indeed, a re-attribution. It could be

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argued that a customer advocate is to be recommended as a voluntary addition to assist such a wide reaching alteration, a role which is not mandatory if the route chosen is a Section 425 arrangement under the Companies Act.

9.5.4 Given that the customers' expectations are being completely overturned, it is also appropriate to consider the involvement of any shareholders. In particular it would seem suitable that:

(1) Any current support from shareholder resources is considered for inclusion in the sum to be distributed to customers.
(2) The shareholders would need to demonstrate that they should not make a heavier contribution to balance the risks which the customers are now taking on; namely the customers' exposure to all future investment outcomes.
(3) In all cases, the interests of what are likely to be competing customer groups need to be weighed carefully.

10. Management Actions Post Abnormal Times

10.1 The ability to recover from abnormal times depends on both the extremity of the stress and the robustness of the plans for the fund. Two salient points are the confidence of the managers of the fund and the limits to which key aspects can go, such as the EBR, absent the hypothecation discussed above.

10.2 A detailed plan for who bears risks, and how, with well defined actions should offer the best hope for weathering stresses, and, indeed, should provide a blueprint for modelling the strength of the fund both before and after the stress. However, one aspect which is more difficult to prejudge, and model, is the impact on the nerves of the managers of such a fund. A return of buoyant times should see an almost automatic reversal of equity sales to one of purchases, if some form of dynamic investment policy is followed. In practice, difficult times undermine the confidence of management and may bring a review of who bears the risks of more aggressive EBRs — a review carried out with the stresses foremost in the management's mind.

10.3 A reluctance to revert to the previous asset stance, unless justified by genuine new information, would be unfair, as a restriction on investment freedom is a potential drag on asset share growth. Similarly, deciding to use derivative protections around an acceptable EBR is an actual cost to the inherited estate or asset share (via put option premia or lost upside performance) and so a drag on hoped for performance (though a potential saviour in bad times).

10.4 The key here is not that any particular firm must be investing as much as it can in equities, traditionally seen as a potentially out performing asset class, rather that it should have both the capacity so to do and the

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governance arrangements to facilitate using such capacity. The test of this key aspect is necessarily the action or inaction displayed by the firm.

10.5 This leads one to ask how 'safe' an asset mix a with-profits fund can have, and still remain credible, compared with the original proposition to the customer taking out his or her policy. There are funds which have almost entirely converted into bonds in response to the equity falls at the start of the century. Some firms now in bonds will have warned customers in their literature that solvency would rule investment policy to some degree; though it is questionable what construction a customer would place on this when faced with a seemingly strong firm.

10.6 What of the firms of middling strength, open or closed, which have not seen a crisis of solvency, but are now seeing both harder times (post equity market falls) and a better assessment of their true position (realistic reporting and/or EC)? Although not forced into bonds, they are now, if not previously, well aware of the risks which the funds face. Should their investment policy and its balance between avoiding risk and investing in what should be profitable sectors (such as equities) be entirely their own business? Under the typical disclosures made, customers would have thought that they were entering a managed fund; a fund which invested in a mix of assets including equities, and often one heavily slanted to equities.

10.7 However, it must be beyond TCF for the fund to maintain an exposure to risky assets which imperil the firm's solvency. Conversely, it would usually be against those expectations for the fund to cut the EBR to nominal levels — 5% of the fund for example — either immediately or as an action in more adverse market circumstances. One way may be possible for a firm to balance this risk/reward tension: either use the capital in the fund to maintain some level of risk; or reduce risks and distribute capital no longer required to customers (and shareholders via the typical 10% share in bonus).

10.8 In some cases, the internal strength of the fund is not the whole picture; the shareholder is supporting the fund to meet TCF. If it is the shareholder who, in part, is supporting such exposure, then the limits to equity disinvestment, and the triggers for reinvestment in equities as the fund regains its strength, are particularly sensitive. There can be a temptation for the shareholder to support what is, in effect, a trading out of difficulties — hoping that equities recover and/or customers do not take up the current available guarantees. It is important that external support of this nature is more than a comfort blanket, and is used in crisis rather than forever cited as being there, but somehow never used. The regulator's TCF rules lay down the requirement for changes to asset mix to be after consideration of the extent of guarantees, representations to customers, established practice, and the amount of capital support available.

10.9 The 'right' level of exposure will be unique to that firm, whether for the entire fund or on a more hypothecated basis. A rule of thumb might be that equity exposure or EBR should not fall below a level of 20% to 25%

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to remain credible to the original proposition. How other risky investments should be included in such an EBR will depend on their attributes — for property on the kind of properties in which the firm invests, as there is a range between good covenant leasehold investments akin to bonds and development properties more akin to equities, and similarly for alternative investment media on their underlying risk levels.

