HYMANS ROBERTSON

With-Profits Market Report 2022

An overview and analysis of the UK with-profits market

March 2023

Welcome to our 2022 With-Profits Market Report

In 2022 the post-pandemic recovery made way for market volatility, high inflation and interest rate rises. Insurers continued to actively manage their with-profits business to protect policyholders and strive for good outcomes.

We are delighted to share our 2022 With-Profits Market Report, which covers the following areas:

Our report draws on the broad experience of our team of with-profits specialists who have played key roles in many high-profile with-profits projects, in the UK insurance industry. We take a closer look at a selection of these projects in the "Strategic changes to with-profits funds" section.

We saw significant market turbulence during 2022 with large increases in gilt yields and the increase in inflation being particularly notable. For example, the yields on 10-year gilts yields rose from under 100bps at the start of the year to over 360bps at the end of the year, while in late September the yields on 30-year gilts rose by c.120bps over three trading days. This caused a liquidity stress with insurers closely scrutinising their liquidity management processes. Inflation increased throughout the year, with the annualised Consumer Prices Index exceeding 11% in October.

We continued our regular With-Profits Community Events to share market insights with With-Profits Actuaries, With-Profits Committee members and senior With-Profits Practitioners on topical issues. We are delighted to say that these events continue to be superbly supported by our clients and we look forward to seeing many of you at our next With-Profits Community Event.

We hope you find our report helpful and we would love to hear from you if you have any comments or questions on any of the subject matter covered.

If you need support in managing any aspect of your with-profits business, we would be delighted to discuss your needs and how our specialists may help you. If this is of interest, please get in touch with one of us in the first instance.

