	Centre for Risk and Insurance Studies ***Enhancing the understanding of risk and insurance***	Nottingham University Business School

Appendix 12

Economics, governance and regulation of with-profits life insurance business

A report for the policyholder advocate in connection with the reattribution of the inherited estates of the CGNU Life and CULAC with-profits funds

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Report By: C.D. O'Brien, M.A., F.I.A., A.S.A. Director, Centre for Risk and Insurance Studies, Nottingham University Business School
Note: This paper is academic research and does not necessarily reflect the views of the Policyholder Advocate

Contents

1.00 Introduction 3

2.00 Shareholder rewards: the “90:10 rule” 5

3.00 Risk And Reward 9

4.00 Incentives And Conflicts Of Interest 21

5.00 Governance 26

6.00 Regulation 38

7.00 Conclusion 41

References 43

1.00 Introduction

1.01. Objectives

This paper examines the nature of with-profits life insurance, as operated in the United Kingdom, which involves a number of issues regarding the roles of shareholders, managers and with-profits policyholders. We examine the interests of these stakeholders and, in particular, review the nature of the risks being taken by shareholders, and the rewards they receive. The paper is largely concerned with proprietary life insurers, although we also refer to mutuals from time to time.

A discussion of the interests of and potential conflicts between stakeholders naturally leads on to a discussion of corporate governance. However, as we shall see, we cannot rely on governance to resolve all the issues satisfactorily. There is therefore a need for regulation of the with-profits sector, where the Financial Services Authority (FSA) has been heavily involved following its With Profits Review that began in 2001, and we will review how regulation has addressed the conflicts of interest between stakeholders.

The remainder of this paper is structured as follows. The remainder of this section 1 contains background material. Section 2 explains how shareholders are rewarded for this business, typically through a 10% share of the profits, and how that has arisen historically. Section 3 reviews what risks the shareholders are bearing, whether the 10% basis is an appropriate basis for rewarding shareholders, and raises some issues about how with-profits business is structured. Section 4 discusses the incentives for stakeholders and the various conflicts of interest. Governance is covered in section 5, regulation in section 6 and the conclusion is in section 7.

1.02. The nature of with-profits life insurance

A with-profits life insurance contract is typically a savings contract which is long-term in nature; contains a minimum guarantee regarding the payout; has a payout that reflects “smoothing”; has some element of life insurance protection; and gives a substantial degree of

discretion to the insurer. We expand on these points below, to understand their implications for the economics of the business.

With-profits policies are long-term contracts, typically with a fixed term at the outset, for example, 5, 25 or 50 years, or possibly a whole life policy, where the benefit is payable on the death of the life insured whenever that is. This long-term nature may inhibit both customers and suppliers from entering into such a contract:

- Individuals may discount the future "too heavily", which may mean that purchases of long-term contracts are less than optimal; in any event, individuals' circumstances change over time, and they are affected by changes in external circumstances, meaning that long-term contracts may be desirable only if they have some flexibility, for example if the policy can be surrendered without a large "penalty";

- Insurers will be aware that they are bearing risks: these can be difficult to forecast and to hedge; some arise from changes in the external environment; and the insurer may be part of a group, which may change the objectives it sets for the firm.

The guarantees in with-profits policies are valuable. However, there is also evidence that many consumers are unwilling to pay what some companies are now asking for guarantees (Cantor and Sefton, 2001).

From the viewpoint of suppliers, guarantees can be onerous, although when policies were written in the bull markets in the 1980s only a low probability would have been attached to the downturn in interest rates and stock markets that led to the solvency problems of many life insurers in 2001-03. In addition to the guarantees regarding payouts on maturity, many policies contained guaranteed annuity options, which were to cause severe financial difficulties for Equitable Life (Penrose, 2004) and elsewhere.

Smoothing is thought to be a benefit to consumers, enabling them to avoid the volatility of unit-linked policies. However, research reported by the FSA found consumers' concerns that smoothing could mean manipulation and holding back of funds (FSA, 2002a). Further, smoothing can have a considerable cost to life insurers. When the stock market more than halved over 2000-03, many insurers decided to change bonus rates more frequently than they normally did and to reduce the amount of smoothing (e.g. some firms that normally restricted changes in payout from one year to the next to 10% increased that limit to 15%).

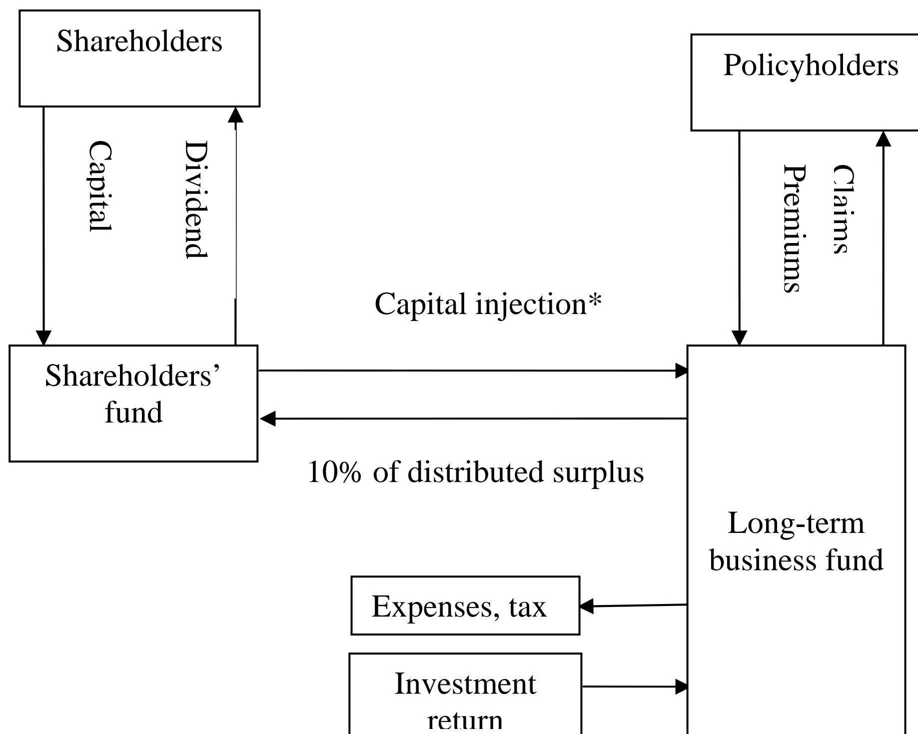
Life insurance protection is automatically included in an endowment assurance policy, and in endowments used for mortgage repayment there would be some additional life insurance cover (on a non-profit basis) to ensure that the payment on death before maturity at least matched the borrowing under the mortgage. With-profits life insurers are therefore pooling mortality risks (although, for some contracts, the life insurance element is quite small). Whilst this means that with-profits life insurance goes beyond a normal savings contract, this is a mainstream activity of life insurers and should be a core skill of the management. Given the reductions in mortality rates, the inclusion of life insurance cover in with-profits policies should have led to higher profits than otherwise for with-profits policyholders. Clearly the insurer, as supplier of insurance protection, has to price, underwrite and manage such risks, and reinsurance is available to assist as appropriate.

2.00 Shareholder rewards: the “90:10 rule”

2.01. Current structure of with-profits life insurance

The typical structure of a with-profits life insurer is illustrated in figure 1. The long-term business fund is where the transactions relating to the long-term business takes place, i.e. into which premiums are paid, and from which expenses, tax and claims are paid, and the fund also grows from the investment returns it generates. Separate from this is the shareholders' fund.

- Figure 1. Current structure of with-profits life insurance business



* An injection of new capital is usually on the basis that the capital is returned to the shareholders' fund if it is not required for meeting obligations to policyholders.

