The with-profits end game

A consideration of the potential approaches to winding up with-profits funds

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With many with-profits funds now in run-off, insurers should be considering the potential approaches to the eventual wind-up of their with-profits business.

The run-off of with-profits funds

It is well known that there has been a steady decline in the UK with-profits sector over the past decade and beyond, with falling customer numbers and assets under management, and few providers now writing material volumes of new with-profits business. As a result, there are many with-profits funds now closed to new business and in run-off.

RUN-OFF ISSUES

There are many interlinked issues that arise as with-profits funds decline in size:

- Primarily, the need to hold back assets from being distributed in order to cover capital requirements (to the extent they are not reduced by assumed management actions) restricts the ability to distribute the estate.
- The prevalence of guarantees can lead to these capital requirements being significant compared to the overall size of the fund. Such guarantees are likely to be backed by low-risk assets, potentially dampening investment returns. This is exacerbated by the current sustained low interest rate environment.
- Expense diseconomies also arise as policy numbers decline.
- Any non-profit or unit-linked business within the same fund with a longer duration than the with-profits business can add to the issues above.

Overall, these issues can make a smooth and equitable distribution of the estate more challenging to achieve, posing a risk of a tontine developing.[1]

Insurers are required to establish and maintain a run-off plan for closed with-profits fund in order to guide the management of the fund as it declines in size. However, one of the key findings from the Financial Conduct Authority's (FCA) thematic review into the fair treatment of with-profits policyholders[2] (TR19/3) was that many firms were not keeping their run-off plans up-to-date or actively using them to guide the day-to-day management of their with-profits business. When regularly updated and used in decision-making, run-off plans can provide early indication of some of the issues that may arise over the run-off of the fund.

WHAT ARE THE OPTIONS?

Given the number of with-profits funds that are now in run off, and the associated issues that arise, insurers should be considering the potential options for the eventual wind-up of their with-profits business.

In many cases, there are sunset clauses in place for with-profits funds to guide the approach to take when the fund size falls below a specified threshold,[3] which have typically been set as part of a historical court-approved Part VII transfer,[4] or in some cases have been set by the firm as part of the run-off plan for the fund. The level of detail within sunset clauses varies. For example, some prescribe the form that the action must take, such as converting policies to non-profit. Others have a "must" wind-up clause, which specifies the point at which action is mandatory, in addition to a "may" wind-up clause.[5] However, the precise methodology is generally not prescribed within a sunset clause. In addition, not all with-profits funds will have a sunset clause to guide the timing for taking action and the form that it should take.

In this paper we consider three different ways in which firms can approach the wind-up of conventional with-profits business, namely:

- Conversion to non-profit
- Conversion to unit-linked
- Options for remaining as with-profits, including merging with another with-profits fund

We examine each of these approaches and consider some case studies to demonstrate where they have been used in practice. We also set out some further considerations that span across these approaches, which may help insurers to determine the most suitable action to take. Finally, we consider some preparatory actions that insurers should consider in order to address underlying issues in the with-profits fund in advance of implementing the approaches discussed in this paper.

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[1] In the context of with-profits, this is the risk of the policyholders remaining in the fund the longest receiving an unfairly large proportion of the with-profits estate.

[2] Milliman Briefing Note: TR 19/3 FCA Thematic Review.

[3] The threshold may not be related to the size of the whole fund; for example, it may refer to the value of the assets backing the with-profits policies of the fund.

[4] A transfer of business or parts of a business under Part VII of the Financial Services & Markets Act 2000 in the United Kingdom.

[5] The threshold for the "may" wind-up will be larger than for the "must" wind-up clause, and so reached first.

Conversion to non-profit

Converting with-profits policies to non-profit would involve replacing a policy's expected with-profits benefit, made up of the basic sum assured plus accrued and prospective bonuses, with a guaranteed sum assured.

The following subsections set out some of the key considerations for converting to non-profit.

ESTATE DISTRIBUTION METHODOLOGY

Policyholders would require compensation for the loss of access to future reversionary and terminal bonuses, ensuring they receive a fair portion of the estate. The estate distribution methodology should take into account factors such as past distributions of the estate and contributions that different classes and generations of policyholders have made to the estate.

If the estate is already being distributed, then the allocation of the estate among individual policies might be expected to follow the established allocation approach, for example by fixing current reversionary and terminal bonus rates. On the other hand, the current allocation approach may be designed to give a bigger share of the estate to policies expected to claim further into the future, to compensate for the increasing uncertainty as the fund matures. This will no longer be a factor once benefits are guaranteed. It may therefore be considered more appropriate to apply a single uplift to policy values at the point of conversion irrespective of the remaining term of the policy.

It would also be important to ensure that the distribution of the estate does not introduce a material discontinuity in benefits in the shorter term and therefore any changes to the current bonus scale and surrender values may need to be smoothed.

For both a mutual and proprietary company, with-profits policyholders may not be the only parties with an interest in the estate. Members or shareholders may also have rights to the estate, and this should be considered when setting the estate distribution methodology.

The enhanced asset share, which reflects the distributed estate, together with any future premiums, can be used to provide a non-profit policy for the policyholder, either with a fixed sum assured or an initial sum assured plus future guaranteed bonuses. However, if the minimum benefit guarantee is in-the-money then the enhanced asset share may not be sufficient to meet the cost of that guarantee, but it still needs to be honoured.

CAPITAL REQUIREMENTS

Following conversion to non-profit, the capital requirements associated with the business would need to be borne by shareholders or, in the case of a with-profits sub-fund of a mutual company, the mutual's main fund.

The conversion terms would be expected to allow for the opportunity cost of using this capital to back the capital requirements rather than investing it in other risk-seeking ventures, as well as the lower expected investment returns as a result of de-risking the backing assets. The basis used to determine the cost of capital may have a material bearing on the conversion terms.

The 6% cost of capital rate used for the Solvency II risk margin may be considered as a starting point. But while some companies argue that this significantly overstates their cost of capital, others use rates well above 6% in their new business pricing.