Stephen Makin
UK Head of Insurance & Financial Services

Dan Diggins
Head of Regulated Roles

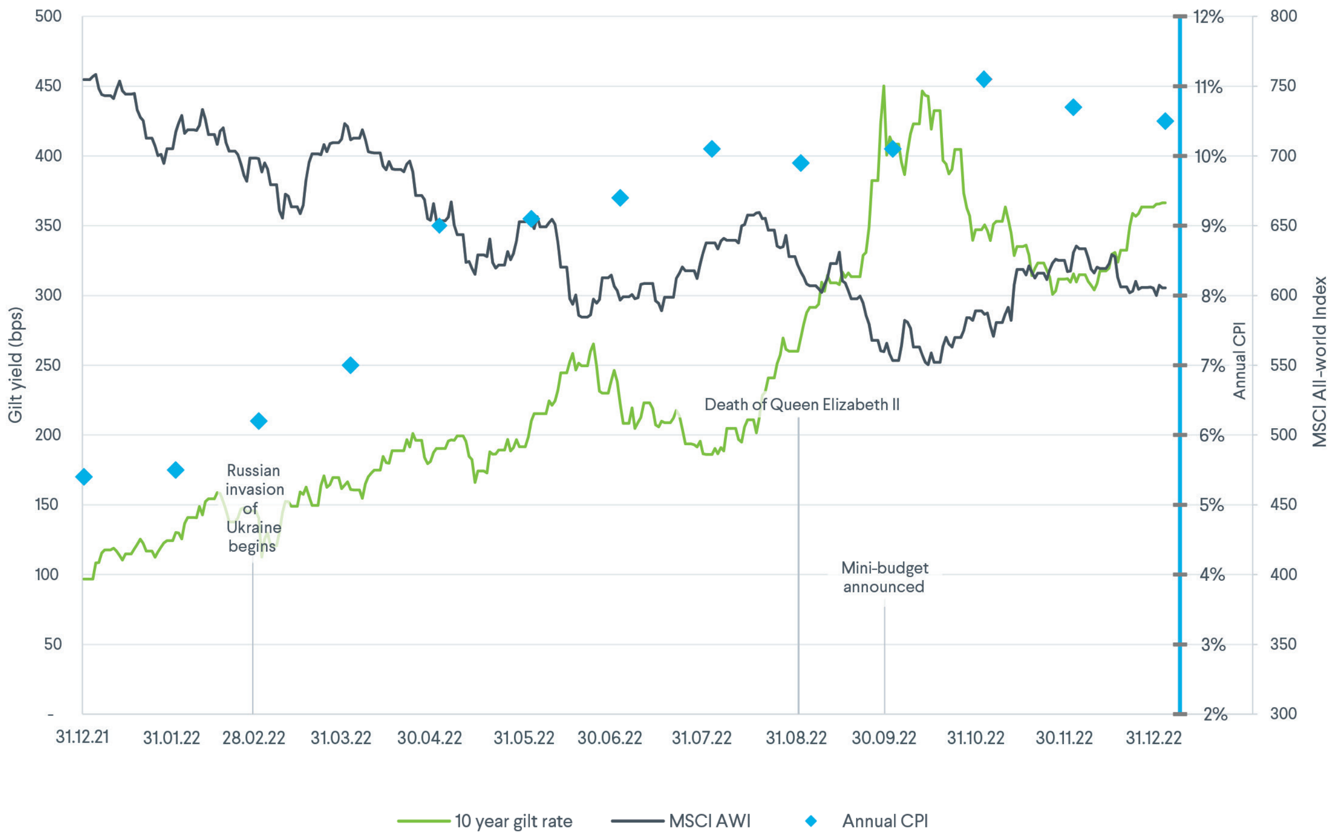
2022 in review

Following a period of recovery during 2021, the events of 2022 brought significant challenges to those responsible for managing with-profits funds.

The Russian invasion of Ukraine in February and the continued conflict throughout the rest of 2022 led to significant market volatility. The FTSE 100 fell to its lowest point in October but partially recovered in the last two months of the year. Global stock markets also struggled with the S&P 500 index falling c.15% over the year.

Many with-profits funds experienced negative investment returns over the year which was reflected in reduced asset shares.

In late September there was a liquidity shock prompting the Bank of England to intervene and managing liquidity became an issue for some with-profit funds as gilt prices fell materially, prompting large margin calls on the interest rate and currency swaps placing a strain on liquidity in some with-profits funds. For example, over three trading days 30-year gilt yields increased by 120bps and putting this into context, the November Bank of England 2018 Financial Stability Report stated "*a 100 basis point increase over a single day or a single week has never been experienced... over a month, it would be a 1-in-1,000 event*". As a result of these market movements, we expect that some insurers will review aspects of their liquidity risk management frameworks, for example by recalibrating their liquidity models or forward-looking stress scenarios and associated practices in light of these events.



Source: Bloomberg, DataStream, ICE, Hymans Robertson analysis

Inflation and the cost-of-living crisis

The high levels of inflation driven by increases in energy and food prices saw a cost-of-living crisis emerging. We saw some insurers increase their focus on key customer behaviour metrics, such as claims and surrenders. The early findings from the most recent FCA Financial Lives Survey that was published by the FCA in October 2022 noted that in May 2022 12.9 million UK adults had low financial resilience, an increase of over 2 million people since the previous Financial Lives Survey in February 2020. The survey didn't find as large an increase in the number of adults already in financial difficulty, partly due to savings accumulated during the pandemic. However, as the cost-of-living crisis continues, it is likely that more people will move from low resilience into financial difficulty, with the potential for a knock-on impact on persistency.

Regulatory Environment

The FCA's final guidance on the new Consumer Duty was issued in July 2022 and this is discussed in detail in the next section. With-profits funds arguably have a relatively strong starting position from which to demonstrate compliance with the new Consumer Duty requirements, however, more will need to be done to evidence good outcomes are being provided for all consumers.

Operational resilience and cyber security were also key themes for the FCA over 2022, with the new operational resilience requirements coming into force from March 2022, and full implementation expected by end-March 2025. Operational resilience is an issue that we have seen with a number of with-profits funds due to the dependence on legacy systems and is highlighted in our Operational issues for with-profits section.