2.02. Shareholders' Rewards

The normal mechanism for rewarding shareholders is that they receive 10% of the distributed profits. We describe the process for this as follows.

Each year, the life insurer carries out a 'statutory solvency valuation' of its assets and liabilities. This is in accordance with the rules in force from time to time: currently the rules of the FSA, previously the Insurance Companies Regulations 1973 and 1981. These regulations, in broad terms, require the assets to be at market value and the liabilities to be valued excluding any future bonuses. A with-profits life insurer would use some of the excess of assets over liabilities to declare an annual bonus, which increases the guaranteed payments to policyholders. This is a 'reversionary' bonus, i.e. it is payable at the time of claim rather

than immediately as cash. As part of this valuation, the shareholders receive a cash sum equal to one-ninth of the cost of the annual bonus, meaning that the shareholders receive 10% of the profits that are being distributed.

On the maturity of a policy, the insurer typically makes a payment to the policyholder about equal to the smoothed 'asset share' of the policy. The asset share is briefly, the accumulation of premiums paid under the policy, together with the investment return earned, minus costs (expenses, cost of life cover, charges for guarantees, amounts transferred to shareholders and tax). Asset share is an amount at market value and is therefore volatile; the desired payment is the smoothed asset share, which aims to smooth out variations. The insurer pays a terminal bonus to top up the guaranteed amount so that the maturity value is at the desired level; to preserve the principle that shareholders receive 10% of the distributed profit, they will receive a payment equal to one-ninth of the terminal bonuses that are paid.

The 10% of distributed profits transferred to shareholders is passed from the long-term business fund to the shareholders' fund. Usually, this amount can then be paid as a dividend to the shareholders.

The transfer to shareholders and the payment of a dividend are conditional upon the regulations on solvency being satisfied. Briefly, the assets in the long-term business fund must be at least equal to the liabilities; and the sum of the excess of assets over liabilities in the long-term business fund, and the net assets in the shareholders fund, must at least equal the minimum solvency margin set by the regulators.

From 2004 major with-profits life insurers have prepared a valuation of assets and liabilities on a new 'realistic' basis as required by FSA. This introduces some additional rules on financial reporting and solvency regulation. Particularly important is a rule that requires insurers to have a 'realistic' value of assets that is equal to or exceeds the 'realistic' value of liabilities; the excess is the firm's 'inherited estate'. In some cases an insurer has 'shareholder support' assets that help satisfy FSA requirements.

The shareholders' fund may make an injection of capital into the long-term business fund. This could be, for example, to finance the growth of business or some other development, or to maintain the solvency of the long-term business fund. If the assets of the shareholders' fund are inadequate, then the shareholders need to inject more capital.

A potentially tricky issue is that, if the shareholders' fund injects, say £100m into the long-term business fund, policyholders will be expected to receive 90% of it. In recent cases, such capital injections have been made as a subordinated loan which, in due course, is repayable in full to the shareholders as long as the insurer's obligations to policyholders are met in full.

2.03. Historical Perspective

Sibbett (1996) traces the development of proprietary with-profits firms, starting with Provident Life Office in 1806 followed by Rock Life. In 1836 the North Scotland Life Assurance Company was the first to offer 90% of profits to policyholders, "the remaining tenth being retained as the company's charge for expenses of management". Sibbett indicates that this example was followed by others, but these more often deducted the expenses of management before striking the surplus. Over the second half of the 19th century, there was an increase in the typical proportion of profits payable to policyholders, and in 1899 24 offices were offering 90:10, the average of all offices was 87% and two-thirds was the lowest. Sibbett goes on to say that, in the next three decades, 90:10 "became almost universal as a result of competition".

The importance of competitive pressures was seen at Royal Exchange Assurance which, in 1899, was allocating only two-thirds of distributed surplus to with-profits policyholders, when the average figure was 87% (Supple, 1970). The directors proposed to increase the policyholders' proportion to five-sixths. They were taken aback by the feedback from branch managers about the difficulty of selling business in competition with mutuals and other proprietary companies: the Birmingham branch manager protested,

"The competition for life business is becoming more keen every year… upon many occasions I have been met with a remark to this effect: 'I have decided to give my proposal to the 'Scottish Widows'. They give all the surplus back to the [policyholders], while you only give two-thirds, keeping one-third for the shareholders'. At the last division of profits in 1895 nearly £84,000 was transferred to the pockets of the shareholders. The public won't stand it" (Supple, 1970, p.278).

These concerns led the directors to change their proposal in order to allocate six-sevenths of distributed surplus to the policyholders and, from 1916, it became 90%. Indeed, the company's actuary pointed out in 1917, "the life business of the proprietary tends to become continually more mutual in character, and the period is rapidly approaching when almost the entire profits will require to be reserved for the policyholders" (Supple, 1970, p.450).

However, the 90% proportion, as the usual rule, did not in fact increase further, and the 90:10 division as standard has been with us for 100 years.

3.00 Risk And Reward

Policyholders typically receive one or more services under their policy:

- Security (protection from adverse events, as the policy provides a guaranteed payment on death or maturity);
- An investment service; and
- "Real" services (e.g. financial planning advice or pension scheme administration).

Policyholders are prepared to pay for these services. The amount they pay should be adequate to pay for the costs the insurer incurs and to provide shareholders with a profit that is adequate compensation for the risks they are bearing.

Say the shareholders inject capital at the outset. Part of this is spent in establishing the business, part used as working capital and part retained as capital to provide security for

policyholders. Although the shareholders have plans that should enable them to make an adequate profit, bearing risks itself does not automatically mean they make that profit: this depends on what policyholders pay for the services the insurer provides.

Consider a business where there is a shareholders' fund and a long-term insurance fund with no inherited estate. The shareholders run the risk that payments to policyholders exceed asset share; if that is the case, shareholders' funds are depleted. Market risks are particularly important: if the guarantees are not hedged, and the assets include a large proportion in equities, a decline in equity values may mean the asset share is lower than the guaranteed benefit. However, the full range of risks is relevant: credit, liquidity, insurance and operational risks.

In practice, with-profits business means risks are also being borne by policyholders (section 3.2). Further, where there is an inherited estate, this rather than the shareholders can bear some of the risks (section 3.3.)

3.01. Risks borne by policyholders and "management actions"

With-profits policyholders are naturally bearing some risks: if the asset share is different from what is expected, the bonuses will be different, although the insurer is obliged to pay the guaranteed benefit as a minimum. Asset shares are subject to investment risk, especially where equities are a large part of the investment; however, the whole range of factors underlying the asset share calculation is relevant, including expenses, insurance claims and tax.

The 'security' service (guarantees that provide protection) that the insurer provides for policyholders can change over the lifetime of the policy, and policyholders bear the risk that the protection is less than they anticipated. This may be the case as a result of "management actions" that insurers may well take, particularly if there is a need to preserve solvency. These actions include:

- Changing the investment strategy so that liabilities are hedged to a greater extent, typically involving switching from equities into bonds or the purchase of derivatives;
- Reducing annual bonus rates;
- Reducing surrender values;
- Increasing or introducing new charges for guarantees; and
- Reducing the degree of smoothing in payouts.

In many ways these are logical actions to take. Nowell et al. (2000) considered future scenarios for life insurers in a low inflation environment and found, for some model insurance companies, a significant probability of insolvency. This led Harley & Davies (2001) to comment that, "If faced with insolvency [companies] would have the option of changing the [smoothing] rules and making more abrupt changes; indeed it would be very odd if companies clung to rules that threatened them with imminent ruin".

