Has participating life business had its day?

Presented by

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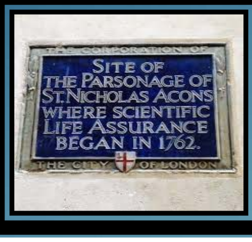
Agenda

- Par business – the basic proposition
- The UK experience – what went wrong?
- Managing market risk
- Handling conflicts and ensuring fairness
- Reorganising par funds

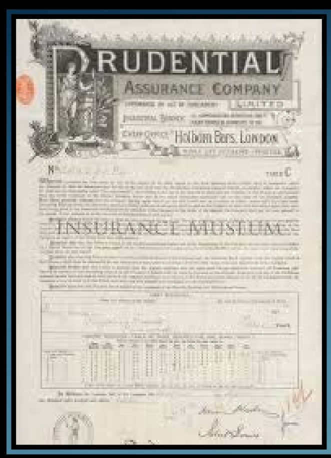
History of participating life assurance in the UK (1)

- Started with Equitable Life – founded 1762
- Bonuses originally designed to distribute mortality surplus
- Strong growth in the second half of 19th century, and many non-profit policies voluntarily converted to with-profits
- Increased investment in equities in the second half of the 20th century – further growth, mainly mortgage endowments and pensions
- Concept of "policyholders' reasonable expectations" introduced in 1973, but not defined
- Unitised with profits products started to displace conventional business in the 1980s



Par business: the basic proposition

- Benefit of some exposure to equity-type assets with reduced volatility and guaranteed underpin
- Considered suitable for mass-market savings over medium to long time horizon
- Relies on fair exercise of discretion by insurers…
- …and limited opportunity for anti-selection by investors



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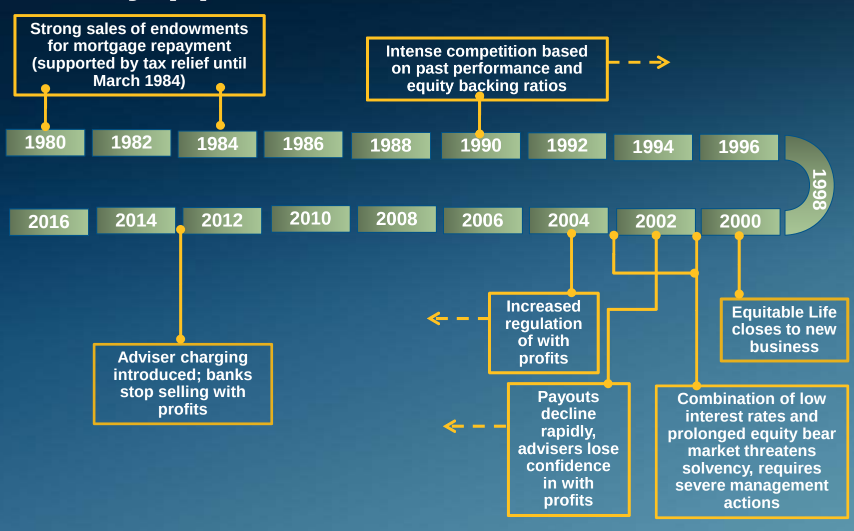
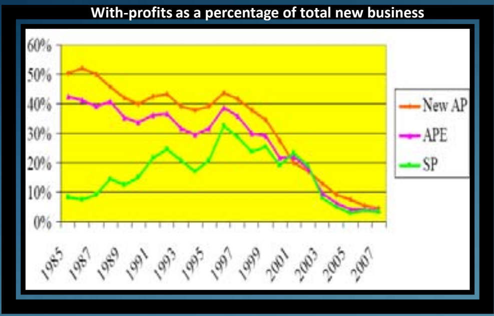
History (2): boom and bust



The UK with profits market: in decline

- At the end of 2009 there were 25 million with profits policies held with UK insurers representing £330bn of assets under management
- With profits policies as a proportion of total new policies written fell to around 3.7% in 2007 from 42.6% in 1985
- New business annual premium equivalent (APE)* almost halved from £1,129m in 1985 to £643m in 2007, and has continued to reduce since then
- Over the same period:
  - New linked business APE rose from £1,172m to £13,555m
  - New non-profit business APE increased from £349m to £3,260m