11. Distribution in Open and Closed Funds

11.1 When one is considering the very radical changes to a fund from hypothecation, low EBR or new charges for guarantees, it would be perverse to ignore the inter-relation with the inherited estate and the balance to be maintained between the classic uses of the inherited estate (higher EBR, etc.) and the augmentation of asset shares. Once a decision is taken to distribute, then considerations arise as to how this is undertaken fairly. This section considers the broad issues of fairness, security expectations, and the development of management actions over the period of distribution.

11.2 Firms must assess their need for capital to inform their actions. Capital assessment is a developing methodology, and one often applied in conjunction with the realistic balance sheet, possibly still a developing methodology. Firms are likely to take time to be comfortable with the results and how they will develop under economic changes. This possibility of future changes in methodology, and hence understanding, cannot be ignored — but should not be a justification for inaction.

11.3 In addition, with-profits funds, open or closed, are likely to be seeing their in-force book declining quite rapidly, the exits over the next few years representing a material portion of their existing business. Delaying augmentation/distribution from worries of what the future might hold can disadvantage significant numbers of customers.

11.4 The targeted risk appetite is again central to these debates. Failure to maintain adequate capital in the form of the EC (not capital at the regulator's minimum risk appetite of 99.5%, but at the firm's risk appetite), would usually imply an increasing risk of an inability to treat one or other group of customers fairly. This test, however, will be somewhat flawed, or at least more difficult to interpret, if the EC is increased by:

(1) holding back material capital to invest in new opportunities, such as acquisitions or extensions to the volume of new business; or
(2) holding back material capital due to an equity bias in the fund's management, which means that the cost of guarantees is backed by a risky asset mix rather than by a hedge or by a more neutral asset mix.

11.5 *Fairness*

11.5.1 A fund closing to new business is required by the regulator to

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provide a run off plan and "demonstrate how the firm will ensure a full and fair distribution of the closed with-profits fund and its inherited estate (if any)." An open fund has an equal duty in fairness to consider its capital position and whether its assessment of capital, possibly heightened by using equities to back its cost of guarantees or by aggressive new business plans, is fair. The principles in ¶11.5.2 should be considered for all fund types.

11.5.2 The starting benefit expectation of customers is 100% of asset share (subject to the current or potential charges and the current investment mix) from the likely presentation to customers, and, indeed, a requirement of the regulator. A distribution of the inherited estate should aim to better this standard, and not, therefore, endanger policies (i.e. give a high likelihood of some policies getting less than 100% of asset share, perhaps from meeting future guarantees costs). In detail:

(1) This aim of a better outcome should be achieved by all policies in all reasonably foreseeable future scenarios, i.e. for likely outturns in the middle ground — which one might describe as the 50% of outcomes between the 25% and 75% quartile events, or, perhaps, events within one standard deviation of the mean. Although there is nothing magical about 25% and 75%, it is a reasonable starting point, and points the way to test this — through the scenarios developed for the realistic balance sheet and/or the business plan.
(2) A firm could fail the aim of a better outcome, and still be fair, if more extreme events actually happen. Such 'danger spots' should be tested through taking tracks from stochastic asset projections to identify any differing impacts on differing products/cohorts, and to identify mitigating actions/planned reactions. The firm can reasonably react differently if more extreme events occur as the portfolio winds down — with-profits policies can reasonably be expected to share in adverse experience, unless there are explicit shareholder support promises/mechanisms.
(3) A fair distribution of capital may not save the last policies from seeing much reduced investment freedom at some point if their guarantees are high. If all the policies exhibit similar out of the money guarantees, i.e. sizeable final bonus cushions, then the firm should be able to aim for stability in exposure to more risky assets as the portfolio contracts. However, if the guarantees are, or become, more in the money as the portfolio reduces, then the firm loses the ability to spread any adverse experience over a larger body of policies. In such cases of the later claims having guarantees more in the money, the firm may need to steadily change the investment mix, unless external capital can be used to take this risk — or capital is expended on hedging such risks.

