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Closed life funds: causes, consequences and issues

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Centre for Risk and Insurance Studies, Nottingham University Business School

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¹ Include if forecasts have been provided to us by [name of the Company]'s management.

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Executive Summary

Closed Life Funds: causes, consequences and issues

This research examines the development of closed life insurance firms in the UK from 1995-2004. Our study covers UK-authorized long-term insurers (excluding pure reinsurers) and significant friendly societies.

At the end of 1994 there were 49 closed firms. There were 67 cases of firms closing over the period to 2004; however, many of the closing firms subsequently transferred their business to another insurer, and some re-opened. The outcome is that the number of closed firms only increased by five to 54. On the other hand, the number of open firms fell from 197 to 134. The assets in closed firms increased from £6 billion in 1994 to £139 billion in 2004, the latter figure being 13% of the industry total of £1065 billion.

In the first half of our period, 1995-99, there were 27 closures (and only 10 of the firms had with-profits liabilities), whereas in 2000-04 the number of closures was 40 (of which 23 had with-profits liabilities).

At the end of 2004, two of the “closed fund consolidators”, Resolution plc and Pearl Group Ltd, owned 12 and 7 closed firms respectively (i.e. 19 of the 54 in total), with £39bn and £28bn assets respectively.

Comparing open and closed firms, we find that closed firms tend to be smaller, financially weaker, and have a higher proportion of their liabilities that are with-profits. They also tend to have relatively high lapse/surrender rates and higher maintenance expenses as a proportion of premiums.

A number of large with-profits life insurers have closed in recent years. We can compare the 21 open and 17 closed firms that have issued a realistic with-profit balance sheet in accordance the FSA rules at the end of 2004. The closed firms tend to be relatively small, have lower solvency ratios and have a lower risk capital margin as a proportion of their liabilities. This is consistent with the “de-risking” that some closed firms have emphasised.

We examine the characteristics of firms that close, two years before closure. We then compare these characteristics with similar firms that do not close. We find statistically significant differences that closure is more likely if the firm:

- ♦ is proprietary as distinct from mutual (***)
- ♦ has low solvency (***)

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- ♦ has a low proportion of linked business (*)
- ♦ has a low level of new business (***)
- ♦ has a high acquisition cost ratio (**)
- ♦ has a high maintenance expense ratio (**).
- ♦ had an increase in its long-term fund assets in the year ending t-2 (**)

(the more asterisks, the higher level of statistical significance).

We then examine the consequences of closure, by examining 24 firms that closed with similar firms that did not close (“matches”). Our analysis is restricted to firms that were in operation 3 years before and 3 years after closure. We find that:

- ♦ the solvency ratio of closers tends to improve after closure;
- ♦ the gap between closers and matches on equity allocation narrows; in the 2nd and 3rd year after closure, the equity allocation improves whereas for matches it falls;
- ♦ the early termination ratio for closers is markedly higher in the year after closure (it increases by 2 percentage points), and while it then drops, it is still higher than for the matches in the 2nd and 3rd years after closure; and
- ♦ the maintenance expense ratio of closers is markedly higher in the year after closure and although it declines somewhat thereafter, the excess of expenses of closers over matches remains higher than pre-closure, (although this finding may be affected by changes in firms’ expense allocation methods).

The analysis of consequences of closure cannot include firms that closed recently, which includes many of the large with-profits firms acquired by closed fund consolidators. Here there is some evidence of maintenance expenses decreasing, and of alternative approaches to equity investment; but a formal analysis of the impact of closure is not yet available.

The Financial Services Authority has introduced new rules for closed firms, and is reviewing the practices of closed firms. We discuss a number of issues of relevance to with-profits policyholders, including the challenge that closed firms face to demonstrate fairness of their payouts, the operation of management services agreements and the proportion of surplus allocated to shareholders. There are challenges to regulators if they are to ensure that value is not transferred from with-profits policyholders to shareholders.

The emergence of closed fund consolidators is a recent phenomenon. They have a focus on the operation of the existing business, and this may enable them to achieve their planned return to shareholders.

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1 INTRODUCTION

1.1 Objectives

The objectives of this research are to:

- ◆ document the progression of closed funds in the UK life insurance market;
- ◆ compare the characteristics of open and closed funds;
- ◆ assess the factors associated with closures, and make a comparison of firms that have closed and those that have remained open;
- ◆ examine changes in the performance of firms after they have closed, which it is hoped will give some insights into the consequences of closure; and
- ◆ set out the issues of concern in this area, and actions being taken by the regulators.

1.2 Scope

Our study covers UK-authorized insurers operating in the U.K. long-term market over 1995-2004, excluding pure reinsurers. We also include what we refer to as ‘significant friendly societies’. The analysis covers not only with-profits but also unit-linked and other business.

1.3 Previous work

The Financial Services Authority (2004) found that 66 out of 110 with-profits funds were closed to new business at end 2003, with assets of £190 billion (20% of the total market). Their survey included, in addition to long-term insurers, what we refer to as ‘significant friendly societies’. Their calculations covered the funds within firms rather than whether the firm (in its entirety) was closed. Our study concentrates on firms as such that are closed.

2 DEFINITION OF CLOSED FIRM

2.1 Definition used in this study

We have used the following definition:

‘A firm is closed to new business:

- ♦ upon the taking effect of a decision by the governing body to cease to effect new contracts of long-term business, as publicly announced in the report and accounts, FSA Returns, or other document such as connection with a transfer of business;
- ♦ when no new contracts are being effected; or
- ♦ where the new contracts it is effecting are incidental and not material;

and where ‘new contracts’ excludes contracts arising under previous obligations permitting policyholders to effect increments or exercise options, and excludes pipeline business following the issue of quotations for new contracts.’

This definition differs somewhat from that used by FSA, whose study was restricted to firms carrying on with-profits business; our study covers firms writing non-profit and linked business as well.