Source: The UK with-profits life industry: a market review – CD O'Brien

*Note: * new annual premiums + 10% of new single premiums*

UK participating endowment performance

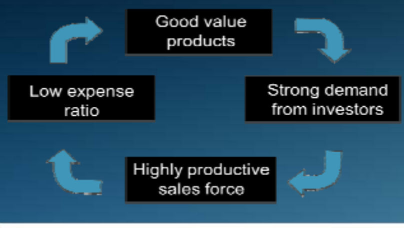
- Endowment policies have produced steadily declining maturity values as the high investment returns of the 1980s and 1990s have been replaced by the low returns of the 2000s

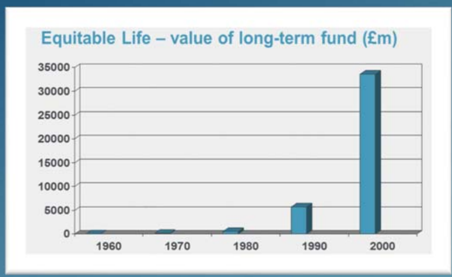
Payout from a 25 year endowment, £50 monthly premium (£)				
Year	General Accident	Friends Provident	Norwich Union	Standard Life
1995	108,081	100,271	92,457	103,704
2000	118,567	102,341	89,518	100,373
2005	57,223	45,295	48,451	51,219
2010	36,797	29,966	28,325	28,139
2013	28,757	29,586	27,330	27,303

Source: Money Management

Equitable Life – expansion 1960-2000

- Grew salaried sales force and focused on defined contribution pensions business
- Paid no commission to intermediaries
- Self-financing business model – mutual with no permanent capital, all profits distributed
- High proportion of business was participating
- Until 1988, all new pension policies included a guaranteed annuity rate (GAR) at retirement



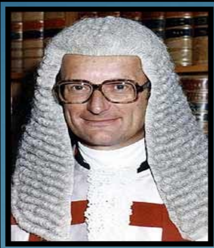


The Differential Terminal Bonus Policy (DTBP)

- Equitable Life held that the guaranteed minimum annuity at retirement was determined by applying the GAR to the guaranteed fund value
- Final bonus was reduced to neutralise the benefit of the GAR as far as possible
- The DTBP was introduced in 1993 but not explained to policyholders until they applied to take an annuity
- Some GAR policyholders argued that the annuity should be determined by applying the GAR to the full policy value
- As Equitable Life was a mutual with no estate, this inevitably implied a transfer of value to GAR policyholders from those without GARs
- The company funded a test case to resolve an increasingly damaging dispute

Equitable Life – decline 2000 to date

- At final appeal in July 2000, Law Lords decided DTBP was unlawful
- Company put up for sale but no buyer found
- Closed to new business in December 2000
- GAR compromise scheme in 2002 improved stability
- Penrose report in 2004 largely blamed management
- Annuity business sold in 2007
- Government compensation scheme announced in 2010
- Payouts now being uplifted by 35%



Closure of with-profits funds

Legal & General
The co-operative insurance
FriendsLife
PEARL
Scottish Life
Britannic
NPI An AMP Company
SUN ALLIANCE
Royal Insurance
Scottish Amicable
AXA EQUITY & LAW
Scottish Provident
Guardian Financial Services
PROVIDENT MUTUAL
Scottish Mutual