11.6 *Security*

11.6.1 The security expectation of policies is that the distribution should not reduce the expected security for the later policies beyond the current

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position. An excessive distribution in the early years which reduced the security for later policies would be unfair, though, in the natural course of events, a benign period followed by an extreme event will necessarily impact those customers remaining rather than the policies which exited in the benign period. One could take the view that:

(1) The EC test covers TCF, i.e. more than just guarantees. It should represent an integral part of the management of the fund (as this is the EC at the firm's risk appetite, not 99.5%), so that meeting the EC for the future is a good test of benefit security. Deferral of distribution to enable the continued meeting of EC is sensible — but that is deferral only of money otherwise immediately paid out as claims. By contrast, the augmentation of all asset shares immediately does not mean an irretrievable loss of capital, but merely a departure of capital in step with claims. Immediate augmentation does ensure that early surrenders do not lose any distribution.
(2) The use of EC does not mean that all policies have the same security — longer-term policies may see a greater range of potential outcomes. Comparison of an EC on a run off methodology compared to an EC on a one-year variance at risk basis leads naturally to the fact that EC (of any kind) delivers a level of security for the later policies of less than the one-year confidence level, though a confidence which spans a greater period of time. This is similar to the credit rating on a corporate bond — security cannot be certain for future periods of the bond's life. Again, similar to a corporate bond, to demand a one in 500 or better confidence level for a guarantee due in 25 years time would imply holding back capital at an extremely high current credit rating — to the detriment of current claims.

11.6.2 Security should be measured in the context of the fund's risk appetite and the quantum of shareholder support (including how extreme a situation would be before this support cuts in). Ideally, this should be consistent with the fund's history, and thus the deal which the customers thought that they were entering. However, where the fund is *now* is much more important than where it *has been*; current realities should predominate — though not to the extent of an over hasty release of shareholder support.

11.6.3 The aim to maintain capital equal to EC is only suitable for relatively benign future scenarios. An initial desire to hold capital in excess of EC, so as to be able to support an EC amount of capital after challenging (future) events, represents a higher degree of strength/security. It sets up margins (the original EC 'margin' which, purportedly, is judged sufficient by management) on margins (ability to recreate EC headroom). This represents a delayed distribution to those policies leaving the fund in the short term, due to conservatism overriding the professed risk appetite of the fund, with consequent unfairness to those policies leaving the fund in the short term.

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11.7 *Management Actions*

11.7.1 The scope for management actions can, and may need to, alter over the run off period, unless the shareholders have given explicit commitments, perhaps under a court scheme. One notes the following:

(1) Management actions on non-guaranteed benefits (or shareholder support) may need to become more aggressive, as the fund diminishes, to avoid a Tontine. While the risks may well diminish in line with the policies in force, a single operational event may loom that much larger in the future reduced scale of the firm.
(2) An EC event only has a certain probability of occurring within the period of run off; most planning should be for mid-range events.
(3) In the presence of clearly defined shareholder support, management actions can, and should, remain close to the current plans, as articulated through the realistic balance sheet/EC and prior policy communications. If the shareholder has committed support, the firm should rely on it and not manage it down.

11.7.2 The balance of distribution between early and late policies will be unique to the fund, but, all other things being equal, the following points should be considered:

(1) A firm should have to justify the fairness of not rewarding early claims to the same degree as later policies, recognising that, whatever is the planned distribution, a later severe event would damage payouts to later customers.
(2) This balance between generations of policies becomes more extreme where a significant majority of policies are projected to be late, or to be early claims, i.e. a mainly short portfolio with a small, but long, tail should not aim to retain excessive capital. A portfolio with most policies (if this represents also most risks) likely to claim late on in the run off could reasonably justify delayed distribution.
(3) A TCF distribution could take a number of forms — possibly reflecting either the duration of the policy's life with the fund (i.e. more skewed to early claims) or the duration of the policy to run (i.e. more skewed to later claims). However, the firm must be capable of justifying the TCF logic of its view over how the distribution is spread over policies. This may be illuminated by previous allocations of miscellaneous surplus or of earlier distributions, but, typically, there will be no relevant past practice. The choice should not be made solely to benefit/protect shareholders.
(4) Distribution should be intended to be smooth in application, rather than planned to step jump or exponentially increase in future. A distribution plan might, in the middle ground of likely events, lead to sharp differences in the distribution between early and late claims. Unless this is justified by other considerations (such as TCF judgements over who should benefit most, or from the retention of capital to cover later risks),

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such a plan would seem unfair if a likely outcome is an uneven distribution. At the extreme, this could be as bad as a Tontine effect — the last few policies reap most of the distribution. A similar effect can be engendered if an immediate total distribution can be subject to material claw back. While material claw back of amounts previously distributed may be needed after more extreme events, harsh claw back may point to a faulty run off plan if it could occur after risk events in the mid range of likely outturns.