In November 2022, HM Treasury published its final proposed Solvency II reforms, which have mostly been welcomed by the insurance industry. The focus on the reforms is a targeted 65% reduction in the risk margin and an increase in the eligibility of assets in the matching adjustment ("MA") fund. The reduction in risk margin is unlikely to have a significant impact on with-profits business, with the outcome potentially being a small release in capital which could lead to a slight acceleration of estate distributions. However, the impact on MA funds has the potential to reduce the cost to with-profits funds of de-risking annuity business and for contracts with guaranteed annuity rates ("GARs").

In summary

While the market volatility in 2022 caused significant demands on insurers managing with-profits business, the industry responded well, demonstrating resilience with actions taken to protect policyholder outcomes and the solvency position of with-profits funds. Some insurers are expected to revisit their liquidity management frameworks and this may have an impact on investment strategies. Although inflation is set to reduce mid-way through 2023, the cost-of-living crisis will continue to be felt by customers, and ongoing monitoring of key metrics such as surrenders and lapses will be needed to understand the impact on customers and consumer behaviour. New regulation continues and firms will need to do more to demonstrate good outcomes for their policyholders.

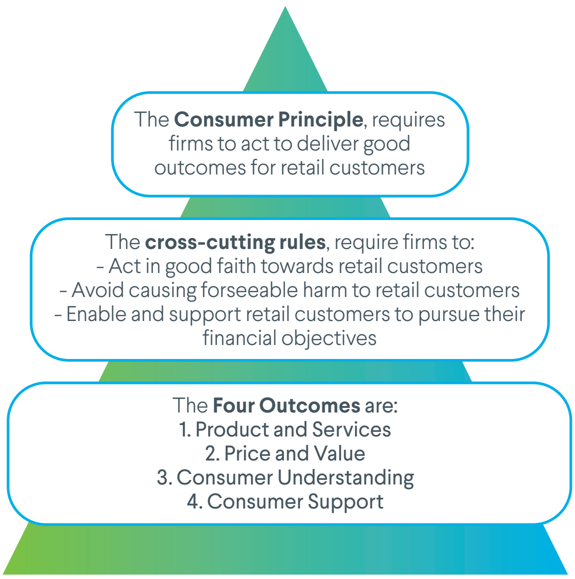
Rakesh Mazumdar
Consultant

Tina McNeill
Associate Consultant

The Consumer Duty: implications for with-profits business

The FCA issued its final guidance on the new Consumer Duty in July 2022. The Duty comes into effect for open books on 31 July 2023 and will apply to closed books on a forward-looking basis from 31 July 2024. This may mean a shift in thinking for with-profits management.

The Consumer Duty builds on previous guidance, such as fair treatment of long-standing customers (FG 16/8), fair treatment of with-profits customers (TR 19/3) and fair treatment of vulnerable customers (FG 21/1). However, the shift to outcomes-based regulation is significant and places an explicit customer focus at the heart of business decisions, with the requirement for firms to "act to deliver good outcomes" arguably going further than the previous requirement of treating customers fairly. The new Customer Duty is summarised in the diagram below:



Consumer Duty Outcomes & with-profits business

The FCA has set out more detailed expectations for conduct, across four key areas supporting the overall principle of acting to deliver good outcomes for retail customers.

1 Products and Services Outcome

The Products and Services Outcome requires firms to ensure products meet the needs, characteristics, and objectives of customers in the target market. It states firms should carry out regular reviews to ensure that the product or service continues to meet the needs, characteristics, and objectives of the target market. Firms should also ensure that the intended distribution strategy for the product or service is appropriate for the target market, a key consideration for open with-profits products. Insurers should consider reviewing all of their with-profits products to ensure they do not have "unreasonable exit fees" including penalties in respect of options and guarantees, to avoid causing harm to customers for whom their existing product does not best meet their needs.

2 Price and Value Outcome

Under the Price and Value Outcome, firms are required to demonstrate a "fair relationship between the price paid for a product or service and the overall benefit a consumer receives from it". Insurers should consider the nature of the product, the benefits that may be reasonably expected and the expected total cost that the customer would pay. The guidance states that insurers may consider market rates for comparable products and whether there are "products that are priced significantly lower for a similar or better benefit".