However, if the management actions are not fully defined but remain subject to discretion – as is the case – this means that the 90:10 reward system cannot be robust. If a policyholder takes out a policy and is ready to forgo 10% of the surplus in return for a potential contribution from the shareholders, then if the shareholders are able to change the rules so as to make such a contribution highly unlikely, this undermines the case for the shareholders receiving that level of reward. For the policyholder to consider whether it is worth forgoing 10%, he or she has to think what actions the firm might take many years hence, which is not practicable.

We have seen some life insurers make significant reductions in the equity content of their funds following their solvency levels having declined in the late 1990s and as the equity market fell in 2000-03. This has led to concerns:

"The result is that an investor who bought a policy offering strong exposure to equities and therefore potentially high growth prospects suddenly finds that their policy is now invested in a low growth, bond dominated fund …the insurance industry seems to be

unique in preserving to itself the right to sell a customer one product and then substitute it with another product which is inferior in key respects" (House of Commons Treasury Committee, 2004).

We expect effectively competitive markets to limit managerial discretion, by forcing insurers to make their products attractive to prospective customers. However, such a mechanism has limited strength, given the less than transparent nature of with-profits business, and the fact that several proprietary with-profits life insurers are closed to new business.

The author believes this subject is suitable for a wider debate. The challenge is whether it is appropriate for the shareholders to take a constant proportion of the profits when they can change the operation of the funds to reduce the risks they are bearing.

3.02. Risks borne by the inherited estate

Many of the risks are now being borne not by shareholders' funds of with-profits life insurers but instead by the inherited estate. It has become the norm for the inherited estate to finance new business, and it is often used for meeting exceptional costs, such as development expenditure, or mis-selling compensation (Smaller et al, 1996). Indeed, it is common for the shareholders' funds to be very small, which raises the question as to what their role is (Benjamin, 1981).

Sandler (2002) said that the principal justification for the 90:10 model is that the shareholders stand ready to provide capital for the fund should it be required and part of their 10% reward is in return for this. However, he indicated that, in general, shareholder funds have not been committed to underpinning with-profits funds, as these tend to have built up sufficient internal capital. Indeed, the logical conclusion of Sandler's argument applied to a strong fund is that, if the inherited estate is now meeting the guarantees, the shareholders are not, in practice, bearing any material risks, and perhaps their reward should be nothing (or little more).

Although the inherited estate now bears risks that might otherwise be taken by shareholders' funds, it is not clear that shareholders would necessarily want to take the investment risks that

insurers with a large inherited estate take. So, while the inherited estate protects the shareholders from risks they would otherwise be exposed to, it is not a straight replacement for the risks the shareholders would otherwise take.

3.03. The logic (or lack of it) in shareholders being rewarded through the 90:10 rule

Introduction

We now consider more fully why do shareholders take 10% of the distributed surplus in proprietary with-profits life insurers? There are two reasons why, in principle, policyholders may benefit from there being shareholders, and therefore be willing to forgo some of the surplus:

- Shareholders provide additional financial resources, which can lead to better security and potentially higher payouts; and
- Shareholders introduce governance mechanisms that may lead to improved performance that benefits policyholders.

We review these and then consider whether the 90:10 mechanism works sensibly in practice.

Additional (or potential additional) financial resources

A proprietary company may have additional financial resources, which enable it to provide additional security compared to a mutual. These additional resources may come from:

- Assets in the shareholders' fund; and
- Possibly, the long-term insurance fund is stronger than otherwise because shareholders have injected money into the fund at some time in the past.

The additional security provided is in two forms:

- A lower likelihood of default; and
- A lesser need to take management actions to protect the solvency of the fund if its financial strength weakens (a mutual may have to move more quickly to, for

example, reduce annual bonuses, change investments and reduce the smoothing of payouts).

However, if the 10% forgone by policyholders is justified by the insurer's financial strength, one would expect the 10% factor to vary according to the financial strength of the insurer and the size of the shareholders' fund: but it does not, and indeed, several mutuals are stronger than some proprietary insurers.

Proprietary insurers may also have potential additional capital, which can lead to additional security:

- They can raise money through a share issue, which is not an option open to mutuals (although a mutual can raise money through debt or by reinsurance); and
- They may be (indeed, usually are) part of a larger group, which may be willing to inject capital.

We have seen some weak proprietary with-profits life insurers where shareholders have injected money from elsewhere in the group: in some cases, they will not get it all back. So some policyholders have gained from the shareholders being able to provide additional security.

However, there is no guarantee that capital would be raised through a share issue or capital injection by the parent. This depends on incentives (what would be the loss of goodwill if the insurer failed?) and ability (does the parent have the financial strength to support the insurer in what are likely to be difficult financial conditions?).

Where the shareholders' fund is called upon, it may not be prepared to meet the cost of guarantees if the with-profits fund proves to be inadequate (although this would be open to a legal challenge). As one firm indicates in its Principles and Practices of Financial Management:

"The fund may have recourse to the assets in the shareholder fund, should this be necessary in order to meet guarantees or to give more freedom to the With-Profit Fund, though this is entirely at the discretion of the shareholders".

There are some with-profits funds that are financially stronger than the parent, so if there are adverse financial circumstances leading to the with-profits life insurer having insufficient assets to meet its liabilities, the parent company is unlikely to be able to provide the backing. We also have the evidence of the problems of London Life, National Provident Institution, and Pearl which, in 2003, requested financial assistance in the form of an injection of capital from their parent, Australian Mutual Provident, which request was declined.

This analysis suggests to the author that the shareholders' financial resources do not justify the shareholders' 10% take. The problem is that we do not have a competitive and transparent market where what the shareholders receive is consistent with the value they are providing to policyholders.

Governance mechanisms

Shareholders' capital is also associated with a set of governance structures, designed to prevent managers acting in their own as opposed to shareholders' interests. Such governance structures may be especially strong in listed firms, as a result of the Combined Code on Corporate Governance, which sets out requirements that those firms are expected to comply with (Financial Reporting Council, 2008). It covers matters such as non-executive directors, audit and other committees, and may lead to improved performance of the insurer, benefiting policyholders.

Compare mutuals, where there are no shareholders, and it can be argued that managers may have freedom to act in their own interests as there is relatively little control from policyholders. There are points to the contrary that can be made; we do not debate the issues here but merely record that the issue has been sufficiently important to warrant a review (Myners, 2004). Given that mutuals have begun to implement a suitably amended version of

the Combined Code, the argument for a benefit from greater formality of governance arrangements in proprietary insurers may not be sustainable.

In practice, there is no consistent evidence in the UK of the expenses of proprietary insurers being lower than mutuals (Diacon et al, 2004). Therefore, using governance arrangements to support the payments to shareholders appears weak.

3.04. General comments on the 90:10 rule

Ensuring that shareholders' and policyholders' rewards properly reflect the risks they are bearing can be difficult. Wallace (1973) suggests the rewards to shareholders may be excessive, given the way in which adverse experiences affect policyholders, through reduced bonuses, rather than putting shareholders at risk. He observed that as with-profits life insurance funds increased in size, the shareholders' risk capital becomes less valuable in providing protection for the guarantees that the fund has given. However, the transfer to shareholders, arising from a fixed proportion of profits, is growing. He considered it to be inequitable for an increasing amount of surplus to be paid to shareholders while the protection they provided for policyholders' guarantees decreased. He referred to one possible solution being legislation to impose a maximum proportion of profits transferable to shareholders that diminishes as the fund size increases, which has been the case in Canada (Rosenfelder & Roberts, 1979).