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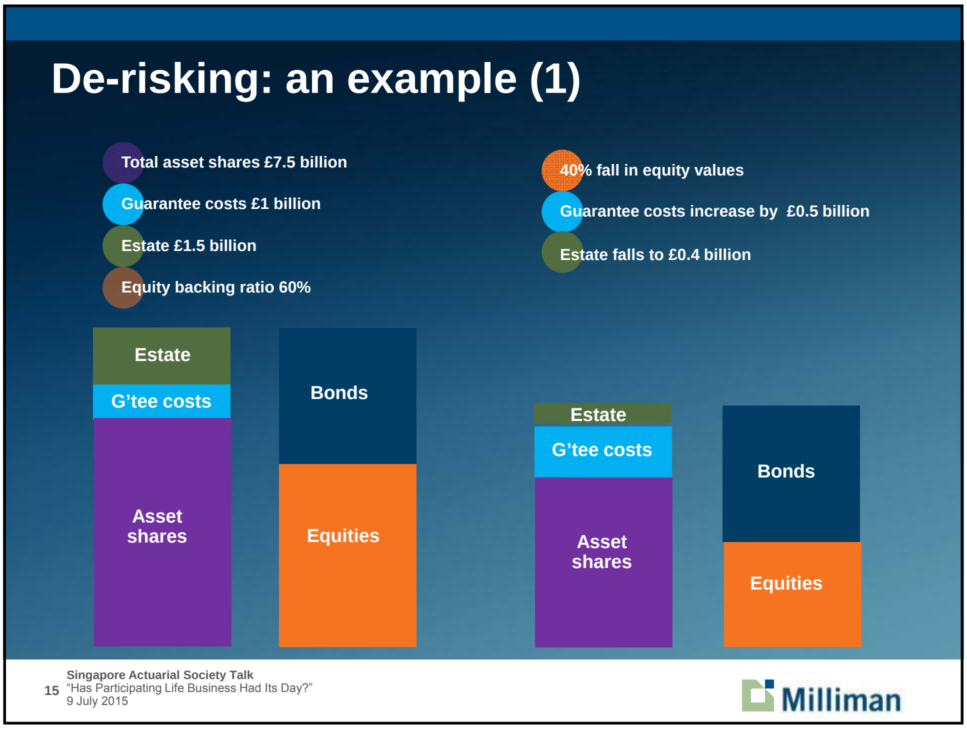
Managing market risk

- A lesson learned from the experience of UK par funds between 2000 and 2003 is that market risk requires careful management
- Risks are now hedged extensively, using both derivatives and internal dynamic hedging
- Strategies which lead to "selling cheap and buying dear" are avoided as far as possible…

…but markets continue to spring surprises


De-risking: an example (1)
Total asset shares £7.5 billion
Guarantee costs £1 billion
Estate £1.5 billion
Equity backing ratio 60%
40% fall in equity values
Guarantee costs increase by £0.5 billion
Estate falls to £0.4 billion
Estate
G'tee costs
Asset shares
Bonds
Equities
Estate
G'tee costs
Asset shares
Bonds
Equities
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De-risking: an example (2)
Keep same EBR for asset shares and estate but reduce overall EBR to 40%
Guarantee costs invested £2.4 billion in bonds and (£1.4 billion) in equities
40% fall in equity values
Guarantee costs increase by £0.5 billion
Assets backing guarantee costs achieve 56% return
Estate falls to £1.2 billion
Estate
G'tee costs
Asset shares
Bonds
Equities
Estate
G'tee costs
Asset shares
Bonds
Equities
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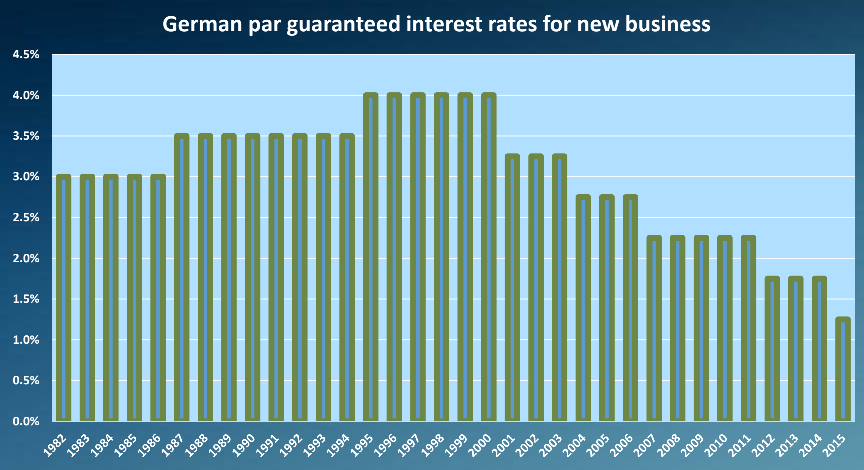
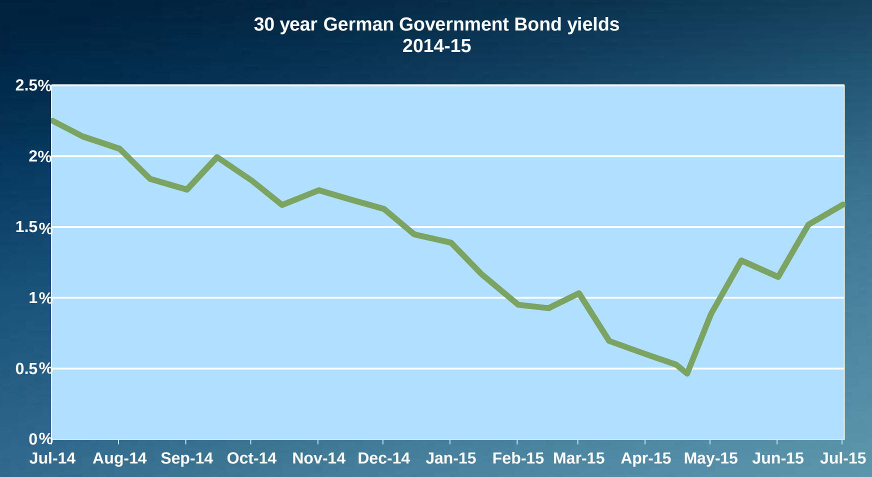
German par business guaranteed rates