Setting the cost of capital rate would need to be a key area of scrutiny when converting to non-profit, as:

- The interests of both policyholders and shareholders (or of the different groups of policyholders in the case of a mutual) need to be balanced
- The rate chosen may have a significant bearing on the non-profit benefit retained by the policyholder

In addition, the timeframe over which the capital requirements are charged for should be considered. For example, if a fund is projected to reach the trigger point in its sunset clause in 10 years, and it would be expected that shareholders or the mutual's main fund would meet capital requirements after this point, then it may be deemed appropriate to include only 10 years' worth of capital requirements when calculating the cost of capital. However, opinion is divided regarding the appropriateness of charging for cost of capital when implementing a sunset clause.

INVESTMENT STRATEGY

Converting from with-profits to non-profit is likely to require a change in investment strategy from a mix of equities and bonds to a purely fixed interest investment approach. Furthermore, some investment vehicles, such as interest rate derivatives, may be held in respect of guaranteed annuity rates, and may be maintained post-conversion. Over the long term this would be expected to reduce the returns that can be achieved on the assets backing policy liabilities, especially given current low interest rates.

The post-conversion investment strategy would need to be reflected in the conversion terms that are offered to policyholders. If the investment strategies pre- and post-conversion differ considerably, it can result in a significant decrease in expected return for policyholders. For example, the case may be that the insurer currently adopts a risk-seeking investment strategy in order to maximise risk-adjusted investment returns for policyholders, which would compare unfavourably in terms of expected returns to a post-conversion fixed interest investment approach.

However, the case may be that the fund has already started to de-risk investments due to the advanced age of policyholders, or due to the capital requirements representing an increasing proportion of the estate. In this case, a comparison of expected returns may not indicate a significant decrease for policyholders. When approaching the point at which policies would be converted to non-profit, firms may choose to start to de-risk so that the impact on expected returns for policyholders as a result of the conversion is reduced. However, firms should ensure that this is an appropriate investment strategy for the fund at present, separately from the decision of whether to convert to non-profit.

Another consideration is the risk-reward preferences of policyholders. Some policyholders may value the potential for higher investment returns associated with a with-profits policy, whereas others may value the security of benefits that a conversion to non-profit would offer. It may be possible to balance the preferences of different policyholders whilst still converting away from with-profits by offering policyholders a switch of policy value into one of their unit-linked polices with no additional fee, thereby retaining some exposure to higher potential investment returns. This would however add complexity to the conversion.

THE TRADE-OFF BETWEEN POLICYHOLDERS AND SHAREHOLDERS

The issues noted above regarding the cost of capital and the current low interest rate environment leads to the question:

Is it possible to offer a non-profit sum assured that is attractive to policyholders and provides an acceptable return to shareholders in current conditions?

To examine this, a comparison of the expected maturity value of a with-profits policy and the sum assured that could be offered on an equivalent non-profit policy can be considered.

Assuming that the with-profits policy is a single-premium endowment with:

- An outstanding term of 10 years
- An asset share of £10,000
- A share of the estate (defined for this purpose as total assets less total asset shares) of 20% of the asset share

Then the policyholder would receive £12,000 if they were to surrender today. In this simple example, it has been assumed that the with-profits fund has an immaterial Solvency Capital Requirement (SCR) and therefore assets do not need to be held back from being distributed in order to support capital requirements. This may be the case, for example, if the full use of management actions is being assumed, or if the run-off of the fund is being managed such that Own Funds exceed the SCR and the fund is therefore able to self-finance its capital requirements.

Assuming instead that this example policy is in a with-profits fund that has just reached the point at which the with-profits policies within the fund may be converted to non-profit, according to the fund's sunset clause. In this scenario, this £12,000 could be used by the insurer to purchase a non-profit single premium endowment with a term of 10 years, in order to effect the conversion from with-profits to non-profit.

The sum assured for the post-conversion non-profit policy has been calculated allowing for different levels of shareholder return, assuming:

- The company aims to hold Own Funds of at least 130% of the SCR.
- The single premium is invested in a 10-year gilt strip[6] yielding 50 basis points (bps) per annum (p.a.).
- Expenses of £40 p.a. are incurred, equivalent to 33bps, growing with inflation. For simplicity we have assumed investment management expenses are included in this figure.

It should be noted that these assumptions are illustrative in nature, but the choice of assumptions does not alter our broad conclusions. In addition, these calculations are approximate only and include various simplifications such as ignoring tax and lapses.

In order to assess how attractive the conversion would be to policyholders, the sum assured that could be offered at different levels of shareholder return can be compared to the amount a policyholder would have expected to receive when their original with-profits policy matured after 10 years.

Assuming an investment return of 1.7% p.a. could have been achieved by holding a mix of equity and fixed interest assets[7] within the with-profits fund, the policyholder would expect to obtain a maturity value of £14,203 from their with-profits policy after 10 years (equal to £12,000 x 101.7%^^{10}).

Figure 1 on page 4 shows, for different levels of shareholder return, the sum assured that could be offered and the resultant reduction in policyholder benefit compared to the expected maturity value of the original with-profits policy as described above.

This illustrates that, in this example, policyholders would be required to accept large reductions in benefits if their with-profits policy was converted to a non-profit policy, relative to the maturity value they would have expected to receive had the policy remained as with-profits until maturity.

For example, for a required shareholder return equal to the Solvency II risk margin cost of capital rate of 6%, the benefits under the non-profit policy would be over 16% lower than the expected maturity value of the with-profits policy. Even if shareholders did not require any return, the policyholder would obtain a non-profit sum assured of £12,206 compared to an expected maturity value of £14,203 after 10 years, i.e., a reduction in expected benefits of over 14%.

[6] A gilt strip is a gilt that has been "stripped" into separate securities for each individual cash flow, i.e., one for each individual coupon payment and the final redemption payment.

[7] Assuming fixed interest assets earn 1% p.a., equities earn 4.5% p.a., an equity backing ratio (EBR) of 33% and a tax rate of 20%.

FIGURE 1: CHANGE IN POLICYHOLDER BENEFIT %

Whilst in this example it would be reasonable to expect some level of reduction in benefit when converting to non-profit, in return for the benefit certainty that is gained from the conversion, it is likely that a benefit reduction in the range shown would be unacceptable to most policyholders.

This example considers the scenario in which a with-profits fund has reached the “may convert” stage of its sunset clause. If, instead, the fund had reached the “must convert” stage of its sunset clause, the analysis would instead relate to a comparison of the non-profit sum assured and the value that the policyholder could have earned if they instead took the £12,000 surrender value of their with-profits policy and reinvested it themselves for 10 years. Overall, the outcome in this scenario would be broadly the same, i.e., policyholders would be likely to experience a large reduction in benefits under a conversion to non-profit.