It may be useful to outline the stages involved in closure. When a firm closes, it may of course continue in closed form for some time. Many closed firms then transfer their business to another insurer, and so cease to have any long-term insurance liabilities: we call this ceasing to be operational. A firm may cease to be operational in other ways: its policies may all go off the books; or, if its business is wholly through inwards reinsurance, the reinsurance contracts may be cancelled. Once a firm is non-operational, its authorisation to carry on long-term insurance business may be cancelled (i.e. de-authorisation). Subsequent to this, the firm may decide to continue in business (but not long-term insurance), or the firm itself may cease to exist (liquidation).

However, note that some closed firms do re-open to new business (see section 5).

2.2 Funds within firms

There are some groups that own more than one life insurance firm (e.g. Aviva plc owns several). Our research is focused on the life insurance firms rather than the groups.

Some firms operate more than one fund (sometimes called sub-funds) within their long-term business fund. Our own survey relates to whether firms rather than funds are closed. This is partly because data on funds is not as readily available as it is at firm level. Indeed, where a firm has more than one fund, the FSA rules do not require separate balance sheets in the FSA Returns for such funds, except that where the firm is a large with-profits firm there will be a form 19 (realistic balance sheet), which refers to the with-

profits business in each separate fund (and somewhat limited information about other business). However, where a firm has more than one fund, policyholders' benefits are usually determined primarily in relation to the finances of the fund of which their policy forms part, which suggests that a proper understanding of the prospects for their policy requires separate balance sheets to be produced.

If further information about funds within firms was published, this may also improve the tradability of such funds. We mention this in section 8.3.

3 FEATURES OF CLOSED FUNDS AND IMPLICATIONS

3.1 Features of closed funds

We set out below the characteristics of closed funds, in comparison with open funds:

- ♦ no new policies or only a small number of policies (usually increments) are written;
- ♦ there is a more limited range of activities, as there are sales or no marketing functions;
- ♦ they will be of smaller size than if they had remained open;
- ♦ they have a limited duration as policies will eventually run off; and
- ♦ there are transitional issues when closure takes place.

3.2 Implications for life insurer finances and risks

There are a number of potential implications of the above. For example:

- ♦ there are no longer the same incentives to achieve a good performance for existing customers that derive from the benefits this can have in attracting new business; and
- ♦ the specialization on the management of existing business may lead to an improvement in performance on that activity;
- ♦ diseconomies of small scale, i.e. higher unit costs than otherwise;
- ♦ surplus assets will need to be distributed; and
- ♦ the substantial risks associated with new business are avoided.

Risk financing may be more difficult as the firm cannot raise capital from new policyholders. However, closed fund consolidators may have the ability to raise capital and carry out improved financial management. Closed fund consolidators may be able to avoid some other potentially adverse consequences of closure, by having a size that enables efficiency gains to be made.

A number of closed firms have “de-risked”, involving not only a more conservative investment strategy, but also reinsuring or transferring annuity portfolios that are regarded as involving undue risk.

4 REGULATION

Financial Services Authority (2004) reviewed a number of issues regarding the regulation of closed with-profits funds. However, they emphasised that the issues should be seen in the context of FSA's regulation of all with-profits funds, a common theme being the requirement for sound governance, with senior management responsibility being critical. FSA has been taking a number of steps to strengthen the governance of with-profits business, including a requirement for firms to prepare PPFM (Principles and Practices of Financial Management) documents describing how their funds operate.

However, FSA (2004) highlighted a number of issues that may raise particular problems in the context of closed funds, including:

- ♦ there may be changes in the management team following closure but, in accordance with FSA rules, the management team should have the relevant skills and experience;
- ♦ the standard of service to customers can be an issue;
- ♦ expenses: FSA keep the management expenses of running a closed fund under close review, particularly as any fixed costs will have an increasingly adverse impact on returns to policyholders;
- ♦ there may be changes in investment strategy, e.g. if a firm is financially weak or as it moves towards maturity: firms have regulatory obligations, including their obligation to treat customers fairly and have due regard to their interests;
- ♦ distribution of surplus as a with-profits fund runs off is an area where FSA expect to have detailed discussions in order to assess how firms are planning to treat different cohorts of with-profits policyholder; associated with this is the distribution of the estate.

FSA has introduced new rules 6.12.94 to 6.12.107, which include the requirement to notify FSA and with-profits policyholders of the closure and of the firm's run-off plans. Other new rules and guidance cover the operation of with-profits business more generally. For example, 6.12.85G refers to changes in firms' investment strategy.

The Financial Services Authority (2005) indicated, "The issues surrounding closed firms continue to be high on our agenda" (para. 5). It went on to indicate that it is carrying out a targeted review of practices within a sample of closed firms. The regulator is also involved in the changes in ownership of funds that can arise from the consolidation process.

5 DATA AND DESCRIPTIVE ANALYSIS

5.1 Data

Our survey covers ‘UK life firms’, where we define a UK life firm as:

‘A UK-authorized long-term insurer (not being a pure reinsurer) or a significant friendly society, which is operational in the UK.’ By ‘significant friendly society’ we mean a society that is required to prepare a full annual valuation return to FSA. By “operational in the UK” we mean having long-term liabilities (gross of reinsurance) in the UK.

Our study is of the UK market and we have therefore interpreted ‘closed’ as meaning closed to UK new business. Where there are two or more closed firms within the same group (e.g. Aviva plc) we count each firm separately as a closed firm.

5.2 Results: number of open and closed firms

Table 1 shows how many UK life firms have been open or closed to new business at 31 December 1994 to 2004. We distinguish two types of open firm. First are those that are open to direct business from policyholders; second are those that, although authorised to do direct business were, in practice only open to business through inwards reinsurance (typically from a sister company in the group). In total, the number of open firms fell from 197 to 134, while the number of closed firms increased from 49 to 54.

Although the number of closed firms increased only by five, there have been 67 cases of firms closing. This is illustrated in Table 2, which shows that there have also been 44 cases of closed firms ceasing to be operational (usually a result of transferring their business to another firm, as mentioned in section 2.1) and 18 cases of closed firms re-opening. Table 2 also demonstrates that 27 of the closures took place in 1995-99 but 40 in 2000-04.

