With-profits, but without much hope for policyholders

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The latest battle over with-profits is remarkable largely because John Chapman, the independent consultant, has called for the sector to be wound up rather than run down over the lifetime of the longest policies in force. Chapman is a respected financial writer who regularly analyses with-profits payouts and capital strength for the professionals' magazine, Money Management.

He first floated the idea of closing the entire sector to new business in a paper commissioned by stockbrokers in July 2001. He saw the only alternative as reforms that would make the contract totally transparent and remove much of the life companies' discretion over payouts. Two things have happened since: The FSA and the industry have together worked out a set of reforms, but have stopped short of transparency of "asset share". This is the market value of the policyholder's share of the with-profits fund, based on the returns earned on their own premiums and their share of costs. It is the one thing that has to be transparent if investors are to make rational decisions about their existing positions. Many funds have closed to new business but, without transparency and effective limits on management discretion, their policyholders are at even greater risk. Chapman rightly notes that some of these are shareholder-owned funds that in several cases stripped capital out before putting them back on the shelf to stew.

I have rarely disagreed with Chapman's technical analysis and share his view of the governing principles in this debate. But I have had a different take on the strategy the FSA and the industry should adopt.

Having a background in modelling financial markets, my insights were into the fallibility of trying to smooth the path of market returns and inflation, aggravated in this case by the dynamics of the interaction between market paths and reserve requirements.

I concluded several years ago that the reform option was not viable. I have since demonstrated my case, as it applies to traditional policies with guarantees, later "unitised" policies with MVAs, the proposed reformed contracts and new "smoothed investment funds", using the same principles and techniques as actuaries themselves. In public comments I have avoided making charges that apply to all investments rather than with-profits only.

In 2000 I started recommending the voluntary wind-up of the with-profit s sector at asset share, giving policyholders the option to transfer at market value into direct investments before it was too late.

"Too late" could mean two things: The Equitable debacle showed that, once a company has angered its policyholders, it has little chance of selling them an alternative product with the same brand. A voluntary wind-up can be instigated for traditional policies only if the assets cover policyholders' guarantees, so it is not a strategy for a bear market.

It may now be too late. Rightly or not, cuts in bonus rates have eroded the good will life companies need to shift their own business model and customers' assets from with-profits to direct investments, where they compete with non-insurance providers.

The fall in the value of the assets has left many closed funds' assets below the level of policyholders' guaranteed benefits. By any conservative measure of accounting, recognising as a liability the policyholders' one-way option on future market movements, they are insolvent.

Against this background, two attacks on Chapman's article in your letter columns appear disingenuous. They were from Mary Francis, director-general of the Association of British Insurers and Ian Maidens, principal of consulting actuaries Tillinghast-Towers Perrin.

It is right that weak funds should close to new business rather than dilute already thinly stretched capital, and it is not true that this necessarily means all closed funds are "distressed". Neither is it self-evident that closed funds will treat policy holders less fairly than an open fund that has the discipline of marketing new policies. In fact, it is marketing departments, inadequately reined in by actuaries, that have done most damage to policyholders' capital.

But it beggars belief to look back at the generosity of past payouts, including for closed funds, to justify continuing confidence in with-profits. But that is what both letters do. Are they really confusing the source of the problem with a job well done or are they out to confuse us?

There is no question that policyholders in a closed fund have more to fear. The main reason is that these are the weakest funds. They therefore fit accurately the general prognosis that weak companies are more likely to pursue a bond-orientated strategy that does not fit the risk preferences on which the original contract was based. They increase the probability of failure to hit a nominal return target (like mortgage repayment) and increase exposure to inflation risk for real return targets (like pensions). They are more likely to have lower returns because of this asset mix difference, increasing the share taken by costs. The cost share will also rise as the pool shrinks.

To overcome the cost wedge they are more likely to seek higher income by junking the credit quality of their bond portfolio. They are also more likely to have inbuilt inequity because policyholders without cover for their guarantees will be subsidised by those who still have it.

The with-profits debate always comes back to secrecy about asset share. It would be far less likely to play as a nightmare if people could make an informed choice about whether to stay or go.

Stuart Fowler is a consultant and long time critic of the with-profits industry.