This example highlights that the capital requirements for a non-profit policy, coupled with the current low interest rate environment, make it challenging to offer non-profit conversion terms to policyholders that represent good value for money.

TREATMENT OF OPTIONS AND GUARANTEES

On conversion to non-profit, a decision would need to be made in relation to any options or guarantees attached to the with-profits policies.

For example, if a with-profits policy has an attached guaranteed annuity rate, the insurer could maintain the guarantee, carrying it over to the converted non-profit policy. However, this would be likely to reduce the conversion terms for policyholders, as the increased capital requirements associated with these guarantees would be reflected in the cost of capital.

Alternatively the insurer may opt to cancel the guarantee, providing compensation to policyholders via the conversion terms. This approach would however add complexity to the process, as it will be necessary to ensure the compensation provided is deemed fair.

SUMMARY

Overall from a policyholder perspective, conversion to non-profit would allow a full distribution of the estate, which may otherwise be restricted due to capital requirements, and avoids policyholders being impacted by tontine effects. It would also remove the volatility in the final benefit for policyholders, as access to future bonuses and the estate would be exchanged for a guaranteed benefit at maturity or death.

On the other hand, as demonstrated above, current low interest rates and the cost of capital implications are likely to lead to a reduced benefit overall. Insurers may wish to set a cap for the maximum amount of the reduction in any individual policy value, but providing this guarantee could be costly. Furthermore, non-profit policies would lose the protection of the FCA’s Conduct of Business Sourcebook (COBS) 20.2,[8] which requires, amongst other things, insurers to pay fair surrender values to with-profits policies. Insurers would therefore need to ensure that the post-conversion surrender value basis continues to be aligned to Treating Customers Fairly (TCF) principles.

Therefore, it may be difficult to achieve good value for policyholders under a conversion to non-profit in the current economic environment. Indeed, if the conversion were guaranteed to provide a negative return to policyholders, there could be an obligation for the insurer to notify policyholders that it may be in their interest to surrender their policies prior to conversion.

[8] FCA COBS 20.2.

Case study: SLoC conversion of with-profits policies to non-profit

BACKGROUND

In 2016, having passed the predefined level stated in the sunset clause, Sun Life Financial of Canada (SLoC) made a strategic decision to convert the with-profits policies in its Sun Life Financial of Canada With-Profits Fund (SLFC WPF) to non-profit and to close the fund.

The SLFC WPF had been in run-off since 1990 and as the fund decreased in size it had become more challenging to manage a diversified portfolio of investments, and to distribute surpluses fairly and smoothly amongst the remaining policyholders. Policies within the SLFC WPF also had settlement options which had an unknown take-up rate and could potentially become costly. The conversion allowed the SLFC WPF assets to be adjusted for the estimated reserve for future settlement options, which were to be met by the shareholder fund post-conversion.

Further, pre-conversion the fund was entirely invested in fixed interest assets, including corporate bonds. The lack of equities, which would have had higher assumed long-term returns, helped ensure the conversion terms were attractive to policyholders.

It was considered better to do the conversion sooner rather than later, as deferring it would mean the costs of the process would be spread over fewer policyholders and it was uncertain whether the favourable market conditions at the time would persist.

Policies were to be converted to non-profit policies and transferred to the firm's non-profit fund. The basic sum assured and accrued bonuses to date under the original with-profits policy formed the guaranteed sum assured under the converted non-profit policy. This guaranteed sum assured would be subject to the following increases:

- Guaranteed annual increases (GAI), applied to the sum of the accrued reversionary bonuses and sum assured on an annual basis at a rate that is fixed for the remaining duration of the policy.
- Guaranteed final increases (GFI), applied to the guaranteed sum assured and accrued GAIs on death or maturity at a rate determined in line with the existing terminal bonus methodology.

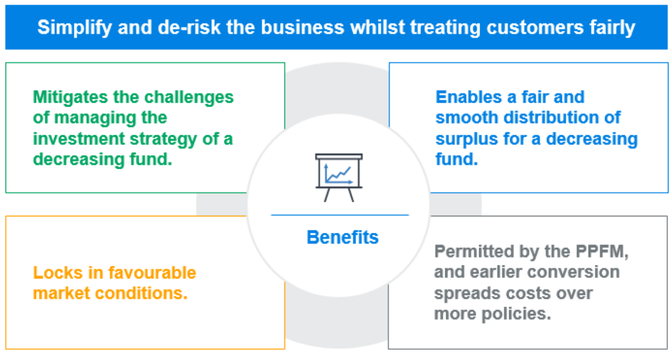
Policyholders of the SLFC WPF were asked to vote on the terms of the conversion. In order for it to proceed, more than 50% of voting policyholders had to vote in favour of the conversion, representing at least 75% by policy value.

SLoC successfully implemented the conversion in 2017.

BENEFITS

For SLoC, the main rationale behind the conversion was to simplify and de-risk the business, as well as to mitigate the challenges of maintaining an appropriate, well diversified investment strategy as the fund continued to decrease in size.

FIGURE 2: BENEFITS OF THE SCHEME



For policyholders, the conversion removed the volatility of benefits and facilitated the distribution of the estate. In addition, credit spreads in the market had recently narrowed and so the conversion gave policyholders the opportunity to lock in the relatively high values of the fund's corporate bond investments. The conversion also locked in the then discretionary expense subsidies in its charges to SLFC WPF policyholders.

CHALLENGES

Benefit reductions

By guaranteeing all policy benefits, SLoC's capital requirements increased. Additionally, in order to manage the increased risk of the now guaranteed liabilities it was decided to de-risk the investment strategy for the backing assets and invest in government bonds instead of corporate bonds, reducing expected future investment returns.

Reflecting these changes in the guaranteed benefits offered to policyholders resulted in a reduction of 20bps in the discount rate used to calculate the GFI and so a reduction in expected maturity benefits. In order to mitigate this the firm agreed to limit the change in projected benefits as a result of the conversion to a maximum of 10%, with shareholders supporting any additional cost beyond this. Additionally, bonuses immediately after the conversion were set in line with those paid pre-conversion in order to avoid discontinuities.