Redington (1981) also felt that shareholder rewards were excessive. He argued:

- Historically, the premium on a with-profits policy was 10% more than the premium needed to provide the guaranteed benefits only (i.e. the premium that would be charged for a non-profit policy);
- It was therefore expected that this additional 10% of premium would produce surplus;
- Given that shareholders were entitled to 10% of surplus, they expected to receive 10% x 10% = 1% of the premium;

- At the time of writing, premiums on with-profits policies were 40% more than charged for non-profit policies;
- Shareholders therefore had a built-in expectation of receiving 4% of the premium, much more than the 1% figure that applied historically.

Given that the shareholders also receive 10% of other surplus, he concluded: "in my view these levels are excessive….. I can see no long-term future for our business which will allow the shareholders to live in the luxury we are letting them become accustomed to" (p.367).

Barton (2002) referred to the rise in interest rates from 1950 to 1990; we might therefore have expected insurers to increase the amount guaranteed, for a given premium, but this did not happen. The outcome was that the guarantees on policies became less valuable and the risks taken by the shareholders, arising from possible insolvency, became more remote: yet the 10% figure for the part of surplus allocated to shareholders did not reduce. In the 1990s interest rates fell sharply, which reduces the validity of some of the above concerns, but this highlights the difficulty of designing a rule that gives a suitable reward over a long period when financial circumstances can change.

The 90:10 rule has been referred to as arbitrary (Smaller et al, 1996) and fails to match shareholder risk and rewards. This can distort incentives: for example, a firm may write large amounts of business of marginal profitability but which generate large transfers to shareholders (Brindley et al, 1992).

Sandler (2002) indicated that with-profits funds need to have capital, and that the provision of this capital should be properly remunerated. However, this should be related to the amount of capital and the level of risk involved. He went on to say that the arbitrary 90:10 rule is clearly not the result of such a pricing process. Although the 90:10 structure appears to align policyholder and shareholder interests, it is not clear why the payment to shareholders for the risks they bear should be related to fund payouts.

3.05. Alternative structures for with-profits life insurance business

The Clay et al model

The lack of transparency in with-profits business has been recognised, and Clay et al (2001) put forward a view on how the business could be structured differently.

They developed a model, where the different aspects of with-profits business are reflected in various separate accounts. Premiums would be allocated to the asset share account, which would be augmented by the investment return and profits or losses from non-profit business. From the asset share account there would be charges for expenses, regulatory capital and tax. There would also be explicit charges for guarantees and risk benefits, into a guarantee account. The asset share account would provide unsmoothed asset shares for the claim account; smoothing would be provided by a flow between the claim account and the smoothing account. The guarantee account would then make payments to the claim account as necessary. The claim account would make the payouts to policyholders.

The model incorporates charges for guarantees but also retains the 90:10 relationship for bonuses, so does not address fully what is an appropriate way of rewarding shareholders.

The Sandler model

Sandler (2002) suggested a new structure for the operation of with-profits business. He contrasted the rather vague contractual rights of policyholders with the rights of the insurers' shareholders. In his model:

- the shareholders would be responsible for management services and for providing protection benefits, with policyholders paying accordingly; and
- an investment return would be created on a 100:0 basis, i.e. with all the investment returns being credited to policyholders.

The FSA published a discussion paper on the Sandler proposals, and suggested that the structure could be simplified (FSA, 2003a). However, it later concluded that it would not be appropriate for this new model to be mandatory for future new business (FSA 2003b). A particular problem was that mutuals would not be able to operate the model, as proposed, without a number of disadvantages; and there were serious concerns that the proposals to mandate the product model would be illegal or unenforceable. However, although there are obstacles to making the model mandatory, it still appears feasible for some insurers to introduce a model on these lines.

Comment

The structure of new with-profits business has not followed the pattern suggested by either Clay et al or Sandler, although it is now common in proprietary firms for expenses to be borne by a separate management services company owned by the shareholders. The absence of change may indicate that the suggestions were non-optimal: should we not be relying on the market forces of supply and demand? However, there may be institutional or regulatory barriers to change. In particular, the existence of inherited estates may give managers a

comfortable buffer in managing the business, and can insulate the shareholders from many of the risks while they still receive 10% of distributed surplus. It is appropriate to continue to challenge the existing with-profits model, and the following issues are put forward.

First, who should bear what risks? Risks may be borne by shareholders or policyholders or shared between them. Sharing on a 90:10 basis is subject to the criticisms expressed earlier in the paper. Sandler suggested that shareholders should bear the risks of expenses and guarantees, with smoothing being a policyholder risk. Alternatively, could shareholders define how smoothing operates, charge for it and bear the risk, hedging as is feasible and appropriate? Or might policyholders bear guarantee risks?

Second, to what extent should the charges for risks borne by shareholders be determined at the outset? If a firm can review its charges during the policy, this is done in what is likely to be a non-competitive environment, the concern being whether governance arrangements and/or regulation can ensure that shareholders receive an appropriate reward while not disadvantaging policyholders. However, policyholders may also suffer if charges were non-reviewable, with shareholders requiring a high charge for taking long-term risks.

Third, how much capital should be held and why? Sandler's model was that firms would not be able to build up an inherited estate, and while the supporting capital could not be too low for solvency purposes, neither could it be excessive: if capital were unnecessary, owners would not be able to charge for it. The FSA (2003a) interpreted the model as new with-profits business would no longer be financed by the inherited estate but instead by shareholders, either from their own funds or from their share of the distributable assets from an existing inherited estate.

This leads to a model where the inherited estate is at the level of capital appropriate for a closed fund. New business is financed by shareholders (who may use a reinsurer or other third party). Shareholders receive part of the premium for this and for other risks that they bear. A further part of the premium is for risks borne by policyholders, which may be non-market risks, together with market risks that it is not feasible or appropriate to hedge. The

accumulation of that part of the premium may exceed what is included in the realistic value of liabilities for such risks. The excess is essentially the inherited estate, although that term is misleading as it is not inherited from a previous generation. We can instead think of it as the policyholders' capital, and when a policy goes off the books, any value remaining in the policyholder's 'share' of the policyholders' capital is returnable to him or her.

There are potential variations in this model. However, the objective is for with-profits business to be more transparent, with greater clarity over who bears the risks and how they are charged. New business would only be written if it was truly expected to be profitable, the policyholders and shareholders being appropriately rewarded for risks they take. The inherited estate is policyholders' capital and is managed with the same scrutiny as should apply to shareholders' capital. As suggested by Sandler, insurers would disclose unsmoothed asset shares to policyholders, to enhance transparency and accountability.

The FSA (2003a) referred to legal difficulties in enforcing Sandler's with-profits model. We should, however, remind ourselves that FSA also commented, "We agree with Mr Sandler's corporate structure within which it is proposed that firms should write with-profits business" (para. 1.4). We also have in mind that the intergenerational transfers in the existing model can lead to problems in ensuring an effectively competitive market and problems of fairness to policyholders in a reattribution (Treasury Committee, 2008). The author therefore believes that the with-profits model is an issue for continued debate. However, whether any model that meets both policyholders' and shareholders' needs satisfactorily at the with-profits business volumes experienced in the past is open to question.

4.00 Incentives And Conflicts Of Interest

Although the 90:10 relationship is intended to align the interests of with-profits policyholders and shareholders, there can be serious conflicts of interest, which are unlikely to be understood by policyholders (Brindley et al, 1990). To understand the conflicts, we need to consider the incentives of stakeholders.

We suppose that shareholders prefer a higher to a lower shareholder value. We suppose that policyholders have a utility function relating to the expected payout under the policy (including any windfall cash payments), the level of security and quality of service provided by the insurer. We suppose that managers have preferences for more remuneration, security and status; and a preference for less effort.