Assessing the relative value for money of a with-profits product is difficult, with comparisons between providers blurred by many factors (including differing target investment mixes, risk profiles, and patterns of estate distribution) and with direct comparisons to non-profit equivalents not capturing the benefits of smoothing and guarantees. When assessing the relative value for money for with-profits business, there will be many factors that insurers will need to consider, including:

Estate distribution: TR 19/3 highlighted a poor practice example of customers exiting a sub-fund not getting their fair share of the estate due to inadequate capital monitoring. Ensuring excess surplus is reviewed appropriately should form part of the overall assessment of value, not just for customers in closed funds but in all funds where new business is declining.

"Gone-away" policies: These policies are becoming an increasingly significant issue for many with-profits funds in run-off. Holding reserves for policies where there are unlikely to be claims risks delaying the distribution of surplus. FG 16/8 set out expectations for proportionate but robust tracing approaches and evidencing compliance with this guidance will also support compliance with the Duty. Distributing an appropriate release of unclaimed maturities and gone-away provisions could help ensure that customers leaving the fund are getting their fair share of the estate.

Charges: For with-profits business, a key challenge under the Price and Value Outcome is likely to be assessing whether policyholder charges for features such as smoothing and guarantees are appropriate and deliver sufficient customer value for the price paid. It will be important for insurers writing new with-profits business to monitor this on an ongoing basis.

3 Consumer Understanding Outcome

The Consumer Understanding Outcome builds on current guidelines, to ensure that communications will be understood by its customers, tailored to meet their needs, and allows them to make "effective, timely and informed" decisions.

The complexities of with-profits products are often difficult to communicate to customers. Many with-profits providers have already adopted a 'layering' approach, with key policy information provided directly to customers and additional information posted online. This outcome may require insurers to develop this approach further to ensure that customers are presented with relevant information at a suitable time, to enable them to make informed decisions on their with-profits policies – for example when making decisions about valuable guarantees and options.

Insurers currently monitor certain policyholder behaviours, for example, GAR take-up rates, but less is done in terms of monitoring the impact of communications on policyholder behaviour. For example, if clear communications were issued highlighting the value of GARs, would that lead to an increase in GAR take-up? The FCA has indicated it expects firms to be doing more for all communications. Therefore, further reviews and impact monitoring of all communications are likely to be necessary to demonstrate adherence to this outcome. In some instances, extending pensions-style "wake-up packs" to other non-pension products may be appropriate, alerting customers a number of times in advance of key dates and adding further detail each time.

4 Consumer Support Outcome

The Consumer Support Outcome is designed to enable and empower customers to make decisions without facing unreasonable barriers. The support or service that insurers deliver to customers should meet their needs, enable customers to "use their product as reasonably anticipated" and ensure that customers are able to understand and assess their options and risks.
For some with-profits business, legacy systems make it difficult to calculate surrender or transfer values automatically and manual calculations are needed. This approach means that processing claims or calculating values can take longer and could create an increased risk of incorrect pay-outs, thus creating "unreasonable barriers". Updating some of these systems, may reduce the risk of incorrect pay-outs, streamline processes, and reduce any perceived barriers.

A new opportunity

Enabling and supporting customers to pursue their financial objectives is one of the three cross-cutting rules under the Consumer Duty. Many of the key features of with-profits business are genuinely valuable to certain consumers, with smoothed returns and guarantees protecting customers from market volatility and unexpected reductions in pay-outs. A clear assessment of this target market, combined with the increased focus on good customer outcomes, could be an opportunity for innovation and growth of new business which incorporates some of the features of traditional with-profits products.

Conclusion

Establishing fair outcomes for policyholders has been a long-established principle for managers of with-profits funds. With the introduction of the new Customer Duty, insurers will now also need to consider establishing practices to demonstrate good outcomes for customers and the FCA are encouraging firms to not be complacent. There are a number of actions that with-profits insurers should consider, for example:

- Assessing their target markets and reviewing whether existing products meet customer needs,
- Assessing whether any existing product features, such as exit penalties, could cause foreseeable harm,
- Reviewing whether products are delivering sufficient value for money, for example considering whether the charges for guarantees and smoothing are reasonable relative to the customer value,
- Reviewing and monitoring communications, ensuring that these enable customers to make informed decisions, and
- Evidencing compliance with other FCA guidance, such as the examples noted throughout this section.