Determining the GFI rates

Whilst the GFI rates were calculated based on the existing terminal bonus methodology, there were a number of complexities that the calculation methodology needed to allow for.

In practice, because GAI rates were fixed at the current rate of reversionary bonus and the SLFC WPF met a capped proportion of costs of implementing the scheme, the GFI rates were derived so that the surplus of the SLFC WPF, allowing for the cost of bonuses, was zero. As is standard practice for terminal bonus rates, for any given year of entry the GFI rates would increase by policy duration.

This was determined as follows:

1. **Pre-conversion GFI rate calculation:** An initial set of GFI rates was calculated using the existing terminal bonus basis, but applying an increase so that the surplus of the SLFC WPF was zero.

2. **Initial post-conversion surplus calculation**: The surplus of the SLFC WPF was then calculated using the calculated GFI rates, but using post-conversion assumptions. The main difference to the pre-conversion assumptions was the reduced discount rate used to allow for the cost of capital, revised investment strategy and the change in expenses as a result of implementing the scheme. The surplus in this calculation was expected to be negative.
3. **Adjusted post-conversion surplus calculation**: The above post-conversion surplus calculation was repeated, but assuming the GFI rates were in line with the existing set of terminal bonus rates for the first 25 years, and in line with the GFI rates calculated in step 1 above thereafter. The surplus in this calculation was expected to be positive.
4. **Interpolation to determine final set of GFI rates:** The GFI rates for the first 25 years after the effective date were determined by interpolating between the two post-conversion surplus calculations, so that the expected surplus was zero. Thereafter, the GFI rates were set equal to the rates calculated in step 1 above.

In addition, the GFI rates needed to ensure the maximum reduction in benefits of 10% was adhered to, tapering down to no reduction for policies claiming immediately.

Finally, because the calculations to derive the GFI rates were sensitive to expected investment returns, it was important to ensure the returns used in the calculations reflected the investment strategy of the SLFC WPF at the point when the final calculation was performed.

Communication

In order to achieve the aims of the conversion, and to enable the SLFC WPF to close, it was necessary for all policies to convert to non-profit, therefore it was not feasible for SLoC to offer policyholders the ability to opt out of the conversion. This presents challenges in terms of achieving a positive outcome from the policyholder vote: policyholders were essentially being asked to vote for a reduction in expected maturity benefits in exchange for a reduction in risk, so the vote was heavily dependent on policyholders' risk-reward preferences. It was therefore necessary to clearly communicate to policyholders the inevitable need for such a conversion to take place and the benefits of doing so sooner rather than later.

As the conversion was complex to explain and policyholders were not able to opt out, particular care was required when producing the policyholder communications, and additional time was built into the timetable to give policyholders sufficient time to review the information and obtain advice. The conversion attracted significant regulatory scrutiny, with extensive feedback being provided regarding the clarity of the communications pack and the accompanying reports.

Conversion to unit-linked

Converting with-profits policies to unit-linked would involve converting the accumulated funds underlying the policy, i.e., the asset share, into units invested in one or more unit-linked funds. The composition of the with-profits benefit, consisting of the basic sum assured plus accrued and prospective bonuses, would be replaced by a benefit linked to the value of the underlying units. If the converting policy has a guaranteed sum assured on death, this would also need to be maintained under the corresponding unit-linked benefit.

The estate would need to be distributed amongst the converting policies to ensure policyholders receive a fair portion of any surplus built up in the with-profits fund. This would likely take the form of an uplift to the policy value used to purchase units. Any guarantees being lost upon conversion would also need to be reflected in this uplifted policy value. Therefore, the discussion on estate distribution methodology in the "Conversion to non-profit" section above also applies for conversions to unit-linked.

Some key advantages of converting to unit-linked instead of non-profit are:

- Unit-linked business is less capital-intensive than non-profit business due to the policyholder taking on at least some of the investment risk attached to unit-linked policies, and because there are typically fewer guaranteed aspects of unit-linked policy benefits.
- Converting to unit-linked would allow most assets to stay invested in an asset mix similar to that used for the with-profits business, meaning the expected investment return could be broadly unchanged following a conversion from with-profits to unit-linked if the policyholder chose to continue with the same investment strategy. However, policyholders would have increased exposure to investment risk compared to the exposure under a with-profits policy.
- For product types that may require a flexible maturity date, such as pension policies, converting to unit-linked provides the policyholder with a readily observable policy value that they would receive upon surrender, as unit-linked policy benefits are expressed as a current value. Conversely, the benefit for a non-profit policy is expressed in terms of a maturity value, and therefore the value that would be payable upon surrender is less clear to the policyholder.

However, the nature of unit-linked business would introduce various other factors that would need consideration. We discuss some of these key considerations below.

UNIT FUND OPTIONS

Given a conversion to unit-linked would remove the benefit of smoothing[9] and increase policyholder exposure to investment risk, it would be appropriate to offer policyholders a selection of unit funds to invest in post-conversion in order to accommodate

[9] The process whereby some profits are held back from being distributed as reversionary bonuses during years of good investment performance in order to boost reversionary bonuses in years of poor performance.

different risk appetites. This adds some complexity to the process that is not present in a conversion to non-profit, and potentially introduces to the need to provide policyholders with access to independent investment advice. However, policyholders may not want this additional responsibility of selecting an appropriate fund to invest in, and so it could be harder to gain the support required to implement the conversion.

It may be more straightforward, both from an implementation and a policyholder understanding perspective, to decouple for policyholders the decision on the conversion from the decision on how to invest their policies if the conversion goes ahead. For those policyholders who do not make a decision on their post-conversion investments, a suitable default investment option would also need to be determined by the insurer. Furthermore, care would need to be taken in deciding the timeframe over which to switch policyholder investments to their chosen funds (or the default option) to reduce the risk of a mass switch of investments over a short timeframe impacting the sale price of the assets.

One implication of offering various unit fund options is on the cost of providing any guaranteed death benefit. As different unit funds will achieve different investment returns, the extent to which a fixed minimum sum assured on death is in-the-money or out-of-the-money will depend on the unit fund chosen. The most practical approach to addressing this issue is to restrict the guaranteed portion of the investment to a default, low-risk fund option. An alternative is to have an explicit monthly charge for life cover, which is based on the actual sum at risk on death and is collected by cancelling units.