German interest rates hit record low



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Regulation of participating business in the UK

- Governance was strengthened in 2004 in the wake of problems at Equitable Life by introducing
  - With profits committees (or other governance structures)
  - With profits actuary
  - Principles and practices of Financial Management (PPFM)
- Requirement for "realistic balance sheet" formalised
- Regulations were introduced covering:

Calculation of asset shares	Relationships with connected parties
Target ranges for payouts	Strategic assets
Expense and tax charges to par funds	Material transactions
Profitability of new business	Closure to new business

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PPFM

Some potential areas of conflict

- Charges from shareholder entities to a par fund
- Build-up of guarantees under par policies
- Guarantee charges
- Asset mix and hedging
- Volume and terms of new business
- Treatment of compensation costs
- Treatment of exceptional costs (timing)
- Distribution of the estate
- Smoothing and payout subsidies
- Market value reductions and surrender values
- Service standards
- Management actions

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Closed book consolidators

- Consolidators have acquired many of the closed par funds since 2004, along with non-profit business
- Main sources of profit are expense savings and release of surplus capital through restructuring
- Attempts to achieve incremental returns from adventurous asset strategies have been less successful
- Shareholder returns have been boosted in some cases by buying cheap and selling dear

ROYAL LONDON
ReAssure
Resolution
PHOENIX GROUP

Case study: Resolution Life

Year	Transaction	Price £	EV %
2004	Bought Royal & Sun Alliance life business	850 million	65%
2004	Bought Swiss Life UK	205 million	76%
2005	Merged with Britannic		88%
2006	Bought Abbey National life businesses	3.6 billion	97%
2007	Cash bid from Pearl Group	5.0 billion	120%

Managing a closed par fund: some issues

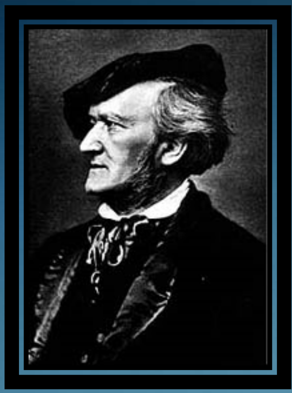
- Expenses – diseconomies of scale
- Asset mix and liquidity
- De-risking
- Non-par business in a par fund
- Fair distribution of the estate
- Scope for restructuring
- Eventual closure and conversion to non-par

Following closure, a company must:

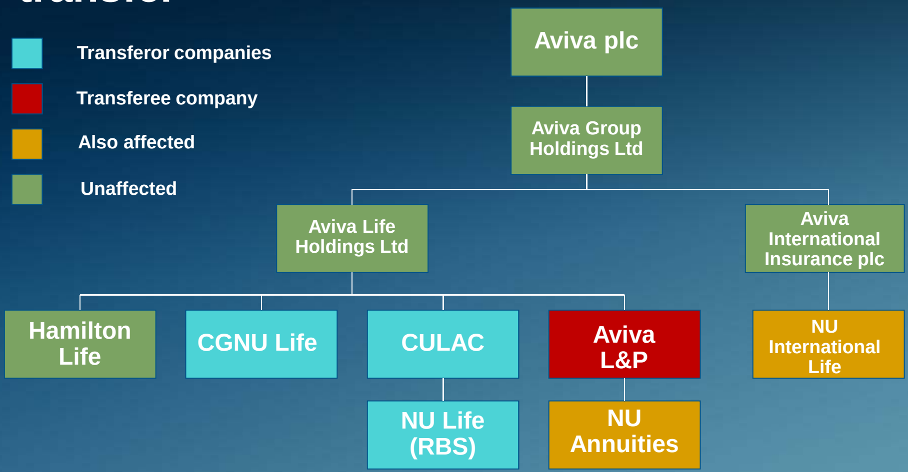
- Inform par policyholders within 1 month
- Prepare a run-off plan within 3 months