While With-Profits Actuaries and With-Profits Committees are not ultimately responsible for the implementation of Consumer Duty, they are well-equipped and ideally placed to support their Boards in preparing for Consumer Duty.

Rebecca Macdonald
Senior Consultant

Kirsten Wilkie
Consultant

Operational issues for insurers managing with-profits business

Many with-profits funds have been in a run-off for a number of years with little to prompt insurers to update their legacy systems and processes. However, there may be implications for conduct and operational risk, operational efficiency and resource flexibility.

For many years, life insurers have been grappling with the challenge of using and maintaining legacy systems and processes and, in the case of closed with-profits funds, there has been little to prompt firms to update these processes. However, outdated legacy processes can cause strain in a number of ways. They can be costly to maintain, resource-intensive and the level of manual intervention required by many increases the risk of error. Where these errors have the potential to impact policyholder pay-outs there is an increased risk of future remediation.

As the life insurance industry continues to evolve, there is a growing recognition of the need to modernise these legacy systems and processes. Using contemporary approaches and developing innovative solutions involving R and Python for actuarial work can help to create cost-effective, streamlined processes which require less manual intervention and have less associated operational risk.

We have identified a number of common triggers which may prompt insurers to update their legacy processes. These include:

Legacy software no longer being supported
The level of support from the original software provider may have ceased or reduced to a point that it poses an unacceptable level of operational risk. It can sometimes be better to make the necessary upgrades now to prevent issues from emerging in future.

Limited skill set leading to key person dependency
Some with-profits management teams rely upon a small (and decreasing) number of staff who have the required knowledge of legacy software and systems which may be many years old. This dependency and associated key-person risk may be unsustainable over the medium term. It can be better to standardise and streamline processes to facilitate greater resource flexibility.

“Black-box” processes
Some legacy processes lack the transparency and demonstrable efficacy required of today’s processes which should offer users the ability to interrogate results, check for reasonableness and to be able to understand what is driving the results. This lack of transparency creates work for the teams who need to understand the results and can lead to difficulties in identifying erroneous results.

The FCA's Consumer Duty (discussed in the previous section) may also prompt some firms to refine their processes as increasing volumes of granular data may be required to provide the evidence of good outcomes for policyholders. We are therefore seeing some insurers seeking to refine their with-profits (and other) processes, with aims to:

De-risk the processes:
Manual and spreadsheet-based processes are error-prone, leading to costly remediation projects when significant errors go unnoticed. Streamlined processes with automated (interim) results and transparent analyses reduce resource strain, manual intervention, and error risk, providing assurance to decision-makers.

Accelerate and enhance process efficiency:
Updated systems can be much more efficient offering quicker delivery times. As closed with-profits funds fall in size, greater efficiency can help to keep unit-costs under control.

Facilitate better resource management:
Automating and streamlining processes can free up valuable actuarial resources from mundane processing to make better use of their skills in analysis, problem-solving and decision-making.

Future-proof key processes:
As funds run-off, and the profile of the business changes, it may be necessary to make changes to certain processes (e.g. bonus methodology). New systems tend to be better placed to offer the flexibility required to allow for future changes.

Case study

Background

We recently worked with an insurer to update their bonus-setting processes for a portfolio of complicated with-profits products. The quarterly bonus-setting process required at least two members of their team and would typically take 12 to 15 days to produce bonus rates. On a number of occasions, the complex production process, combined with the time required to perform an adequate check and review had squeezed the time available for the With-Profits Actuary's review ahead of presenting the proposed rates to the With-Profits Committee. The actuaries' time was spent "turning the handle" instead of focussing their time on producing valuable analysis and insight for decision-making.

The process involved multiple spreadsheets, VBA and legacy actuarial modelling software which had been implemented over a decade ago. The original designers of this process had left the team and the knowledge of the process amongst those who remained was limited. The insurer had a "black-box" process and was looking to remedy the situation.