SYSTEMS AND ADMINISTRATION

Converting from with-profits to unit-linked would have implications for systems and administration, as in many respects unit-linked business requires more active daily management than other types of life insurance. Infrastructure would need to be in place to deal with regular unit allocations, switches and cancellations. The system would also need to enable policyholders to access the current value of their policies upon request, which would move on a daily basis.

If an insurer already writes other unit-linked business, then the converting business could potentially be migrated onto the same system. However, if new infrastructure needs to be developed and embedded to manage the unit-linked business, it would add considerable complexity and cost to the conversion.

LAPSE IMPACT

The benefit associated with a conventional with-profits policy is linked to a date in the future (i.e., a maturity date or a date of death), which would be recalculated if a policy were to surrender prior to this date. On the other hand, the benefit associated with unit-linked policies can be seen as a more readily observable "current value." This increased transparency associated with unit-linked policies may therefore increase surrender or transfer rates, as policyholders may view their benefits as being more "immediately available" and therefore opt to terminate their policies early.

This effect would also be present at the point of conversion, with policyholders being able to observe the current value of a policy following the conversion, compared to the future maturity value of the policy prior to the conversion. Insurers would therefore need to carefully tailor communications to policyholders to explain this effect and address any perceived drop in policy value, and to consider the surrender charges that will be applied post-conversion.

SUMMARY

Much as with non-profit conversion, unit-linked conversion would facilitate a distribution of the estate to policyholders. However, the capital requirements for policies converted to unit-linked are likely to be lower, in which case there would be a smaller deduction from the estate to meet the premium payable for the shareholders or another group of policyholders meeting the capital requirements associated with the converted business.

Conversion to unit-linked gives policyholders greater ability to tailor their investments to suit their particular requirements and risk appetite. Some policyholders will require guidance and/or advice on how to make their investment choices. This flexibility will not be welcomed by all policyholders, and so reasonable default investment mixes will need to be determined for those policies for which the policyholder does not make an investment choice.

However, from a policyholder perspective conversion to unit-linked would result in direct exposure to investment risk, as policyholders would no longer benefit from the protection against market volatility provided by the guaranteed benefit, reversionary bonuses and smoothing. There would also be operational and persistency implications that insurers would need to consider carefully.

Overall, conversion to unit-linked offers increased expected returns for policyholders over the alternative of converting to non-profit. However, it may introduce greater complexity from an insurer's perspective as well as from a policyholder's perspective, if they are required to make decisions on the investment strategy for their policies.

Case study: Equitable Life's conversion of with-profits policies to unit-linked

BACKGROUND

In January 2020, Equitable Life Assurance Society (ELAS) completed the conversion of the majority of its with-profits policies to unit-linked, alongside a simultaneous demutualisation and transfer of almost all ELAS policies to Utmost Life and Pensions (Utmost).

Prior to this, ELAS was a mutual company that had been closed to new business since 2000. ELAS's with-profits business had accumulated a sizeable estate, but the existence of significant investment guarantees limited the extent to which the estate could be distributed.

Having considered a number of options, the proposed solution was to convert ELAS's with-profits policies to unit-linked, removing the investment guarantees and (together with the demutualisation and the transfer to Utmost) so enabling an immediate distribution of the estate.

The conversion from with-profits to unit-linked was implemented as follows:

- A primary fixed uplift of 72% was applied to all asset shares in order to distribute the estate.
- A secondary uplift was applied to the asset shares of certain policies in order to provide compensation for those giving up the more onerous guarantees. The size of the secondary uplift varied by policy.

Policyholders were able to choose to invest the uplifted policy value in a range of 13 unit-linked funds, with a default managed fund for life policyholders and a default "lifestyling" investment strategy for pension policyholders.

ELAS set six fairness criteria that the conversion must satisfy, which aimed to achieve fairness for policyholders when comparing policy values prior to conversion to those after the conversion. Some small upwards adjustments were required to the uplifts applied to policies in order to meet these criteria.

BENEFITS

The conversion to unit-linked allowed ELAS to address the need to hold back assets to support guarantees, enabling it to distribute assets more quickly to policyholders rather than developing any tontine.

For converting policies, if taken at the implementation date, the benefit received on their policies would be higher than they would have received if the conversion had not been implemented, due to the restricted level of estate distribution prior to conversion.

Conversion to unit-linked also allowed policyholders to choose an investment fund appropriate to their needs, with the potential to earn additional returns by opting to invest in higher risk assets than those held by the with-profits fund.

CHALLENGES

Extent better off

One of the fairness criteria required that, at specific future dates, the best estimate of the converted policy value invested in a medium-risk fund should be no lower than the best estimate of the with-profits benefit that would have been payable in the absence of the conversion.

Prior to conversion, policy values were being uplifted by a claims enhancement factor (CEF) of 35%. Broadly speaking, given the minimum uplift under the conversion was 72%, it may be expected that this fairness criterion would always be met. However, due to the assumed continuation of the current (cautious) approach used in setting the CEF, it was projected to increase significantly as the with-profits business ran off.

However, further analysis was performed to assess the "extent better off" for policyholders investing in lower-risk funds and at earlier retirement dates. For some groups of policyholders, for example those at younger ages, retiring at a later age and investing in a low-risk fund, the "extent better off" was negative. That is, the projected average benefits are higher when remaining as a with-profits policy than after conversion to unit-linked. It was concluded that the uplift should not be expected to compensate for investing in very low-return assets for long durations. Communications were carefully worded to ensure policyholders understood that meeting the fairness criteria did not guarantee that an individual policy would be better off in all scenarios following the conversion.

Calculation of the uplift

The first step in calculating the uplift was to determine the assets available for distribution. This was taken to be the Solvency II Own Funds plus the reserves held for the investment guarantees and a portion of the expected reduction in expenses. The value of assets to be distributed as a proportion of policy values was then calculated to arrive at an average uplift.

Determining the primary and secondary uplifts from the average uplift was an iterative process, with the two uplifts being adjusted and the residual value of guarantees being recalculated until the total distributed assets were equal to the sum of the policy values and the residual value of guarantees. In addition, adjustments were applied as necessary to ensure the fairness criteria were met.