Table 1 *Open and closed UK life firms*

	Open				Total operational
	To direct business	To inwards reinsurance		Closed	
		only	Total		
1994	189	8	197	49	246
1995	179	9	188	53	241
1996	181	10	191	51	242
1997	181	12	193	46	239
1998	176	13	189	38	227
1999	168	10	178	43	220
2000	161	9	170	43	213
2001	146	9	155	45	200
2002	140	8	148	50	198
2003	128	9	137	56	193
2004	125	9	134	54	188

Table 2 *Progression of number of closed UK life firms*

	Closed firms that			Closed at year- end
	New closures	became non- operational	Closed firms that re-opened	
1994				49
1995	11	6	1	53
1996	2	2	2	51
1997	3	5	3	46
1998	3	10	1	38
1999	8	3	0	43
2000	9	8	1	43
2001	10	4	4	45
2002	6	0	1	50
2003	11	2	3	56
2004	4	4	2	54
1995 to 2004	67	44	18	

Given the particular interest in closed with-profits firms, we show in Table 3 whether the firms that closed each year had with-profits liabilities. In 1995-99 only 10 of the 27 closures had with-profits liabilities, whereas in 2000-04 23 of the 40 closures had with-profits liabilities.

Table 3 Closures by class of business

	With-profits liabilities?*		Total
	Yes	No	
1994 year-end	21	28	49
1995	2	9	11
1996	1	1	2
1997	1	2	3
1998	2	1	3
1999	4	4	8
2000	5	4	9
2001	4	6	10
2002	4	2	6
2003	7	4	11
2004	3	1	4
1995-2004	33	34	67
2004 year-end	30	24	54

* treating firms that have reinsured their with-profits liabilities as "No"

At the end of 1994 the assets in closed firms amounted to £6 billion (see Table 4), being 1.5% of the industry total of £420 billion. However, by the end of 2004, the assets in closed firms had grown to £139 billion, being 13% of the industry total of £1065 billion.

Table 4 Assets in closed firms 1994-2004 (£ billion)

1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
6	13	14	26	24	37	111	103	108	139	139

Note that there are 44 firms that have with-profits liabilities, not wholly reinsured, but are not writing new with-profits business (14 of these are open to other business). If such firms are not planning on writing further with-profits business they will need to have or to consider a plan for the distribution of surplus assets.

Six of the 54 firms closed at 31 December 2004 have, in 2005, transferred their business to other firms. That leaves 48 closed firms of which we are aware at present. Of these 48 closed firms, 3 are friendly societies and 4 are other mutuals. Hence 41 of the closed firms are proprietary firms. Resolution plc and Pearl Group Limited are prominent as

closed fund consolidators. They own 12 and 7 closed firms respectively, though this will change as some of the firms they have acquired are merged. More relevant is the assets they control, being £39 billion and £28 billion respectively, or 28% and 20% of the assets in closed firms. Resolution's assets are also about 3.6% of the total market.

5.3 Characteristics of open and closed firms

We now compare the characteristics of open and closed firms, using a number of indicators. Table 5 shows these indicators at the end of 2004, these being weighted averages of open and closed firms. We also show a number of charts, indicating how these differences have changed over time.

Table 5 Indicators of open and closed firms at end-2004

Indicator	Open	Closed
Solvency ratio (%)	6.51%	5.36%
With-profits proportion (%)	34.49%	41.53%
Acquisition cost ratio (%)	51.71%	38.51%
Maintenance expense ratio (%)	8.20%	18.49%
Early termination ratio on annual premium business (%)	6.23%	8.70%
Non-linked equity proportion (%)	35.23%	16.01%

The items in Table 5 are defined as:

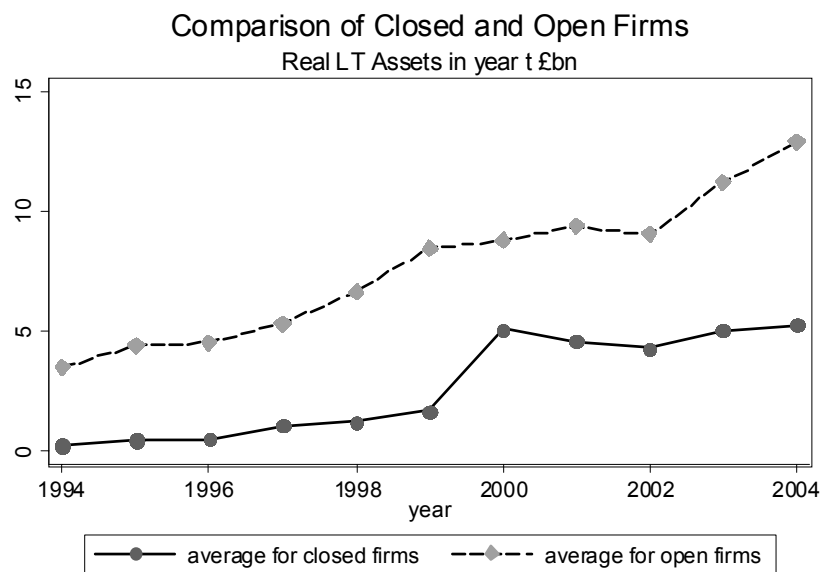
- ♦ solvency ratio: excess of assets over mathematical reserves and other liabilities;
- ♦ with-profits proportion: with-profits liabilities as a proportion of all long-term liabilities;
- ♦ acquisition cost ratio: acquisition costs (including commission) as a proportion of new business annual premium equivalent (which is new annual premiums + 10% of single premiums);
- ♦ maintenance expense ratio: maintenance expenses (excluding commission) as a proportion of existing business annual premium equivalent (which is regular premiums + 10% of single premiums);
- ♦ early termination ratio on annual premium business; annual premium in respect of lapses and surrenders as a proportion of annual premium in-force; and
- ♦ non-linked equity proportion: equities as a proportion of non-linked assets.