There were a number of operational frustrations that the client was seeking to solve. For example,

- A manually updated policy file which was maintained in spreadsheets and updated to reflect the evolving in-force population, according to a set of rules. This process was time and resource intensive and prone to error. Significant time was spent doing and checking the updates each quarter.

- A number of disjointed VBA scripts were used to assist in the preparation of data, but these relied upon careful execution by the user and would often fail.

- The legacy actuarial software was slow to run and inaccessible to the team. This meant that when errors occurred, which they frequently did, it was difficult to quickly identify the source of the error. The firm had made a strategic decision to move away from that particular software in the wider business and hence the pool of resources with those skills was diminishing rapidly. Maintaining the status quo was not a viable option. A number of "out of model adjustments" were also required resulting in another involved exercise which initiated a doing and checking process for the team before the bonus rates could ultimately be determined.

- The collation of model outputs, results and summaries was performed manually, prone to error and time-consuming.

Although there was no evidence of inaccuracy in the historical bonus rates, the opaque and complex nature of the bonus-setting process led to heightened and increasing concerns over the risk of errors. The insurer wanted to de-risk and future-proof their legacy processes while providing operational efficiencies, reducing key-person dependencies, and accelerating the production of accurate results.

The Task

The insurer tasked us with improving the bonus-setting process, and our initial deliverable involved conducting a comprehensive review of the systems, modelling software and data sources and creating a clear and comprehensive end-to-end process diagram which detailed every step in the bonus-setting process. We also proposed how we might approach improving the processes.

We were tasked with working closely with the insurer's with-profits management team to design, build, and implement a new solution. We brought our unique blend of actuarial and software engineering skills and leveraged open-source technology to produce a robust, largely automated, and actuarially sound solution with built-in self-checks and automated analyses supported by detailed documentation.

We conducted thorough testing, including unit-tests, back tests, and regression tests, to ensure the solution was robust and aligned with the insurer's needs. After successful delivery, we provided ongoing support in the form of demonstrations, workshops, and training exercises to ensure the insurer's with-profits team was well-equipped to use and manage the solution going forward.

The Result

The new de-risked and automated process accelerated the production of accurate bonus rates from taking two resources 12 to 15 days to a single user a few hours. As the new process could produce rates in a fraction of the original time, the actuarial resources are now able to focus their time on more value-adding activity including reviewing results and producing insightful analysis, rather than turning the handle.

The level of manual intervention was significantly reduced, while the extent and nature of checking was exponentially increased via automation and design. Hence the production of bonus rates was significantly de-risked – reducing the extent of rework required during the process and reducing the risk of future expensive remediation processes.

By simplifying the process and clearly documenting everything, the necessary level of transparency required by the insurer's with-profits team was provided and the "black-box" process was eliminated. We also provided training and a formal handover which, along with the documentation, meant that the client's team was well placed to own the new processes going forward and they could easily challenge or update the bonus methodology in future as required.

Rakesh Mazumdar
Consultant

Ross Bagley
Associate Consultant

Strategic changes to with-profits funds

A number of insurers are seeking to transform their with-profits funds using strategic actions to reduce sponsor risk and improve policyholder outcomes.

Drivers for insurers considering strategic transformation

Many drivers exist for the transformation of with-profits funds. In some cases, action has been driven by the run-off of the business with action taken before the funds are no longer viable. In other cases, insurers have acted earlier to take advantage of a greater range of options, which may lead to better outcomes, such as a more equitable distribution of the estate. Additionally, some insurers have considered merging funds or converting policies where the funds are expected to remain viable for many years.

Insurers with multiple with-profits funds may have a commercial desire to standardise the management of the funds to provide operational and oversight efficiencies. We have observed firms transitioning business onto more modern administration systems and aligning the methods to determine policyholder pay-outs. Where fund consolidation is achievable, there may also be an opportunity to reduce the time spent on assessing compliance with PPFM documents, reviewing run-off plans and assessing excess surplus.