Given that the calculation was a time-consuming process involving the use of stochastic modelling (to assess the value of guarantees), it was impractical to perform the final uplift calculation at the implementation date. Therefore, the amount of the secondary uplift was calculated and fixed around three months prior to the implementation date and the primary uplift percentage was calculated on the implementation date to distribute the balance of the estate after deducting the total of the fixed secondary uplifts.

Policyholder understanding

Converting from with-profits to unit-linked is a complex arrangement which necessitates that policyholders understand, make investment decisions and possibly vote on what is being implemented. In this case, the simultaneous demutualisation of ELAS and the transfer to Utmost, which was necessary in order to effect the conversion and full estate distribution, added to the complexity.

As a result, clear communications and a comprehensive guidance and advice offering were vital to ensure policyholders could make informed voting and investment decisions, with ELAS subsidising the costs associated with obtaining advice.

Despite the complexity of the conversion and the subsidy provided, there was a very low take-up of advice and a low voting turnout by number. Whilst this is not unusual and does not in itself indicate insufficient measures were put in place by

ELAS, it does raise the question of whether policyholders fully engaged with and understood the conversion. Having said that, because policyholders' funds would have been invested in the default unit fund if they did not engage with the conversion, the expected maturity value of their policies would be broadly the same as the maturity value had the conversion not taken place.

Options for remaining as with-profits

Conversion to non-profit or unit-linked are likely to be the primary options for many insurers. However, there are other approaches available that can address some of the issues that arise during fund run-off whilst maintaining the business as with-profits.

The options that we will discuss in the following subsections are:

- Merging with another with-profits fund
- Sale of with-profits business

MERGING FUNDS

The merging of two or more with-profits funds is an option available to insurers with multiple funds, and so won't be available as a course of action for all insurers.

Merging with-profits funds would:

- Maintain the product type that was originally chosen by policyholders
- Increase diversification within the newly merged fund, which may result in lower combined capital requirements
- Simplify the operation of the with-profits business, as the funds no longer need to be accounted for separately
- Increase the size of the fund to help to address expense diseconomies

This option would be particularly effective if the fund that is taking on the with-profits business is writing sufficient new business to offset expense allocations from exiting business in the run-off, alleviating the issue of expense diseconomies. The extent to which these diseconomies can be mitigated will also depend on the harmonisation of administration systems, as systems used for the merging business may need to continue to be maintained to support other remaining business using the same system.

In terms of dealing with the estate, one approach would be to distribute the entire estate of the fund that is to be wound up, with a deduction made to compensate the target fund for meeting future capital requirements and cost of options and guarantees of the policies of the wound-up fund. The compensation due in this scenario may be lower than under a non-profit conversion as, depending on the relative investment strategies that would be adopted, it is likely that the capital requirements would be less onerous when remaining as with-profits. In this case the former policies of the wound-up fund would not participate in any distributions from the estate of the acquiring fund.

Another approach could be to equalise the estates of the merging funds by declaring a special bonus for policies in the fund with the greater solvency buffer, in order to broadly align the financial strength of the two funds and to enable with-profits policies of the wound-up fund to participate in any future distributions from the estate of the acquiring fund alongside existing with-profits policies of that fund. This would, however, require the two funds to have similar features. If one fund has significantly more onerous capital requirements, the merger could adversely affect the pace of estate distribution for policyholders in the other fund.

It would be important to ensure that the merging of funds is fair to all policyholders. This may require problematic features to be addressed prior to merging to avoid placing an unacceptable burden on the new combined fund. For example, if the fund being wound up has significant levels of guaranteed annuity rates it may be preferable to first buy out these guarantees, to reduce the level of risk associated with the business and the potential volatility of estate distributions.

The level of approval required to effect the merger would also need to be considered; this may be dictated by a clause within the scheme documentation of a past Part VII transfer. Historically, transfers have typically included a clause that would require actions of this type to be approved by the courts. However, more recently clauses are being written into schemes that require less onerous approval requirements, instead requiring internal board approval as well as a report from an independent actuary and no objection from the regulators.

Overall, merging with-profits funds is not without its complexities. However, it may be viewed as a more attractive option than converting to non-profit or unit-linked, especially for smaller funds that could be merged with larger funds, as it avoids the need for a conversion to be implemented, maintains the original product features and may, depending on the manner in which the funds are merged, may enable continued estate participation for policyholders and maintains the original product features.

SALE OF WITH-PROFITS BUSINESS

Finally, selling the with-profits business may be deemed the best course of action, for example if the business still has many years left to run but is out of line with the longer-term company strategy. A recent large-scale example of this was the sale of Legal and General Assurance Society Limited's significant book of with-profits business to ReAssure Limited.

There has been a lot of consolidation activity in the market over recent years, and so there is clearly an active market which could make this a viable solution. However, certain features such as the presence of significant guarantees would impact the price that could be achieved. In addition, hybrid policies with investments in both with-profits and unit-linked funds may make it difficult to sell the with-profits business on its own.

Further considerations

There are a number of additional aspects insurers will need to consider, which may influence the best course of action to take during their with-profits business run-offs.

SUNSET CLAUSES

As noted earlier in the paper, in many cases there are sunset clauses in place for with-profits funds to guide the approach to take when the fund reaches a specified size. As highlighted by the FCA in its thematic review into the fair treatment of with-profits customers, insurers should review whether the operation of a sunset clause would be fair to policyholders. Insurers should consider the ongoing viability of the with-profits fund on an appropriately regular basis rather than waiting until close to the trigger point of the existing sunset clause. Such considerations of viability should include avoiding excessively high per policy expenses due to the fixed cost trap. Furthermore, insurers should consider any action taken (or plans for actions that will be taken) from a TCF perspective and should not rely solely on the existence of a sunset clause as sufficient rationale for implementing changes.

The FCA's findings did not contain any guidance on what could be done if the exercise of a sunset clause, as required by the court, is not in the policyholders' best interests. For example, as discussed earlier in this paper, there are scenarios where a conversion may result in a poor outcome for policyholders. However, many sunset clauses cannot be amended without approval from the court. The relative benefits to policyholders of effecting a change to the sunset clause, or of undertaking a scheme of arrangement (SoA) as covered in the subsection below, would therefore need to be weighed against the cost of doing so.

For insurers undertaking new Part VII transfers involving with-profits business, it would be prudent for insurers to consider building more flexibility into the sunset clause; for example, removing any "must" trigger points.