Case Study:
Aviva - Project Wagner

- The 90:10 with-profits funds of Commercial Union Life (CULAC) and CGNU Life (formerly General Accident Life) were transferred to Aviva Life & Pensions (Aviva L&P) and merged into a single fund
- Together with a reattribution of the inherited estates of CULAC and CGNU Life
- Existing Aviva L&P (former Norwich Union) with-profits fund remained separate and its estate was not reattributed



Aviva's UK life businesses before the transfer



The fund merger

- Merging UK with-profits funds is rarely attempted because of the difficulty in ensuring that each group of policyholders is treated fairly
- In this case the CULAC and CGNU Life with-profits funds were similar in size, asset backing and financial strength
- New business had been apportioned between the funds using reinsurance, with the proportions adjusted if necessary to reflect differences in the financial strength of the two funds

CGNU

COMMERCIAL UNION

The reattribution

Policyholders were offered a choice between
- accepting a policyholder incentive payment (PIP) in return for giving up their interest in the inherited estate, or
- forgoing the incentive payment but retaining an interest in the estate

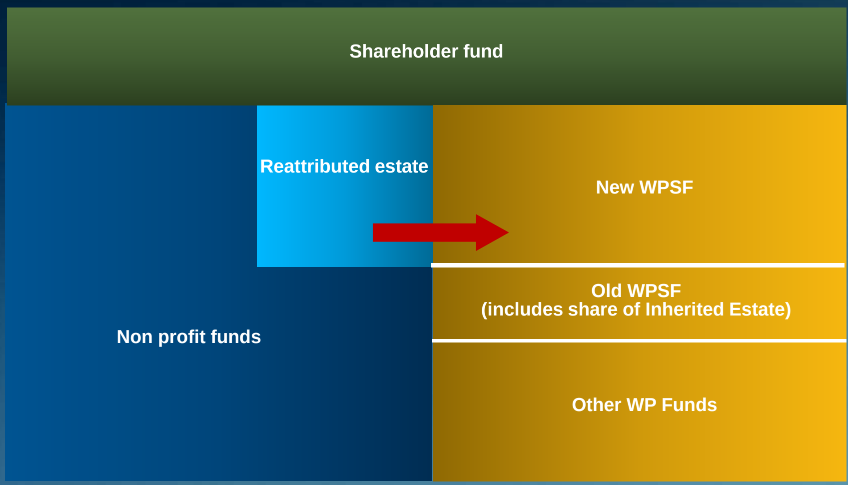
→ Two sub-funds were created, one (the New WPSF) for those who accepted the PIP, and one (the Old WPSF) for those who didn't

→ The Old WPSF received:
A share of the inherited estate, based on PIPs forgone ÷ PIPs offered,
plus
the realistic liabilities for policies allocated to the sub-fund

→ The New WPSF received only "enhanced aggregate asset shares", plus a contingent loan to cover the balance of its regulatory liabilities

→ The remaining assets were allocated to the Reattributed Inherited Estate (RIEESA) within the non-profit fund, which provided the contingent loan

Fund structure



Potential conflicts

- Minimum benefit guarantees for policies in the New WPSF are effectively charged to the RIEESA, which received the guarantee provision at the reattribution date…

  …so shareholders benefit from any reduction in guarantee costs
- New non-profit business may be written/strategic assets held in the RIEESA, which could reduce security for WP policyholders