We examine the interests and incentives of stakeholders in key decisions that the insurer makes:

- What amount of capital should it have? and
- How much new business should it write (and on what terms)?

In considering the amount of capital, we may suppose that shareholders would, in many respects, prefer a lower to a higher amount of capital. A lower amount:

- avoids unnecessary capital locked into a business, which is an illiquid asset;
- minimises agency problems of managers using resources to pursue their own interests (noting that accountabilities are difficult in managing long-term contracts, where measuring performance is a problem); and
- increases the value of the put option to default: this is the value that shareholders gain, when the insurer is insolvent, from not paying the liabilities it would ordinarily be obliged to pay. When an insurer has a low (high) amount of capital, it is more (less) likely that it will be insolvent at some time in the future, and hence the value of the put option to default is therefore relatively high (low).

However there are also problems if capital is low:

- The firm may not be seen to be satisfactorily secure, and may fail to attract new business (and also managers);
- More generally, the costs of 'financial distress' increase; and

- The firm's operations may be constrained so that it is not able to make best use of its resources.

Managers, on the other hand, are likely to prefer "large" amounts of capital, since that may give them more freedom of action. Furthermore, much of managers' wealth is human capital linked to their continued employment with the firm, and a higher amount of capital means a greater likelihood of continued employment (usually). Indeed, the insolvency of an insurer may mean the manager finds difficulty in finding another suitable job in the industry.

We also expect that policyholders would tend to prefer "large" amounts of capital, since that increases the security of their benefits.

However, policyholders' interests are not all identical. For a policyholder whose policy is due to mature next year, then if the fund appears financially adequate now, his or her main interest is likely to be the amount of payout next year; if this can include a return of capital, so much the better. However, for someone whose policy has many years before maturity, he or she has a greater interest in the continued financial strength of the fund over a longer period. If this permits greater risks in the investment strategy, and if these are accompanied by higher rewards, then his or her payout will benefit from retention of capital (strong insurers have typically undertaken a riskier investment strategy, although this does not always create value for shareholders). On the other hand, if large amounts of capital lead to it being used inefficiently, this is also to the detriment of policyholders who share in the profits. If there is excess capital, there is potential for conflict between different groups of policyholders when a distribution of excess capital is discussed.

As regards new business, it is likely that the shareholders would prefer large as opposed to small volumes of new business. New business will generate transfers to shareholders equal to 10% of distributed surpluses; and, typically, additional new business does not cause significant increases in shareholders' risk. If new business is unprofitable, this does not eliminate (although may reduce) the surpluses that are allocated to shareholders; rather, it diminishes the inherited estate. Shareholders may therefore be willing to accept unprofitable

new business, although obviously not without some limit. Indeed, a lower inherited estate means a lower expectation of an excess surplus that leads to distributions of some or all of that excess to policyholders and shareholders.

We suppose that managers will have a strong preference for large as opposed to small amounts of new business. That is likely to increase the size of jobs, and managers' prestige. Large amounts of new business may also increase managerial remuneration.

New business can bring both advantages and disadvantages to policyholders. Large amounts may lead to lower unit costs, and consequently higher asset shares and payouts, although if the insurer has established a management services company owned by shareholders, such cost benefits would not accrue to policyholders. New business may also bring some tax advantages, depending upon the circumstances of the insurer.

However, new business can also lead to a reduction in the film's solvency position as a result of "new business strain". The security of policyholders' benefits may therefore be reduced somewhat, although if the persistency experience of the new business is good, the effect on security may be modest. Indeed, under the realistic valuation of assets and liabilities, new business may result in little or no strain.

Policyholders may prefer the fund to be closed since; in that event, the insurer is obliged, under FSA rules, to arrange a distribution of the inherited estate, of which 90% would ordinarily be allocated to the existing with-profits policyholders. This is particularly attractive if the fund is strong. However, the author's view is that policyholders entered when the fund was open and should not reasonably expect a firm to close to new business, just for the purpose of accessing the inherited estate.

Policyholders will, though, normally expect products will be priced to take into account the cost of capital and the cost of market and non-market risks and avoid the expectation of a loss. There may be circumstances where writing new business at a loss has benefits for existing with-profits policyholders: for example, expenses may be lower than if the fund were closed.

In some circumstances there might be tax or investment advantages. However, there is an adverse effect on existing policyholders from the depletion of the inherited estate, which reduces the security of their benefits, and reduces their interest in future distributions or reattributions of the inherited estate. The potential conflicts in this area need to be monitored carefully.

Policyholders' and shareholders' interests in the inherited estate raise further issues. There are potential conflicts between policyholders and shareholders, and managing these conflicts can be difficult. These difficulties may crystallise in a reattribution, where policyholders are offered a payment by the shareholders for forgoing any future distributions from the inherited estate. We do not pursue this subject here, but we mention the issue of intergenerational transfers. A policyholder who enters a fund has some expectation of future distributions from the inherited estate, although whether such distributions happen depends on matters such as whether the fund has excess surplus or is closed to new business. Policyholders entering the fund do not pay for such expectation. Quantifying such expectation is necessarily difficult since it depends on future financial conditions and on management actions taken by the firm (e.g. fund closure), the probability of which cannot be easily assessed. It would therefore be difficult to calculate the appropriate amount to charge to new policyholders for such expectation of future distributions, which may or may not be realised. However, we should recognise that the ongoing nature of the fund means that there are generations of policyholders, across which the inherited estate is transferred, without charges being made for expectations of distributions from the inherited estate. Existing policyholders therefore find their interest in the inherited estate diluted by new business, even though those new policyholders are not paying for that interest (and neither did the existing policyholders).

FSA rules recognise that businesses can face conflicts of interest, and require these to be managed fairly. We shall consider this further in section 6.

5.00 Governance

5.01. Introduction

Corporate governance is the system by which companies are directed and controlled (Cadbury Committee, 1992). It is particularly concerned with potential conflicts between managers and shareholders: will the former act in the interests of the latter? Some corporate governance studies have focussed on the position of other stakeholders, such as customers and, in with-profits life insurance, where policyholders participate in profits, discussions of governance must encompass policyholders.

We mentioned in section 3 that governance has been an issue in mutual life insurers. The governance difficulties at one of the UK's largest mutuals, Equitable Life, were reported in detail by Penrose (2004). Myners (2004) suggested a specially adapted version of the Combined Code for mutuals, the aim of which was to strengthen the rights of policyholders, being both customers and owners of mutual organisations.

5.02. Transparency

The UK insurance regulatory regime has sometimes been presented as founded on "freedom with disclosure". Insurers have been required to make publicly available their regulatory returns, which contains more information than in many other countries. However, these returns are complex and not, in practice, accessible to policyholders and their advisers, and while they have been expanded in recent years to give more information about the operation of with-profits business, the focus of the returns has been the insurer's solvency and the factors affecting it.

More information was made available for with-profits policyholders following the implementation in 1988 of the Financial Services Act 1986, including disclosure of "product particulars" and the publication of With Profits Guides. However, the with-profits industry has still been criticised for a lack of transparency, with concerns that customers do not understand what they are buying, whether it is appropriate, whether it is good value, what the

equity content of the investment is, and how market value reductions (MVRs) operate (Clay et al, 2001).

Following its review of with-profits governance the FSA introduced a requirement for with-profits firms to issue a Principles and Practices of Financial Management ("PPFM") document by March 2004. The FSA said this would mean that firms would be more transparent about the nature of their discretion and the parameters within which it is exercised. The PPFM document sets out, inter alia:

- How the insurer calculates asset shares;
- The range within which payouts are expected to lie, as a proportion of asset shares;
- The investment strategy for the fund, and whether non-tradable investments are held;
- How surplus is divided between policyholders and shareholders; and
- The governance procedures for changing the PPFM.