IMPLEMENTATION PROCESS

The process to be undertaken for different actions will depend on a number of factors and will require legal clarification. If, for example, policy terms and conditions allow certain features of the policy to be varied without policyholder consent, then these features could be amended via a unilateral variation. However, if the action being taken involves asking policyholders to compromise a certain aspect of the policy, such as giving up a portion of the estate or making a material change to the policy type, then it is likely that a SoA will be required.

A SoA is a legal process under Part 26 of the Companies Act 2006. The process is similar to a Part VII transfer; however, a key distinction is that policyholders are able to vote on a SoA. For each voting class, over 50% of policyholders in number and over 75% in value must vote in favour of a SoA in order for the court to sanction it. The SoA process is complex, requiring:

- Input from many internal and external stakeholders
- Court approval
- Significant time and cost investments

However, in practice, even if a formal SoA is not required, any process that will impact policyholder outcomes, even if the impact is deemed to be small, will require some level of engagement with external parties (such as an independent actuary) to demonstrate that the action taken is fair and appropriate to policyholders.

Another point to consider is the ability of policyholders to opt out of having a proposed action applied to the policy. For example, if being asked to compromise a guarantee attached to the policy, policyholders would typically have the right to opt out, so that even if the action is approved it will not apply to their policy. However, certain actions would only be effective if they are applied to the entire block of business in question. For example, if policyholders were permitted to opt out of a conversion to non-profit, this would be likely to result in some policyholders remaining as with-profits, failing to fully address the issue at hand. However, if policyholders are not given the opportunity to opt out then this would be likely to lead to increased regulatory scrutiny, and would increase the risk of failing to achieve the required voting thresholds under a SoA.

Finally, if the action taken involves making changes to the estate that constitute a reattribution under the FCA's COBS rules, more onerous requirements would need to be met during the implementation, such as the appointment of a policyholder advocate. This should be determined at an early stage and requires legal and regulatory input.

Overall, it is important to establish at an early stage the process that will need to be followed to implement any action, seeking appropriate legal advice and ensuring all aspects of the process are understood.

TIMING

The timing of implementing changes to with-profits funds in run-off is a crucial consideration, given that the pool of policyholders will be reducing over time. An earlier conversion allows the costs of implementation to be spread over a larger pool of policyholders and reduces tontine effects. However, early conversion may be more costly, in particular if it means a SoA is required.

The process of considering the options available, determining the most suitable option, design, approval and implementation can be a very time-consuming process and so insurers should start considering their options for the cessation of with-profits funds well in advance of when action becomes essential.

CUSTOMER BASE

Finally, when deciding the approach to winding up with-profits business, insurers should not overlook the characteristics of the customer base and its preferences.

Whilst it could be argued that, because policyholders opted for a with-profits product, it is the most suitable option for them, research into customer appetites may highlight that non-profit or unit-linked product types are actually a better fit, in particular for groups of policyholders where the understanding of the policy may be low, or where policyholders would value the certainty of benefits associated with a non-profit policy. Policyholders may also place value on crystallising returns earned to date to ensure the policy can meet its intended need, such as to cover funeral costs.

In contrast, policyholders may place a high value on the upside potential offered by their with-profits policy and may have a preference against conversion to another product type.

In either case, insurers should not assume they know the preferences of a customer base, as doing so could hinder the outcome of any action taken, for example by failing to achieve the required voting outcome in a SoA, or triggering increases in lapse rates.

Preparing for the end game

Before embarking on any of the potential actions discussed in this paper, insurers should first address any other underlying issues in the with-profits fund that could hinder the effectiveness of any action taken, or the efficiency of its implementation. Even in the absence of taking the actions described in this paper, addressing underlying issues in a with-profits fund should form part of the orderly management of the fund.

Some of the issues that insurers should consider are discussed below.

GONE-AWAY POLICYHOLDERS

A common issue for with-profits funds is the existence of policyholders with whom the insurer has lost touch (commonly referred to as "gone-away" policyholders). This is an issue that tends to build up over time, for example through blocks of business changing hands in historical Part VII transfers, reduction or loss of regular contact points with customers or customers moving address without informing the insurance company. The management of gone-away policyholders is a key area of interest for the FCA.

There are a number of with-profits funds that now hold best estimate reserves for gone-away policyholders, which are lower than the full reserves, on the basis that not all gone-away policyholders will be traced despite ongoing best endeavours to reestablish contact.

Before taking any of the actions described in this paper, insurers should take measures to address gone-away issues in the fund. This may involve:

- Ensuring the population of gone-away policyholders has been fully identified.
- Taking steps to reestablish contact with these policyholders, for example by engaging with an external tracing company.
- Considering an appropriate reserve to hold in respect of potential future claims from gone-away policyholders with whom contact is reestablished. For example, holding a best estimate reserve for these future claims, rather than a full reserve for each gone-away policy, may facilitate an increased level of estate distribution.

Insurers will also need to consider how gone-away policyholders will be treated following the implementation of any proposed action, and any retrospective rights that these policyholders may have upon reengagement. If a material change is applied to gone-away policies, such as a conversion to non-profit, then insurers would need to be able to demonstrate that reasonable attempts were made to contact the policyholder before implementing the change.

It has recently been announced that the Dormant Assets Scheme[10] will be expanded to include the unclaimed proceeds of certain insurance and pensions contracts. We note that with-profits funds, industrial branch policies and assets held by mutual insurers and friendly societies are explicitly excluded from the Dormant Assets Scheme. Nonetheless, this expansion of the Dormant Assets Scheme should further encourage insurers to take more active steps in managing the assets associated with gone-away with-profits policies, and to consider a redistribution of a portion of these assets to the estate by holding best estimate rather than full reserves.

EXPENSES

Many closed with-profits funds now have expense agreements in place with other funds which fully or partially remove expense diseconomy risk. Whilst this may be the primary tool for managing expense diseconomies in with-profits funds, there are other options to address growing expense diseconomies in a with-profits fund during run-off.

Direct measures could be taken to reduce expenses incurred by the fund by improving efficiency. For example, aligning processes such as bonus calculations to make management of the fund less time-intensive, outsourcing the administration of policies or model aggregation.[11]

Expense diseconomies could also potentially be addressed indirectly by writing new non-profit business into the fund, expanding the policy base over which expenses are spread. However, this new business may have a longer duration that the with-profits business in run-off and may not be aligned with the insurer's longer-term strategy. In addition, the new business strain arising from the new non-profit business would need to be met by the estate, reducing the estate distributions that might otherwise be made.