We comment below on the main differences between open and closed firms. Closed firms tend, in relative terms, to:

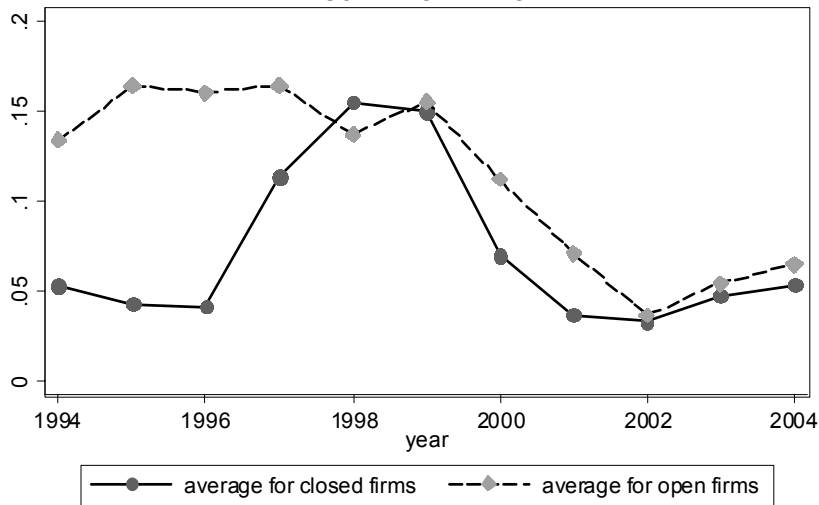
- ♦ be small (although the average closed firm is now much larger than it was) – the chart shows the average size using long-term fund assets in real (i.e. inflation-adjusted) terms;
- ♦ be financially weak (having a lower solvency ratio than open firms);

- ♦ have a higher proportion of their liabilities as with-profits, although this is a change from the late 1990s, when closed firms had a lower with-profits proportion than open firms;
- ♦ have a higher maintenance expense ratio;
- ♦ have a higher termination ratio;
- ♦ have a lower equity allocation, i.e. what part of their non-linked assets are allocated to equities (although in 1997-1999 the closed firms had a higher equity allocation than the open firms) – note that this analysis is not ideal as it would have been preferable to examine only the assets backing with-profits liabilities, but this is not readily available from firms' regulatory returns.

The analysis of solvency ratios is affected by the way in which with-profits firms do not include non-guaranteed benefits as a liability and may therefore have a relatively high solvency ratio; we are conscious that the closed firms have, over 1995-2004, included an increasing number of with-profits firms. However, section 5.4 demonstrates the relative solvency of open and closed with-profits firms that report realistic balance sheets, where the picture is presented more clearly.



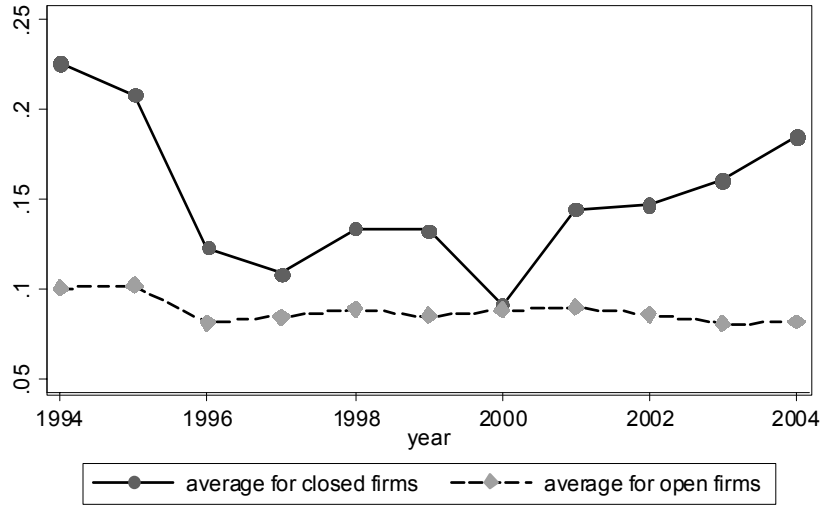
Comparison of Closed and Open Firms
SOLVENCY RATIO



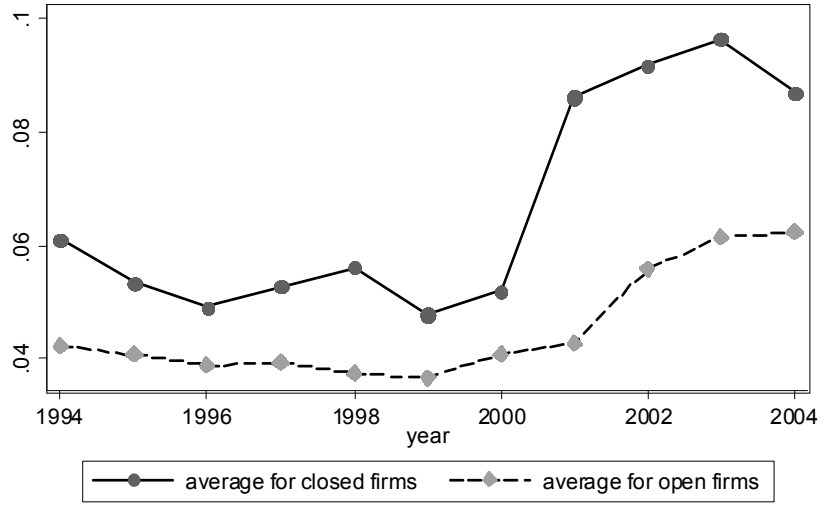
Comparison of Closed and Open Firms
WITH PROFIT PROPORTION