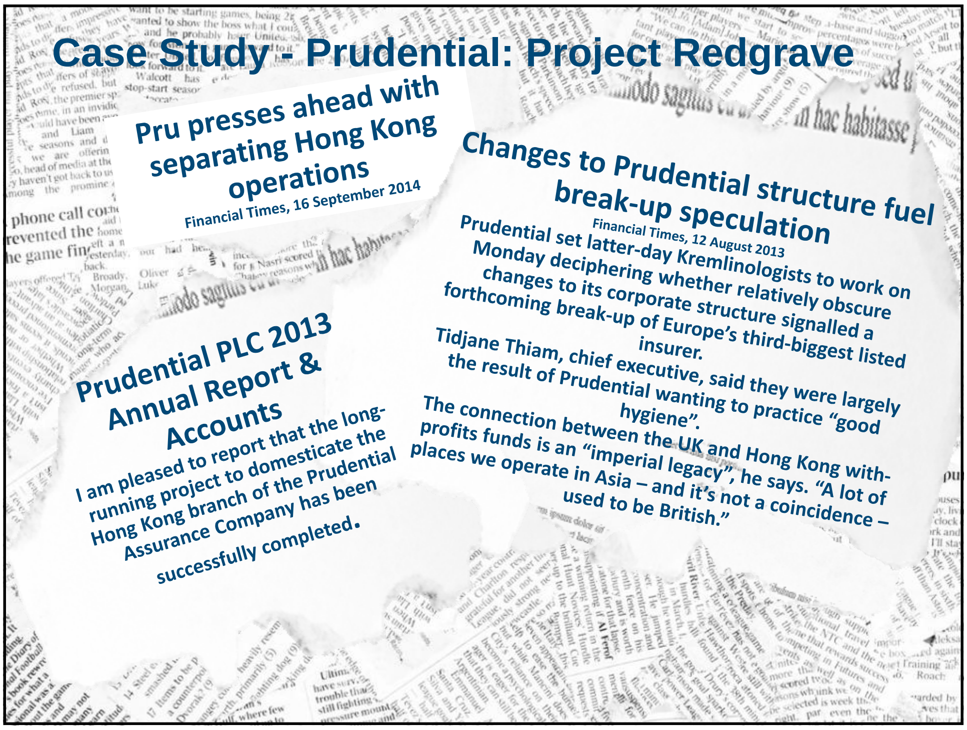
Operation of the sub-funds

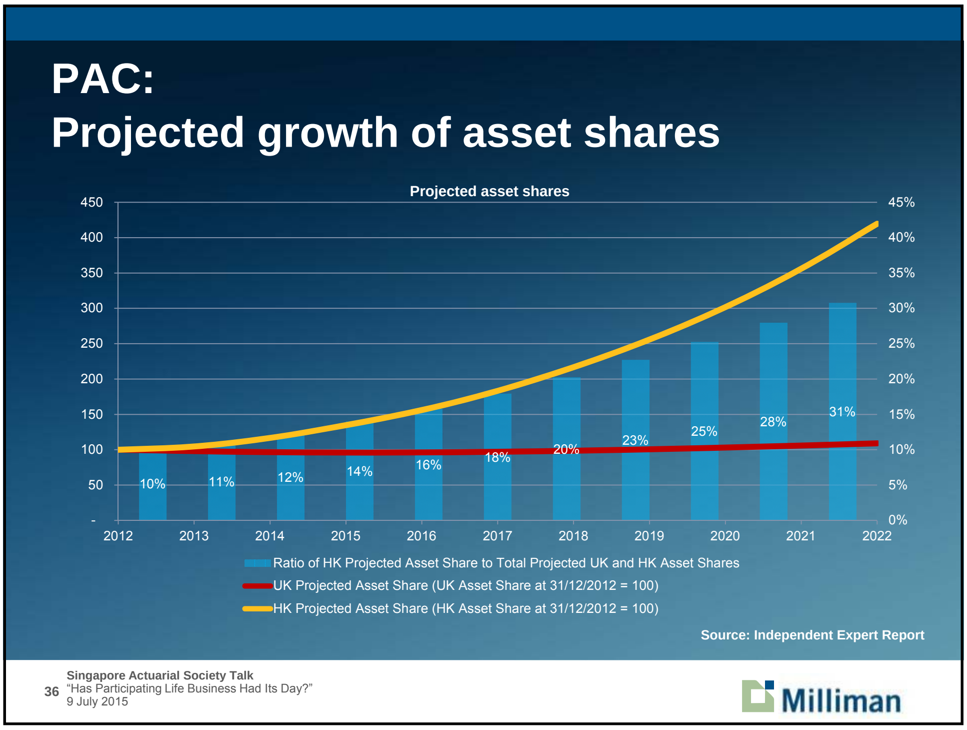
- The initial allocation of assets between the Old WPSF and the New WPSF was designed to achieve comparable levels of financial strength and, subject to that, to preserve the aggregate value of potential estate distributions to non-electing policyholders
- The two sub-funds are run in a consistent way and will normally be expected to produce identical payouts for equivalent policies, aside from any estate distributions to policies in the Old WPSF
- New with-profits policies, and those which were not eligible to participate in the reattribution, are split proportionately between the New WPSF and the Old WPSF
- Releases from the reattributed estate, and distributions from the estate of the Old WPSF, are based on financial strength criteria linked to risk appetite