The FSA provided some feedback on what they found helpful, or less so, about these documents (FSA, 2005). They subsequently introduced a rule requiring firms to issue a customer-friendly PPFM document. Boards are also required to prepare an annual report on whether they have complied with the PPFM, and make this available to policyholders. This report includes a (short) report from the with-profits actuary.

The author's view is that steps to improve the transparency of with-profits business were needed, but that what has been done to date is only a start. The PPFM helps fill in information about the product that the policy document does not contain, and while these documents have largely been ignored by policyholders, they go some way to providing a useful discipline on management. Nevertheless, the documents still typically retain substantial discretion to the firm regarding how it can operate, so the contract is far from well-defined.

Indeed when one considers a policyholder who cannot understand why his or her payout is what it is, and the firm does not disclose asset share information to explain this, it suggests that what has been done to date is not enough. Changes may be needed in the nature of the with-profits offering if it is to be made attractive to a new generation of customers. Whereas past customers were pleasantly surprised by payouts on policies that reflected good investment returns in the 1970s-90s, new customers are not expecting such a good performance from financial markets and, conscious of some firms having mis-treated customers in the past, they will be looking for greater accountability of with-profits life insurers. Whether there is a market for supplying transparent and profitable with-profits policies that meets customer demands is open to question.

5.03. Governance and regulation

The International Association of Insurance Supervisors (2003a) includes corporate governance of insurers as one of the issues that insurance regulators should address. IAIS has, as one of its core principles:

> "The corporate governance framework recognises and protects rights of all interested parties. The supervisory authority requires compliance with all applicable corporate governance standards."

The IAIS goes on to say that corporate governance includes corporate discipline, transparency, independence, accountability, responsibility, fairness and social responsibility. Its principles require that boards of directors set out policies that address conflicts of interest, fair treatment of customers, and information sharing with stakeholders, reviewing these policies regularly. The principles do not, however, consider the position of with-profits policyholders in proprietary life insurers in detail.

The OECD (2005) set guidelines for the governance of insurers, with a number of guidelines, the first of which relates to governance structure:

"The governance structure must establish an appropriate division of administrative and oversight responsibilities, stipulate and delineate the qualifications and duties of persons bearing responsibilities, and protect the rights of policyholders and shareholders or 'participating policyholders'".

However, their reference to participating policyholders was primarily in the context of mutual insurers, and the guidelines do not specifically address the conflicts between participating policyholders and shareholders in proprietary insurers.

Regulators are likely to be particularly concerned about governance in with-profits funds. This is especially the case in proprietary firms, where firms' accountability to with-profits policyholders is more limited than in the case of mutuals, and firms may be able to do things without policyholders knowing or having a say (FSA, 2003b). In the UK, the FSA put forward a number of options to improve matters (FSA, 2002c), which we consider in sections 5.04 to 5.08.

5.04. Policyholders' beneficial ownership of assets

One of the options considered by the FSA (2002c) was that with-profits business be re-arranged to give beneficial ownership of assets to policyholders.

One example could be if policies and the assets supporting them were transferred to a corporate body similar in structure to an open ended investment company (OEIC) sitting along side the life company, which might then be appointed as corporate director and manager of the assets. The policyholders would become shareholder members of the OEIC. Legal ownership of the assets would reside with a depository, holding them for the OEIC as beneficial owner and acting in a supervisory role in relation to the corporate director.

However, FSA's view was this would be costly and complex and it is questionable whether it would achieve greater clarification. In itself it would not bring transparency to the exercise of discretion, nor to the way in which conflicts of interest were managed.

5.05. The role of directors

The FSA also considered an option whereby a statutory duty under company law would be placed on directors to have regard to the interests of policyholders. The rationale could be that with-profits policyholders share in the profits and risks of the company and the directors should, therefore, have a direct duty to consider their interests. A key number of issues would need to be considered in formulating this duty, including how it should be enforced. FSA also considered that the regulatory regime already places obligations on firms in respect of their policyholders.

FSA was concerned about the complexity in formulating an appropriate duty, thinking that it was questionable how much value there would be in an amendment to company law and how the duties should be enforced.

Another possibility would be to follow the practice in Australia, in accordance with the Insurance Act 1995, where section 48 states that:

- A director of a life company has a duty to the owners of policies referable to a statutory fund of the company;
- The director's duty is a duty to take reasonable care, and use due diligence, to see that, in the investment, administration and management of the assets of the fund, the life company… gives priority to the interests of owners and prospective owners of policies referable to the fund.
- In order to avoid doubt, it is declared that, in the event of conflict between the interests of owners and prospective owners of policies referable to a statutory fund and the interests of shareholders of a life company, a director's duty is to take reasonable care, and use due diligence, to see that the company gives priority to the interests of owners and prospective owners of those policies over the interests of shareholders.

It would be of interest to consider how such a provision might work in practice in the UK.

5.06. The role of actuaries

Introduction

Actuaries have an important role in the management of life insurers, and their professional expertise and responsibilities mean they potentially have an important role to play in the governance of life insurers (Goford & Ross, 2006). Indeed, the actuarial profession has had a special role in safeguarding the interests of policyholders (Dewing & Russell, 2006). Regulators may prescribe specific roles for actuaries in firms, so that they play a part in the regulatory regime. There are a number of different models for the use of actuaries (IAIS, 2003b), and indeed their role in the UK has changed recently. Morris (2005) accepted that, at present, there is a continued need for roles to be reserved for actuaries in life insurance.

The Appointed Actuary and With-profits Actuary

The UK operated an 'appointed actuary' regime from 1973 to 2004. Under regulations set by the Department of Trade and Industry each authorised life insurer had to appoint an actuary, who had a specific responsibility for placing a value on the insurer's long-term liabilities in the statutory solvency valuation. In practice, the appointed actuary had a number of other responsibilities, such as advising the Board on bonus rates on with-profits policies, and whilst there could be a range of responsibilities that the appointed actuary undertook (e.g. he may or may not be responsible for product development), he would ordinarily be expected to advise the Board on issues of long-term financial management.

The actuarial profession developed a series of guidance notes for its members, and GN1 and GN8 were of particular relevance to appointed actuaries. GN1 required the appointed actuary to ensure, as far as practicable, that the long-term business of the life insurer was conducted on sound financial lines. It also required him to advise the Board on his interpretation of 'policyholders' reasonable expectations' which was particularly important in framing bonus recommendations. Brindley et al (1992) recommended that appointed actuaries should draw boards' attention to areas of potential conflict between policyholders and shareholders, and recommend action to deal with potential conflict.

However, the role of the appointed actuary was very largely one of providing advice to the Board, with the exception of his responsibility for the valuation of long-term liabilities, which was carried out in a personal professional capacity.

GN1 required the appointed actuary to consider the interests of policyholders, but the appointed actuary was not required or expected to act as a 'policyholder champion'. Needleman et al (2002) felt that such a requirement would not be appropriate: "In the normal course of business a balanced approach is required and in exceptional circumstances, such as a reconstruction, a separate person may be appointed as a 'negotiator' on behalf of the policyholders" (p.35). They felt that, "It would be inappropriate to place the burden of ensuring that policyholder interests are adequately considered on any individual" (p.20).

There were concerns that the appointed actuary position may be unduly influenced by his being appointed by the board and, often, being an employee and a member of the management team (possibly a director) of the insurer (Sandler, 2002). Needleman et al (2002) believed that, for many insurers, there can be significant advantages in having an internal appointed actuary, who can be close to the business and able to influence the management of the insurer. However, this was not the only possible model.