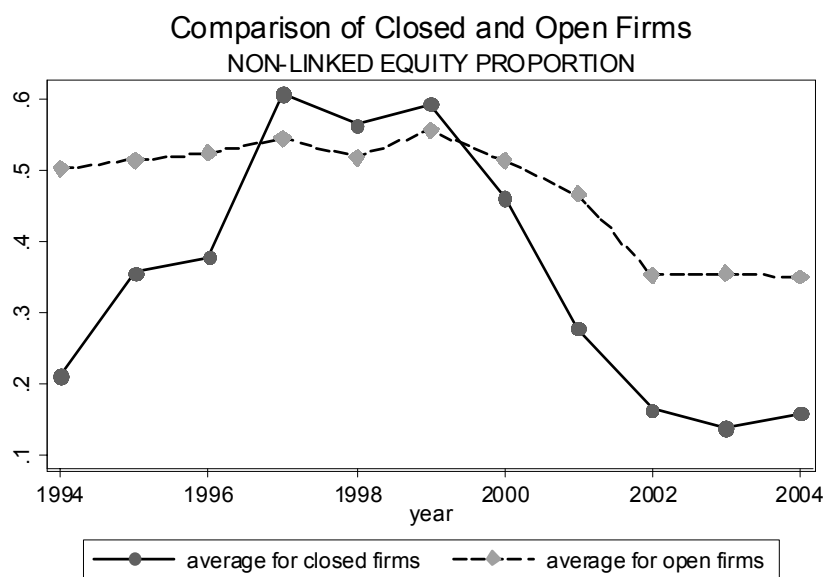


Comparison of Closed and Open Firms
MAINTENANCE EXPENSE RATIO



Comparison of Closed and Open Firms
AP TERMINATION RATIO





5.4 Comparison of open and closed firms having realistic with-profits business balance sheets

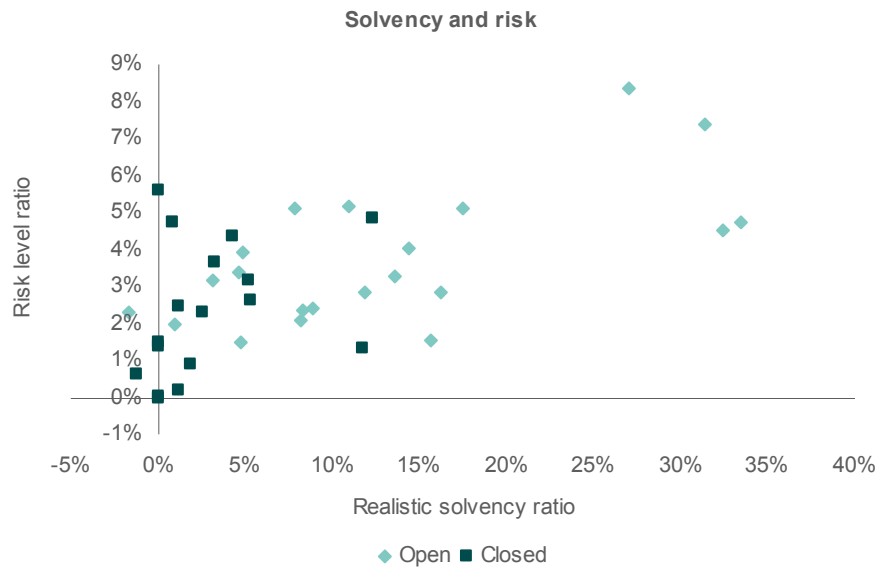
We have also used the data on realistic balance sheets as provided in the FSA Returns of 38 large with-profits life insurers as at 31 December 2004. This includes 34 long-term insurers and 4 friendly societies. Of those firms 21 are open and 17 are closed to new with-profits business.

Closed firms tend, in relative terms, to:

- ♦ be small, having with-profits assets of £4.7 billion on average, compared to £14.9 billion for the open firms;
- ♦ Be financially weaker, their realistic value of assets being 2.81% in excess of their realistic liabilities, compared to 8.39% for open firms.

Chart 1 shows the solvency of open and closed firms, and also their risk levels. Many closed firms have a relatively low risk capital margin, reflecting their having “de-risked”.

Chart 1 Solvency and risk in large with-profits firms



For the purpose of the above chart, we have used the following definitions, which we appreciate are not ideal, but they are adequate to show the trend):

- ◆ realistic solvency ratio is the excess of the realistic value of assets over the realistic value of liabilities, divided by the latter; and
- ◆ the risk level ratio is the risk capital margin divided by the realistic value of liabilities (in relevant cases, the effect of the stress tests on contracts outside the fund is included).

6 CAUSES OF CLOSURE

6.1 Analysis: methodology

We wish to find the differences between firms that close ('closers') and firms that do not ('non-closers'). This should help throw light on why firms close.

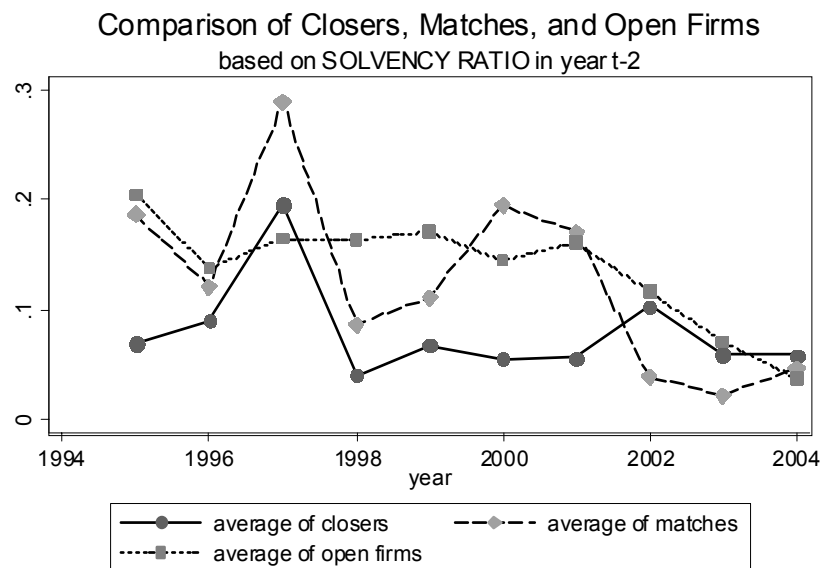
There were 67 closures over 1995-2004. In our analysis we exclude seven cases, which may otherwise distort the analysis, e.g. where business was obtained by internal reinsurance. We therefore have 60 closures to analyse. We focus our attention on indicators of business strategy or performance 2 years before the year of closure i.e. if t is the year of closure, what were the indicators in $t-2$?

We do two sets of comparisons. In one set we compare the closers with all firms that were open in year $t-2$ and which did not close.