REDUCTION IN GUARANTEES

Any guarantees within the fund, such as guaranteed annuity rates or investment guarantees, should be assessed. Such guarantees can significantly increase the level of capital requirements within the fund. Therefore, retaining such guarantees could significantly reduce the portion of the estate that can be distributed to policyholders in the near term. Accordingly, insurers may wish to consider buying out guarantees in order to reduce their impact on the run-off of the fund. However, the extent to which guarantees are bought out would need to be balanced with the expected

[10] The Dormant Assets Scheme is a government-backed scheme aimed at reuniting people with their financial assets, and making contributions to social and environmental initiatives across the UK where this is not possible.

[11] In this context, model aggregation could involve combining the modelling approach used in the ongoing management of different with-profits funds.

future profits forgone on these guarantees, and determining an appropriate level is likely to be based primarily on expert judgement. A recent example of this was Royal London Mutual Insurance Society Limited's compromise of guaranteed annuity rates in the Scottish Life Fund.

DURATION MISMATCH

It is often the case that a with-profits fund contains conventional non-profit and unit-linked business with a longer outstanding duration than the with-profits business in the fund. Because the estate of the fund would effectively be used to meet the capital requirements of the non-profit and unit-linked business, as the with-profits liabilities run off the provision of this capital would become an increasing proportion of the with-profits estate, which could lead to a tontine.

This issue could be addressed by transferring the non-profit and unit-linked business out of the fund, removing the need for the estate to be held back to cover the capital requirements of business with a longer duration.

This would be particularly effective if the non-profit and unit-linked business represent a significant proportion of the with-profits fund, as this may be locking up significant levels of capital that could otherwise be distributed to with-profits policyholders.

If, however, the non-profit and unit-linked business does not represent a significant proportion of the with-profits fund, judgement would be required as to whether to retain or sell the business. If the decision were taken to retain the longer-duration non-profit and unit-linked business, it would need to be transferred at the point of winding up the with-profits fund.

Transferring this business out of the fund could result in with-profits policyholders losing out on any future profits arising on non-profit business, depending on whether the with-profits fund gets a fair price for the transferred business.

Finally, insurers should ensure that the issue of duration mismatch in closed with-profits funds is not being exacerbated by allowing new non-profit business that would have previously stayed within the fund to be written into the fund, for example newly vesting annuity business.

PENSION SCHEMES

In some cases a with-profits fund is responsible for meeting the liabilities of a defined benefit (DB) pension scheme. In this situation, the with-profits fund is exposed to any volatility in the size of the pension scheme deficit, placing constraints on the ability to distribute the estate. Insurers may consider taking measures to cap this exposure in order to reduce the burden on the fund, for example by putting in place an agreement for another party to meet liabilities in excess of a certain level. Alternatively, the liability may be passed to another party entirely in exchange for a premium, in order to aid a more straightforward conversion in the future.

ALLOWANCE FOR MANAGEMENT ACTIONS

Throughout the paper, it has been noted that the need to hold back capital will affect the distribution of the estate. The extent to which it can hinder the distribution of the estate depends on the approach taken to allowing for management actions in the calculation of the capital requirements:

- Some firms or funds include little in the way of additional assumed management actions in the capital requirements, and so these requirements are higher and present a more material issue on the fairness of the distribution of the estate.
- Other firms or funds include much more by way of additional assumed management actions in the capital requirements, and as such are lower. For example, in the extreme it could be assumed that all terminal bonuses are removed and the benefits are the guaranteed benefits only.

As the run-off of the with-profits fund progresses, considerations could be given to the approach taken to assumed management actions, as they may change the run-off and end-game considerations for the with-profits fund.

Conclusions

Clearly there is a range of actions that insurers can take as with-profits funds run off and reach a stage where they are no longer viable in their current form, and we expect to see increasing levels of activity in this area over the coming years.

However, the key options that have been discussed in this paper are complex to implement, require balancing the interests of policyholders and shareholders or members (or different groups of policyholders) and entail the involvement of many different stakeholders, both across the business and externally.

It is crucial that insurers do not underestimate the time required to address run-off issues, nor allow run-off issues to accumulate without careful monitoring. To assist, insurers should build a review cycle into their run-off plans. For example, the fund should be regularly assessed for actual versus expected run-off and monitored against key metrics such as average per policy expenses. This would provide insurers with an early warning when issues are expected to arise. The review cycle could also involve a less frequent but more comprehensive assessment of longer-term options for the fund, enabling early planning and sufficient time for implementation in advance of the fund reaching a level where it is no longer viable.

In addition, in light of the FCA's recent feedback, insurers should consider any sunset clauses in place for their with-profits funds and assess whether the implementation of any actions prescribed within the sunset clause would not be in the best interest of policyholders. This will enable identifying and dealing in advance with any potential conflicts between treating customers fairly and following a court-approved sunset clause, reducing the risk of problems arising at a later date.

Finally, our view is that the issue of gone-away policyholders should be a key area of focus for insurers in the near term. The management of gone-away policyholders is a key area of interest for the FCA, and the upcoming expansion of the Dormant Assets Scheme brings to light the need for insurers to give careful consideration to the treatment of unclaimed policyholder assets.

How Milliman can help

Milliman consultants have extensive knowledge of the policyholder issues and fairness considerations that arise in respect of with-profits business.

We have fulfilled With-Profits Actuary roles and With-Profits Committee advisory roles for a wide variety of insurers and acted as the Independent Expert/Actuary for many of the large transactions and transfers of with-profits business over the last few years. This includes acting as advisers, Independent Experts and With-Profits Actuaries to several funds which have carried out conversions to non-profit and unit-linked, both under existing scheme powers and under SoAs.

We are able to support our clients with in-depth experience and tailored insight in relation to with-profits business, including both the application of discretion (for example, the choice of smoothing methodology) and the general management of with-profits business.

In addition, through these roles and through our work with the FCA, we have a strong understanding of the regulators' requirements in relation to with-profits business, and are well placed to guide you through any dealings with the UK regulators and to identify and advise on areas that they may query.

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