Our team has significant experience helping a number of insurers implement strategic transformations, as illustrated in the following case studies.

Case study 1: Independent Actuary to the merger of Aviva's "FLC" with-profits funds

Aviva proposed the merger of two of its with-profits funds which required oversight by an Independent Actuary, as stipulated in the historical court scheme of transfer. The with-profit funds were originally one fund but had been split following the reattribution of the inherited estate. Those policyholders who chose to take a cash lump sum were allocated to the New Fund and those who didn't remained in the Old Fund.

As the Independent Actuary, our role was to provide an opinion as to whether there would be a material adverse effect from the merger. The review focused primarily on the impact on benefit expectations, which was informed by considering projections of pay-outs in the status quo and post-merger scenarios for a variety of model points. The projections were carried out based on both expected future experience and in stressed conditions, so that we could assess whether the merger's impact on both expected pay-outs was commensurate with the change in the level of risk to which policyholders were exposed. We also considered how sensitive the results of the analysis were to differences in the relative sizes of the estates of the Old and New funds at the merger date, which required us to form a view on how much the relative financial strength could change before the merger.

Case study 2: Independent review of the development of guaranteed annuity option pricing basis

A large number of policies in an insurer's closed with-profits fund had guaranteed annuity options (GAOs) and the capital requirements from these GAOs were constraining the rate of estate distribution in the run-off of that fund. When a policy vested, the closed fund would purchase an annuity from the firm's open fund, with the price based on prevailing market annuity rates at the time of vesting.

Our client proposed to transfer certain GAO risks from the closed with-profits fund to the open fund by fixing certain elements of the pricing basis for several years, with extra margins being added to the basis to allow the open fund to make a commercial profit in exchange for accepting the extra risks. Our independent review of the proposals assessed whether those margins were fair and commensurate with the risks being transferred, having regard to the market prices of other risk transfer mechanisms such as reinsurance.

Case study 3 : Independent review of the internal reallocation of non-profit annuity business

We supported an insurer to reallocate a large amount of non-profit annuity business from a closed with-profits fund into another open fund. The reallocation was part of the insurer's plans to de-risk the closed with-profits fund and release capital in that fund to facilitate the future management of the estate. The proposed reallocation would also offer the open fund the opportunity to generate a commercial return in return for accepting the reallocated annuity business.

Our role was to provide an opinion on whether the proposed pricing of the reallocation would be fair to policyholders in both the closed with-profits fund and the open fund. Our opinion also considered whether the proposed reallocation would be expected to satisfy the requirements of the PPFM and the historical court scheme. To form our view, we performed a bottom-up review, which looked at management's processing of the underlying data, the approach to pricing and the appropriateness of assumptions used for the reallocation, and a top-down analysis which considered whether the cost to the with-profits fund was reasonable relative to the capital released and the improvement in its risk appetite position. We also considered whether the price would result in the open fund receiving an appropriate return on capital and whether the price would be expected to remain reasonable under a range of circumstances and scenarios.

Case study 4 : Independent peer review on commercially sensitive strategic projects

A number of clients have sought an independent peer review from our team when proposing to implement strategically important and commercially sensitive projects. For example, our independent peer review was sought by the Chief Actuary and With Profits Actuary on a proposed restructure of their business with the focus of our peer review being the actuaries' reports.

Case study 5 : Independent Review of the mutualisation of a 90:10 block of business

Our client was an insurer with a 100:0 with-profits fund that contained a block of business that had been acquired from another firm. The main fund's estate was entitled to receive one-ninth of the profits distributed to policyholders in this block of business, and the firm proposed to buy-out future transfers in exchange for a one-off deduction from asset shares.

We carried out an independent review to assess whether this was fair to both the affected policyholders and other policyholders in the main fund.

Dan Diggins
Head of Regulated Roles

Rebecca Macdonald
Senior Consultant

Stephen Makin
UK Head of Insurance & Financial Services

Kirsten Wilkie
Consultant

London | Birmingham | Glasgow | Edinburgh

T 020 7082 6000 | www.hymans.co.uk