Whilst it is common for a life insurer to have a nominated actuary with specific responsibilities, there is no uniformity internationally on how this is done. The International Association of Insurance Supervisors (2003b) compared the position of what they called the 'responsible actuary' in Canada, where there are some extensive responsibilities, with the French approach, where the actuary plays a relatively limited official supervisory role. IAIS did not express a view on whether a 'responsible actuary' regime should be implemented, but concluded that where it applies the actuary should have clearly defined tasks and responsibilities, as well as rights and obligations under the law.

The FSA has been keen to emphasise that it is the directors of a life insurer who are responsible for the management of the company, and whilst they can (and indeed would be expected to) take actuarial advice, the decisions they take should be theirs. FSA therefore

discontinued the role of the appointed actuary at the end of 2004, and introduced two new actuarial roles in with-profits life insurers: the actuarial function holder (AFH) and the with-profits actuary (FSA, 2002b).

The AFH is responsible for managing the actuarial functions of the life insurer. This is distinct from the role of the with-profits actuary, who advises the life insurer's senior management on key aspects of the discretion they exercise on the with-profits business (FSA rule SUP 4.3.16A). In advising or reporting on the exercise of discretion, the with-profits actuary should consider the implications for the fair treatment of with-profits policyholders (SUP 4.3.16B). The requirement that the with-profits actuary cannot be a director of the life insurer can help manage conflicts with shareholder interests; in contrast, the AFH can be a director.

There is some limited information on how this new regime is working. Kaye (2008) found that the typical remuneration of the with-profits actuary was less than expected and it may be that this role "is being taken by a more junior employee reporting to, and overseen by, an AFH who is on the board." She adds, "It is difficult to see how such an individual can find the conflicts of interest easy to resolve. In these situations, one wonders whether the new regime has fulfilled its purpose" (p. 41). This suggests that the new governance arrangements, which are part of the system for protecting policyholders, may not be working as intended.

The Independent Actuary

Where long-term insurance business is to be transferred from one insurer to another, the process involves the appointment of an independent expert (in practice, an actuary) to report to the court on the effect of such a transfer for policyholders' interests. This is a well-established procedure, and it may also be used in other major transactions. It appears fair to believe that this gives protection to policyholders that they would not otherwise have; after all, an insurer, when putting forward a proposed transfer of business, would clearly not wish to make a proposal that the independent expert regarded as detrimental to the interests of policyholders.

Some concerns about the independent actuary system were expressed by Paul (1996), who referred to firms proposing to restructure their inherited estate in the 1990s needing to obtain a report from an independent actuary. He said, "…independent actuaries will have differing views… I would go even further and suggest that there is a danger that the selection process could be biased towards the actuary most inclined towards the view of the party making the appointment" (p.677). We recognise that there is a limited number of individuals who commonly act as an independent actuarial expert, and who may be exposed to pressures. Nevertheless, the role of the independent actuary can be an important one in ensuring policyholders' interests are properly represented.

5.07. With-profits Committees

One option considered by FSA was a with-profits committee constituted separately from the Board: the Board would appoint external independent persons to be members of that committee. However, FSA felt that such a committee could be "distant" from the working of the company, and that this structure could impair the efficiency of the management of the company, for which the Board should remain responsible.

If the with-profits committee were a sub-committee of the Board, then this would fit more closely with the existing governance structures of company committees but could provide more transparency and accountability as to the interests of with-profits policyholders. This was the approach that FSA favoured. It therefore introduced a requirement for with-profits insurers to introduce an independent element into their decision-taking and most large and medium-sized insurers have chosen to have a With-profits committee.

However, this has not been operating satisfactorily. Dumbreck (2006) reported that most of his experience of with-profits companies suggested that, if there is a direct conflict between the interests of policyholders and shareholders, then, in the absence of strong protection for policyholders' interests, shareholders' interests are likely to prevail. The Pensions Institute et al (2007) investigated closed life funds, and were concerned to find that there was little independence in many committees, concluding, "Our research, therefore, identifies an

important area where policyholder representation and protection, in the context of managing the fund in the policyholders' best interests, is insufficient and flawed." AKG's (2008) survey also found what they regarded as insufficient independent members on committees. Furthermore, the FSA (2007a) also found some funds with minimal independence of input, or where the independent review had limited scope or was not provided with information on a timely basis.

The Treasury Committee (2008) was also concerned that the role of with-profits committees was restricted. It felt it important that committees have a strong, clear commitment to protecting and promoting policyholders' interests and it saw merit in the suggestion that the committees consider whether firms have treated customers fairly.

5.08. Policyholder Influence

Policyholders on Boards

It can be argued that with-profits policyholders should be entitled to elect board representation: they enjoy the same hopes as shareholders that profits will be made and similarly accept the risks that they may lose their capital if losses are made (Wallace, 1973).

Lord Joffe put forward an amendment to the Financial Services and Markets Bill which would have required proprietary with-profits life insurers to have policyholders represented on the board of directors. He was concerned by the conflicts that arose, such as:

- He felt that the compensation costs arising from the mis-selling of personal pension policies should have been met by the shareholders rather than the inherited estate; and
- Very large volumes of single premium with-profits bonds were being sold at 'extravagant commissions' of up to 6-7%, without which, policyholder bonuses might be higher.

Lord McIntosh replied that the issue would be considered by the company law review being carried out by the DTI, and the amendment was withdrawn.

The proposal was in fact considered by the FSA as part of its governance review (FSA, 2002c). While the FSA felt that this option would have the advantage of giving direct visibility to policyholders' interests in board discussions, policyholder elections would be expensive and possibly impractical; it would be difficult for the policyholder representative to represent all policyholders (bearing in mind that different classes of policyholders have different interests); and, unless there were a change in the law, the policyholder representative would have the full range of director responsibilities covering the whole of the company's business.

The Policyholder advocate

There were concerns in the AXA case, involving a reattribution of the inherited estate, that the views of policyholders were not properly represented. This led the FSA to implement new rules, requiring that any re-attribution of life insurance funds would have to involve the appointment of a Policyholder advocate whose responsibility it was to represent policyholders. This can involve extensive consultation with policyholders, including the use of open meetings. Doubtless there will be a number of issues to be considered following the first experience of the Policyholder advocate procedure.

Other possibilities

This leads on to the issue of whether there should be an ongoing means of policyholder views being expressed. While this would doubtless be uncomfortable for management it could help provide the accountability and transparency that is currently lacking.

One approach would be to consider the mechanisms used by mutual life insurers, whereby they have a report and accounts addressed to their policyholders, as members, and an annual general meeting. Myners (2004) was concerned to improve accountability of management further, and recommended that life mutuals should endeavour to put in place adequate arrangements to enable them to take account of members' views. He gave examples of

mutuals that have member panels, forums and councils, which were advisory rather than decision-taking.

The question this raises is whether some such ideas could be suitable in with-profits proprietary firms, where the policyholders usually have a 90% interest in the profits. The author's view is that this is worth exploring. In particular, the web could be used to facilitate collection of member views (as well as management communications).

The author's view is that improved links with with-profits policyholders should include more effective communication. While many proprietary with-profits life insurers do provide helpful information, this is not uniform. Insurers prepare an annual statement to indicate their compliance, or not, with their PPFM document, but this may turn out to be quite bland: a more satisfactory and coherent report would also include information on what have been the investment returns, payouts, expenses, etc, rather than merely indicating that outcomes were consistent with the PPFM. In addition, we have recognised the potential conflicts between stakeholders as regards the amount of capital held and the new business written. To help ensure that these conflicts are managed in a way that properly takes into account policyholders' interests, an annual report to policyholders could also include information on:

- the amount of new non-profit and with-profits business written in the last year, and the expected profitability to shareholders, existing with-profits policyholders and the inherited estate;
- the way in which management actions have been exercised over the year, (including changes in charges for the year), and their effect on the interests of policyholders and shareholders;
- the capital position of the fund, including the analysis of change in the inherited estate; and the way in which shareholders' capital supports the fund;
- the amount of policyholders' and shareholders' tax for the year and how these have been paid for;
- a report on transactions with related parties, such as management services agreements and intra-group reinsurances; and

- information on the board's deliberation regarding whether there is an excess surplus and whether retaining any such surplus is consistent with treating customers fairly.