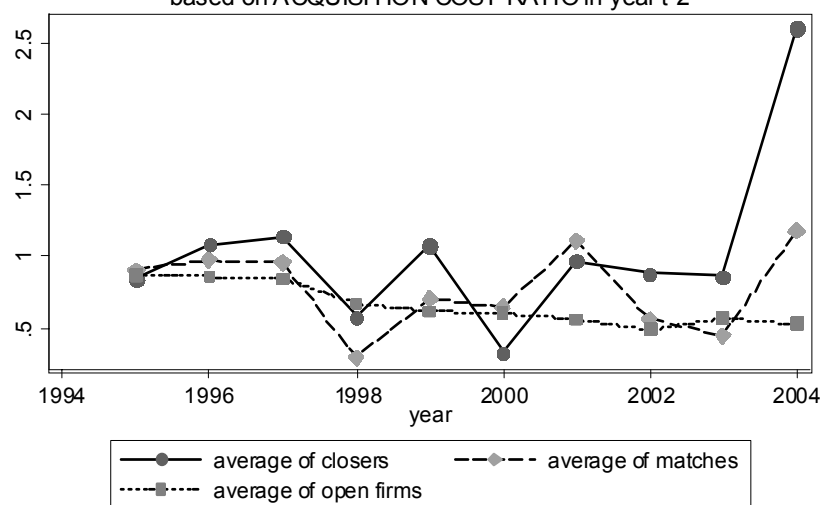
In the second set we compare the closers with firms that were similar in size. For each closer we find three firms that we regard as "matches". In some cases the full data is not available, and our sample therefore covers 57 closers and 169 matches.

6.2 Analysis: results

We show the following charts, which illustrate that closers tend, 2 years before closure, to have lower solvency and higher acquisition costs than other firms.



Comparison of Closers, Matches, and Open Firms
based on ACQUISITION COST RATIO in year t-2



We carry out a full statistical comparison of closers with open firms, using the information available at t-2, we find that closing in year t is more likely if the firm, compared to all open firms:

- ♦ is proprietary as distinct from mutual (**)
- ♦ has low solvency (**)
- ♦ has a low proportion of linked business (*)
- ♦ has a low level of new business, indicated by a low ratio of new business annual premium equivalent to existing business annual premium equivalent (***).

Where *, ** and *** indicate statistically significant at 10%, 5% and 1% respectively, 1% being the strongest.

When we move to the comparison of closers and matches, we find similar results, but with the addition of high expense ratios being likely to lead to closure. In addition to the factors previously identified, we now find that a firm is more likely if the firm:

- ♦ has a high acquisition cost ratio (**)
- ♦ has a high maintenance expense ratio (**) and
- ♦ had a high increase in its long-term fund assets in the year ending t-2 (**).

There is one further factor to mention. Although external economic variables overall do not appear to have a sizable effect, we find that if a firm writes with-profits business and the rate of interest is low at year t-3, then this does produce a greater likelihood of closure in year t.

7 CONSEQUENCES OF CLOSURE

7.1 Methodology

To examine the consequences of closure, we examine the change in specified performance indicators for firms before and after closure. However, we also examine how those indicators have changed for the closing firms in comparison with how they changed in the case of the matched non-closing firms.

However, this limits our analysis to closures taking place in 2001 or previously. We also have to omit firms which did not stay operational and closed for the 3 years after the closure date. We therefore have 24 firms to analyse and 72 matches (i.e. 3 matches for each firm).

7.2 Results

The charts below show the average, separately for the closers and matches, for these variables in each of the 3 years before closure, the year of closure itself, and the 3 years after closure (i.e. from t-3 to t+3, where t is the year of closure). The averages are unweighted. We report the averages here:

Table 6 Performance indicators pre- and post-closure (all figs in %)

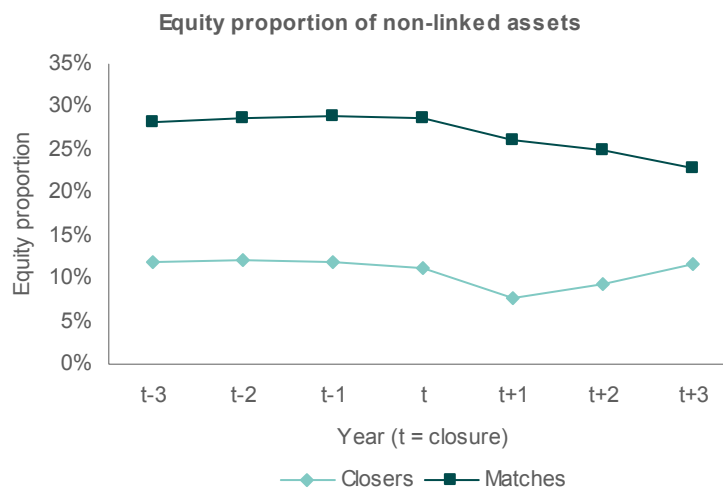
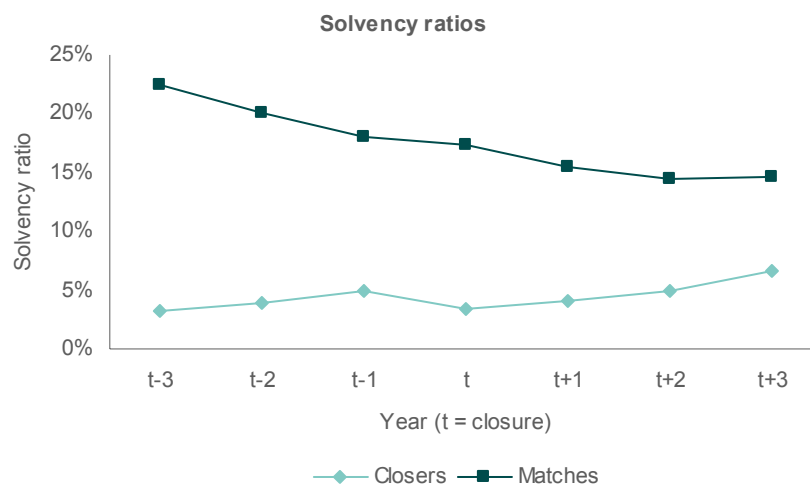
	Year	t-3	t-2	t-1	t	t+1	t+2	t+3
Solvency ratio	Closers	3.20	3.88	4.97	3.47	4.14	5.01	6.59
	Matches	22.44	20.11	17.95	17.43	15.44	14.48	14.55
Equities proportion of non-linked assets	Closers	1.86	12.16	11.80	11.24	7.63	9.30	11.64
	Matches	28.18	28.59	28.95	28.62	26.12	24.94	22.92
Early termination ratio	Closers	5.90	5.47	5.12	4.81	7.35	6.32	6.42
	Matches	5.33	5.06	4.75	4.62	4.74	5.42	5.13
Maintenance expense ratio	Closers	15.21	17.52	17.05	20.97	52.59	42.75	39.83
	Matches	17.96	31.53	18.63	18.40	15.82	15.02	16.73