11.7.3 A firm should be aware whether the fund becomes more volatile over time, or stabilises as it diminishes. The risk sharing seen in an open fund does not automatically reduce with size, but can with lack of scale to meet/share problems. The typical 'self insurance' or lack of hedging, practised by a strong, open fund becomes less affordable, and possibly reckless, as the fund runs down and lacks the scale to cope with risks which remain material and volatile. Much depends on whether the policies with high guarantees last longest. To hedge against long-term GARs, for example, may well prevent excessive capital being held back.

11.7.4 The shareholder has a responsibility (i.e. where no explicit support is cited in the PPFM) to manage and support (*in extremis*) a fund in the final stages of run off. The shareholder is the manager of the policies, and has a clear duty to meet TCF. If it views a 'ring fenced', with-profits fund as never having a call on external shareholder resources, this may impede a sensible run off. In particular, the shareholder may need to assume or reassure some of the unhedgeable risks, such as persistency and longevity.

11.7.5 Examples of distribution methods include:

(1) *A flat percentage addition to all asset shares of the opening capital.* This equal addition to all asset shares is a common method for distribution in demutualisations. Its logic is, perhaps, either that risk is roughly equal across all products, or that all products have the same rights to the inherited estate. It is aligned with the typical distribution of miscellaneous surplus, and relies on the augmentation of the asset shares of policies claiming later also acting as the EC capital for these same policies.

(2) *An annual percentage increase to asset share to exhaust the opening capital.* Capital is released more slowly — the distribution being slanted to the latest exits, whether by surrender or maturity — and the rate of release is easier to adjust subsequently. Whether it tends to throw up persistent increases in the necessary rate of distribution depends on the experience seen as the fund runs down and how risks are spread over time.

(3) *An addition to surviving asset shares of any excess over the EC, perhaps as a flat percentage.* This represents the most delayed of the three distribution methods described here, and the most cautious, as no part of

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'their' supporting capital is allowed to go out with current claims, but rather any excess is assessed after the year's experience and granted to the survivors.

12. The Future

12.1 There needs to be a balance between the maintenance of discretion and the avoidance of confusion of mind as to the definition of TCF — given the tensions which exist between generations of customers and between customers and shareholders. A with-profits fund with no discretion would be a dangerous construct to manage over the long timescales of the typical portfolio. A firm needs to settle certain elements of discretion, reducing the historically wide scope of discretion, but retaining justifiable discretion to manage the fund. This paper has argued that such clarity comes mainly from understanding which part of the fund and the shareholders bear various risks, and to what appetite.

12.2 There is considerably more formality now around the governance structures of a with-profits fund. There should be a with-profits committee or equivalent, and invariably a with-profits actuary. Such structures, while mitigating tensions, cannot remove them. The Institute President in his 2006 Presidential Address (Dumbreck, 2007) highlighted the situation of the with-profits actuary in a proprietary fund, and the regulator has recently questioned the focus and the involvement of with-profits committee structures.

12.3 A long-standing control has been the ability to compare a fund with the actions of the fund's peer group — the other with-profits funds in the U.K. — perhaps those of similar size. These can be useful to either set the actions which are acceptable or, more likely, to provide a context against which deviations from such industry common practice have to be justified. Common investment policy and bonus setting between the non-electors' and electors' funds, with reference to the wider industry practice, was used in the AXA re-attribution.

12.4 However, the uniformity of the management of funds across the U.K. industry has become more fragmented. For example, apart from the retreat from equities and often closure of the weaker funds, hypothecation of assets by product is now more common, and makes more complex the creation of a fair benchmark for any fund. The utility of a peer group is lessening; other funds will face different risks and have different histories and have reached different points — a present example being the current divergence between open and closed funds over investment policy.

12.5 The alternative of 'hard coding' certain major elements of management — in a scheme, in a PPFM, in internal documents which describe the fund — often concerns actuaries. The long-term nature of such funds can make any constraint on management action seem unwelcome, if

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not dangerous, and undermine the delivery of TCF. However, the alternative is also unattractive, often leaving an unresolved conflict between differing objectives of existing customers, new customers, and the shareholders/managers. Lack of clarity has already caused much unintended change, as the industry experienced the early century equity market falls. More limited, but clearer, discretion is a more sustainable and viable future.

12.6 Clear principles of which risks and rewards are being borne by each of the stakeholders are not only worthwhile, but vital, given the changes which are being wrought to existing funds by new methodologies, new hedging opportunities, and changes in new business levels. Such principles will help inform the communications with customers and the investment market. An end result which delivers TCF, and a better working structure for actuaries within with-profits firms, would be well worth considerable effort.

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