However, these governance mechanisms will inevitably struggle when the with-profits product itself is complex and opaque. The business is based on smoothed asset shares but policyholders do not know their asset share or how the smoothing rule has affected them. It is not surprising that customers in the 21st century are unenthusiastic about such a policy; but there are still millions of existing policyholders needing protection.

6.00 Regulation

The need for financial services regulation is widely accepted, although there are disagreements on how much regulation is appropriate (Llewellyn, 1999; Benston, 2000). There are potential market failures that may lead governments to intervene in markets (FSA, 2006). Insurance raises some particular issues as imperfect and asymmetric information can lead to difficulties. For example, policyholders may know more about the risk being insured (for example, their state of health) than does the insurer. However, the policyholder may well know less than the insurer about the product on offer, which can expose the customer to mis-selling, especially when the selling is done by an agent who has incentives to earn commission. Further, the policyholder would not find it straightforward to judge the financial strength of the insurer and hence the likelihood that a claim will actually be paid. Insurers are also concerned about the potential for moral hazard: the way in which the policyholder may change behaviour once insured (for example, by taking longer to return to work if receiving a high level of sickness insurance benefit). Insurers have ways of countering moral hazard (for example, by limits on the amount of benefit payable), but customers need to understand this. In the case of long-term insurance, the timescales over which the risks are borne may result in further difficulties: for example, the difficulties in forecasting over a long period may mean an insurer sets prices that are unduly high or low, and customers cannot easily determine what, if any, insurance product will meet their needs.

We have seen a number of issues in with-profits life insurance, which is a complex product, with limited transparency and much discretion left to the firm. One of the tools available to regulators is ensuring that insurers define more precisely how they will operate with-profits business and communicate this to customers. This requirement for disclosure has increased considerably following the introduction of the Financial Services Act in 1988, and requirements for insurers to publish statements to policyholders at the point of sale, and upon acceptance of the contract. With Profits Guides were introduced in 1990, which provided further information on how with-profits funds were run.

The Financial Services and Markets Act 2000 led to further changes with the FSA becoming the industry regulator in 2001, one of the FSA's priorities was to carry out a 'With Profits Review', with several discussion papers and consultations leading to new rules that changed the regulatory environment significantly. The new conduct of business rules meant that, inter alia, insurers had to define more precisely how they calculated payouts on maturity and surrender, and there were new rules applying to how firms determine their investment strategy and manage risks. Insurers also had to issue PPFM documents (see section 5.2) and the rules require insurers to review, each year, whether they have complied with the PPFM, and report to policyholders accordingly. In 2004, the FSA introduced new rules that required major with-profits insurers to publish a 'realistic balance sheet[1]', enabling their financial strength to be better understood. Assessing the effectiveness of these changes is beyond the scope of this paper.

The FSA has recognised conflicts of interest in with-profits business, and a number of the conduct of business rules are specifically designed to minimise the likelihood of those conflicts adversely affecting with-profits policyholders. Naturally, a major point is that the insurer cannot increase the proportion of surplus distributed to shareholders without a strong and appropriate reason, and this was also addressed, prior to the FSA taking responsibility as regulator, under the Insurance Companies Act 1982. However, the FSA has also begun to

[1] This sets out the assets and liabilities of an insurer on a broadly market-consistent basis, and consistent with the way the business is operated, using asset shares.

address other areas of potential conflict, such as whether the insurer is retaining excess surplus and addressing the issues that arise upon major changes such as fund closure. We comment below on two particular areas: the amount of capital held, and the amount of new business written (and the terms on which it is written).

One issue is the amount of capital that the company holds. There have been, for many years, rules on the minimum capital that insurers must hold (the 'minimum solvency margin'), and the FSA has made innovative changes for major with-profits life insurers, associated with the 'realistic balance sheet'. It aims to ensure that the minimum capital appropriately reflects the risks that the insurer is running, providing a proper level of protection to policyholders, without (it is hoped) leading shareholders to have to maintain excessive amounts of capital in the fund, which could lead to competition in the industry being restricted.

The FSA has also introduced a rule (20.2.21) that requires with-profits life insurers to consider, annually, whether the fund has an excess surplus. The regulator ordinarily expects a fund to distribute any excess surplus (FSA, 2007b); in a 90:10 fund, 90% of the distributed surplus would be allocated to policyholders. The rule recognises the concerns that managers and shareholders may have incentives to build up capital. However, the rules are not clear on exactly how whether there is excess capital should be determined.

Another conflict concerns the writing of new business. The FSA's rule 20.2.28 indicates that new business must only be written on terms that are, "in the reasonable opinion of the firms' governing body, unlikely to have a material adverse effect on the interests of its existing with-profits policyholders". This recognises the concern that while managers and shareholders have a positive interest in new business, and may feel it is appropriate to write new business at a loss to the inherited estate, this may disadvantage existing policyholders.

The FSA (2008) has in fact indicated that "we do not allow new business to be subsidised… What we would not be allowing is a clear, unreasonable degree of subsidisation against what would be considered to be reasonable industry norms." We mention two points. First, one possibility is that an insurer does not charge explicitly for non-market risks, such as the

possibility that expense and mortality experience is more adverse than assumed, increasing the value of guarantees. That would be a subsidy, potentially disadvantaging existing with-profits policyholders. Second, one industry norm is, of course, the intergenerational transfers of the inherited estate, which means that new policyholders have, without payment, some expectation of a future distribution of the inherited estate: essentially a form of subsidy. It is, however, a well-established practice and the FSA has provided guidance that it does not object to this practice. Nevertheless, it has been challenged (see section 4).

7.00 Conclusion

With-profits life insurance business is characterised by the shareholders receiving a proportion of the distributed surplus. That proportion decreased over the 19th century, reflecting competitive pressures, and was 10% by the beginning of the 20th century. That proportion has broadly remained constant since then.

However, it is not clear that such a reward is a reward for the risks that shareholders are taking, consistent with a well-functioning competitive market. Indeed, in many firms, shareholders have been shielded from significant risks by having a substantial inherited estate, and have also been able to change the operation of the business by, for example, reducing the riskiness of the mix of investments, to reduce the risks that shareholders bear.

These questions regarding the size and nature of the rewards to shareholders in with-profits business raise wider questions about the nature of the with-profits product. The nature of the current with-profits model continues to be challenged.

While, in principle, the sharing of profits between shareholders and policyholders might be thought to align their interests, many conflicts remain. With-profits policyholders in a proprietary company, who are entitled to 90% of distributed profits, have a different role compared to the with-profits policyholders in mutuals, where they are entitled to all the distributed surplus. In proprietary firms, policyholders have less say in how the firm is managed, and receive less information about what happens. Although the FSA has introduced new rules on the governance of with-profits life insurers, the doubts that have been

raised about their effectiveness suggest a need for review. In particular, the author suggests that we consider mechanisms for involving and communicating to policyholders, which would bring more accountability to management.

The FSA has been very active in the regulation of with-profits life business. The author suggests that further work is needed to examine conflicts of interest and ensure that policyholders' interests are protected.

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