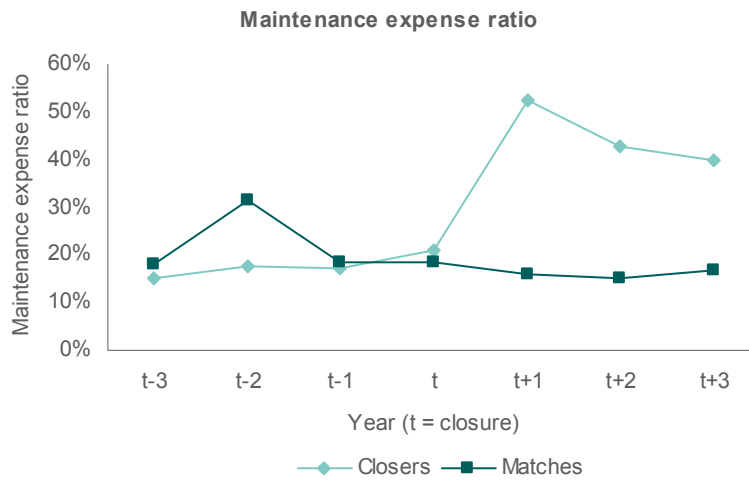
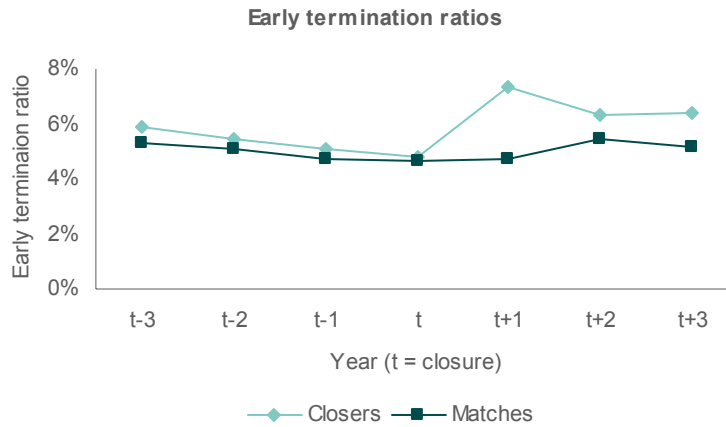
The key results are:

- ♦ the solvency ratio of closers tends to improve after closure;
- ♦ the gap between closers and matches on equity allocation narrows; in the 2nd and 3rd year after closure, the equity allocation improves whereas for matches it falls;
- ♦ the early termination ratio for closers is markedly higher in the year after closure (it increases by 2 percentage points), and while it then drops, it is still higher than for the matches in the 2nd and 3rd years after closure; and
- ♦ the maintenance expense ratio of closers is markedly higher in the year after closure and although it declines somewhat thereafter, the excess of expenses of closers over matches remains higher than pre-closure.

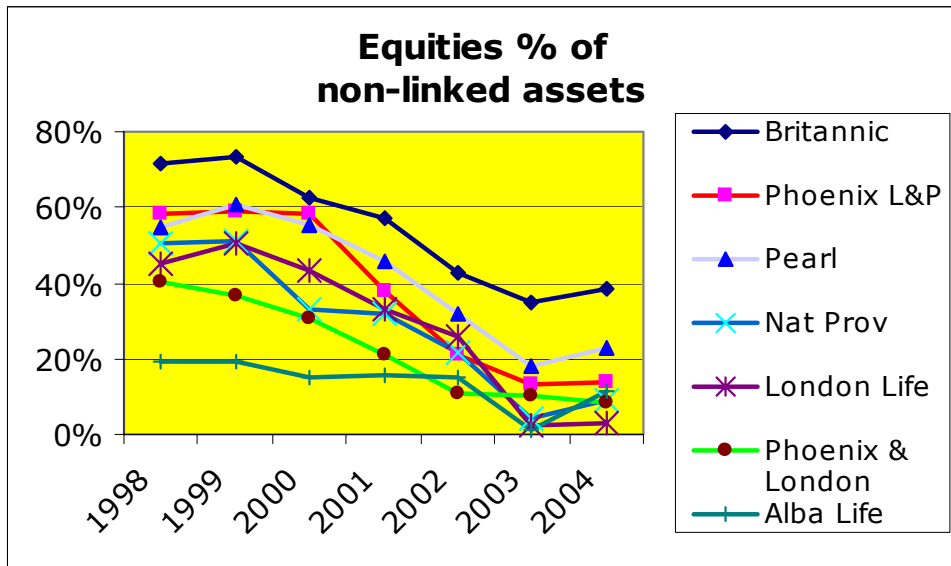
It is possible that the increase in closers' maintenance expenses apparent above over-states the true impact of closure. This is because some expenses may have been classified as "acquisition" prior to closure, and hence the maintenance expenses as reported only reflect true maintenance costs after closure.

We also show this information in graphical form, as follows.