Incentive payments

- Payable to eligible with-profits policyholders of CGNU Life and CULAC who remained invested in with profits from 21 November 2006 to the date of the reattribution (31 October 2009)
- Total value £470 million, compared to an inherited estate of £1.25 billion
- Allocated in proportion to a proxy for asset share, adjusted to reflect the potential interest of policyholders in future special distributions in the absence of the reattribution
- Paid as tax free cash in most cases
- Funded from other Aviva Group resources

Clare Spottiswoode
Policyholder Advocate


Case Study - Prudential: Project Redgrave
Pru presses ahead with separating Hong Kong operations
Financial Times, 16 September 2014
Changes to Prudential structure fuel break-up speculation
Financial Times, 12 August 2013
Prudential set latter-day Kremlinologists to work on Monday deciphering whether relatively obscure changes to its corporate structure signalled a forthcoming break-up of Europe's third-biggest listed insurer.
Tidjane Thiam, chief executive, said they were largely the result of Prudential wanting to practice "good hygiene".
The connection between the UK and Hong Kong with-profits funds is an "imperial legacy", he says. "A lot of places we operate in Asia – and it's not a coincidence – used to be British."
Prudential PLC 2013 Annual Report & Accounts
I am pleased to report that the long-running project to domesticate the Hong Kong branch of the Prudential Assurance Company has been successfully completed.


PAC:
Projected growth of asset shares
Projected asset shares
450
400
350
300
250
200
150
100
50
-
45%
40%
35%
30%
25%
20%
15%
10%
5%
0%
10%
11%
12%
14%
16%
18%
20%
23%
25%
28%
31%
2012
2013
2014
2015
2016
2017
2018
2019
2020
2021
2022
Ratio of HK Projected Asset Share to Total Projected UK and HK Asset Shares
UK Projected Asset Share (UK Asset Share at 31/12/2012 = 100)
HK Projected Asset Share (HK Asset Share at 31/12/2012 = 100)
Source: Independent Expert Report
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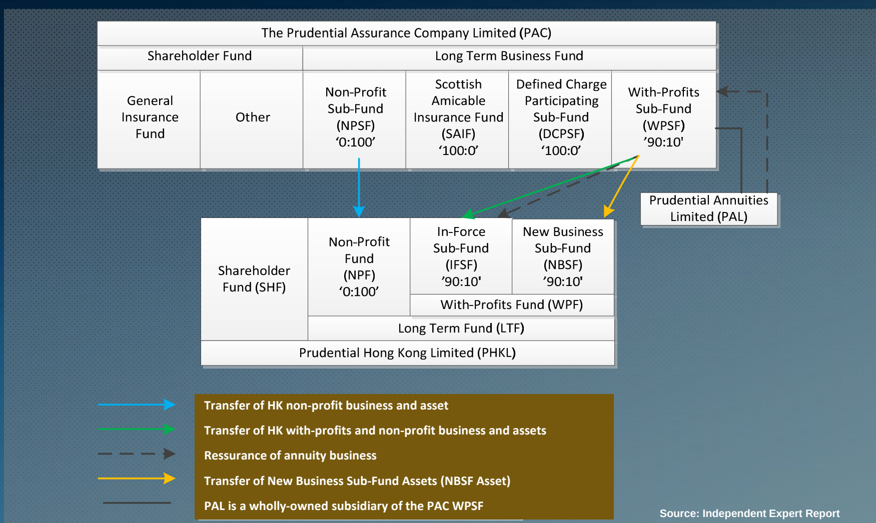
Project Redgrave: Main issues

- Alignment of risks
- Apportionment of the inherited estate
- Allocation of UK annuity business
- Protection of the interests of transferring with-profits policyholders
- Approval by UK and Hong Kong regulators and courts

Project Redgrave: structure diagram




Thank you
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