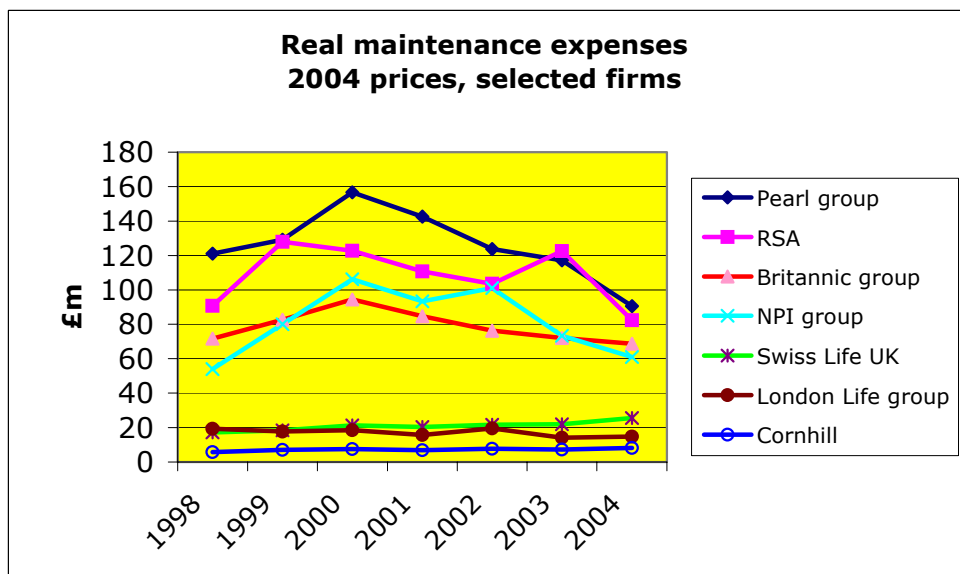




The above analysis is unable to cover recent closures. We can illustrate the equity allocation of some recent closers: the allocations have been reducing over the years but there was a slight upturn in 2004. Since then we have seen the announcement by Pearl Assurance (2005) of an increase in the equity content of their fund. Further research will be needed to incorporate more years' evidence in deriving a conclusion.



We also show a chart that illustrates the maintenance expenses of some recent closers. The expenses are inflation-adjusted. We see, in a number of instances, a downward trend in recent years, and the precise effect of closure is not clear yet.



8 CONCLUDING COMMENTS

8.1 Policyholder issues

Leading closed fund consolidators have referred to the importance of meeting customer concerns. Pearl Group Limited plans to focus on financial security, long-term investment returns and service standards for policyholders (Life Company Investor Group, 2005). Resolution Life Group has indicated it will write to policyholders with a potentially valuable option to surrender without a market value reduction applying, as an example of the importance it attributes to fair treatment of policyholders.

Policyholders also have the benefit of the attention being paid to closed funds by the FSA. The regulator has applauded some moves by closed funds to help policyholders make decisions about their investments, though adds, “But more needs to be done” (FSA, 2005, para. 12).

We raise four specific points:

(1) FSA is implementing new rules that will require with-profits firms to manage their business such that payouts on maturity and surrender are largely within a range that firms specify and publish (Financial Services Authority, 2005). Given some of the recent poor publicity on closed funds it is clear that such funds have much to do if they are to convince policyholders that they have had a fair deal. Closed firms can also expect to be asked to justify their investment strategy in the light of new FSA rules.

(2) Overall, closed firms do a material amount of new business. Firms that were closed at the end of 2003, and which did not re-open in 2004 did £198.6m new business APE in 2004 (direct UK business). This was 1.72% of the market figure (though 5% of new with-profits business was done by closed firms). This business is typically increments and options. However, the firm may well be in a different financial position compared to when the policyholder originally effected a policy. There are therefore some arguments suggesting it would be appropriate to review the information available to policyholders effecting new business with a closed firm. On the other hand, there are also views that the information already available is adequate.

(3) The traditional approach to with-profits business has been that the policyholders share in surplus from all sources, including expense surplus. More recently, however, some with-profits policies have been written on the basis that policyholders are subject to a fixed charge that is intended to cover expenses, so that expense savings or overruns are borne by either the shareholders or the estate.

Some firms have also introduced, or are considering introducing a management service agreement, whereby a sister company of the life firm is established, within the same group, which will operate the management functions for the life firm, so that it will be the management services company that incurs expenses and makes a profit or loss depending

upon the expense outcome (Britannic plc, 2005). In other words, with-profits policyholders will no longer share in expense surpluses (or deficits).

From the perspective of policyholders, management services arrangements may have advantages, notably that they give security to policyholders about expense levels (which may be especially important in closed funds where diseconomies of small scale are expected). However, these arrangements raise a number of concerns for policyholders: this is a change in the nature of the contract, to which policyholders are not being asked to give their consent, and policyholders are giving up their right to participate in expense savings at the time when some firms are expecting significant expense savings from their new focus on maintenance of existing business.

(4) Shareholders typically receive about 10% of the surplus allocated in with-profits funds. This may be thought to be largely a reward to the shareholders for the risk they are bearing. It may be thought that firms should review this factor if de-risking has taken place, which has changed the nature of the shareholders' role. On the other hand, it may be thought that the 10% factor is established practice and independent of the risks that are being borne.

8.2 Shareholder perspective

A key issue for shareholders is the attractiveness of closed funds for purchase. It is too early to carry out any research on the success or otherwise of the new closed fund consolidators, so we make a limited number of observations.

The prices at which closed funds have been traded in 2001-04 showed a discount of over 20% of embedded value. However, we have also seen the emergence of Resolution as a closed fund consolidator, with its shares listed on the London Stock Exchange. When its 2005 half-year results were published in September, its embedded value was disclosed as £5.81 per share; in contrast, the share price was £6.50.

Resolution Life Group has a target growth rate of dividends of 11% p.a., and that in judging future closed life insurance acquisitions, it will look to achieve an internal rate of return target of at least 12% after tax, including synergies (Britannic plc, 2005).

8.3 Information: possible improvement

We have noted a number of areas where we feel there is a case for improving information on closed funds and, in the case of (2) and (3) on open funds as well. These areas are: if firms:

- ♦ stated, in their annual report and accounts, that the firm was closed to new business, if this be the case; this could also be included in the FSA Returns;
- ♦ provided a balance sheet for sub-funds in their FSA Returns, where policyholder rights depend on the financial position of the sub-fund; and
- ♦ provided information on the payout on surrender and maturity of unit-linked policies in their FSA Returns.

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