Financial Services Authority

A Description and Classification of With-Profits Policies

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Objective

1. This paper seeks to provide a broad classification of the different types and features of with-profits policies, and the most common methods of operation of a with-profits fund containing such policies. It is intended to serve as a reference document that sets out in a factual way the main practices and principles applied to with-profits business. Some of the issues and concerns arising from these practices and principles will be covered in a series of Discussion Papers to be issued during the course of the With-Profits Review.

2. The paper is not exhaustive, however the FSA has tried to ensure the descriptions given are as inclusive and as accurate as possible. Comments and corrections will of course be most welcome and should be sent in writing to the Project Manager:

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3. A glossary of with-profits terms is attached at Annex A.

Characteristics of With-Profits Policies

4. This section sets out some of the main characteristics of the various types of with-profits, classified under the following headings:

   - Purpose
   - Forms of premium payment
   - Types of benefit

- Types of policy
- Basis of profit participation
- Basis of profit sharing

5. A matrix summarising the main characteristics is provided at Annex B.
6. With-profits products have certain features that normally include:
    - The use of premiums to invest in a pooled fund made up of a range of assets, a significant proportion of which are usually in the form of equities and property;
    - The 'smoothing' of the amount of claim payments to cushion the policyholder from the extremes of fluctuations in the property and equity markets;
    - A share in certain of the profits or losses of the insurer, often including those arising from mortality risks and expense risks, and any distributions from the inherited estate;
    - Certain guarantees, which usually increase over the lifetime of the policy. For example the payment of a guaranteed amount at maturity or retirement, or on death.

Purpose

7. With-profits policies are long-term in nature, and the majority of policies have one of the following aims:
    - To repay a mortgage;
    - To finance a pension;
    - To provide a regular income from savings;
    - To serve as a general investment/savings vehicle.

    All policies will also contain life insurance within them, the precise extent of which will depend on the policy's purpose and form.
8. With-profits policies are marketed under a wide range of names that are usually chosen by the insurer to reflect a particular aim of the policy on offer, such as the 'Lifestyle Saver', 'Balanced Accumulator' or the 'Pension Builder'. On a wider level there are also industry terms for generic products marketed to consumers, such as *With-Profits Bonds*. Where possible, descriptions in this paper have been cross-referred to common generic terms, but no attempt has been made to list the large variety of marketing names.

Forms of Premium Payment

9. A policyholder purchases a with-profits policy through the payment of *premiums*, either as:

- A single lump sum, known as a *single premium*;
- A series of non-contractual lump sums, known as *recurrent single premiums*;
- A series of regular contractual amounts, known as *regular premiums*. Regular premiums are usually paid monthly, but could be more or less frequent.

Types of Benefit

10. In return for the payment of premiums, which will be invested in a pooled fund, the insurer will provide benefits in the form of either:

- A cash amount, or
- An *annuity*.

11. The benefit payable on death, and often on some other specified date(s), will be subject to a minimum *guaranteed amount*. The amount of benefit payable at other times, such as on *surrender* of the policy, will usually be subject to the discretion of the insurer. The guaranteed amount, at least initially, will often be set at a level that represents a return of policyholder premiums less expenses. Policies may have included in their design an assumption of some modest future *investment return*, leading to a higher guaranteed amount being offered. The structure of the guaranteed amount depends to a large degree on whether the policy is of a *conventional form* or *unitised* form.

Conventional with-profits policies

12. Conventional, or traditional, with-profits policies have been written since the late 18th century. A conventional policy has a clearly defined initial guaranteed amount (known as the *sum assured* on non-pension policies).

13. The guaranteed amount is increased from the initial level throughout the duration of the policy by the addition, usually annually, of *regular bonuses* (also called *reversionary bonuses*), which once added cannot be removed. Regular bonuses may be expressed in one of the following ways:

- A simple bonus as a percentage increase to the initial guaranteed amount;
- A compound bonus as a percentage increase to the initial guaranteed amount and total amount of regular bonuses added to date;
- A super compound bonus as a percentage of the initial guaranteed amount plus a higher percentage of the total amount of regular bonuses added to date.

14. The regular bonus rate declared by the insurer will be the same for all policies within a class of policies (grouped according to factors such as policy type, the level of guarantee included and the date it was taken out), but can vary between different classes. The regular bonus is added retrospectively. Bonus rates declared in the future can vary up or down.

15. The current guaranteed amount (the initial guaranteed amount plus the total of any regular bonuses and interim bonus added) will be paid when a claim is made on death, maturity or retirement usually together with an additional, discretionary, *terminal bonus*. Terminal bonus usually varies within classes of policies, for example by calendar year of issue or payment of premium. The addition of terminal bonus is usually the method by which the insurer targets the total benefit considered to be appropriate for the policy. The level of terminal bonus that will be paid on a claim may be set infrequently, perhaps only once per year, or may be adjusted repeatedly over the year.

16. Whilst conventional policies have a guaranteed amount payable on death, maturity, retirement, the benefits that would be payable at other times on *surrender*, *transfer*, or partial withdrawal, will be at the discretion of the insurer. Nowadays a terminal bonus is usually paid on surrender (see paragraph 58).

17. At the end of 2000 the amount of with-profits business in force was £345bn, of which £164bn was conventional with-profits business. However, few insurers now offer such policies and the majority (87%) of new with-profits business is written in unitised form.

Unitised with-profits policies

18. Unitised with-profits policies emerged in the early 1980s as a means to provide policyholders with greater flexibility over the timing of the premiums they wished to pay and to facilitate, through a single policy, partial investment in the with-profits fund and partial investment in other, *unit-linked*, funds offered by the insurer. Such policies may also provide the policyholder with the opportunity to switch between the two types of fund.

19. Premiums are used to purchase units in the with-profits fund at the current unit price. Two basic types of unitised with-profits fund are operated:

    - Fixed price: where the unit price does not vary. When a regular bonus is added, extra units at the same price are allocated to the policy;
    - Variable price: where the unit price is increased through the addition of regular bonuses, and is guaranteed not to fall. The commonest method of allocating the bonus is by daily increases in the unit price throughout the year.

20. Regular bonuses on unitised policies are announced on a prospective basis (with the actual amount added possibly being higher or lower than indicated at the outset). Certain policies however may include in their terms the addition of a minimum level of regular bonus. The guaranteed amount payable under a unitised policy is the number of units allocated to the policy times the current unit price. This is known as the *face value of units*. A terminal bonus may then be added to this amount. On dates where the guaranteed amount does not apply, the payment to the policyholder could be reduced in certain circumstances, at the discretion of the insurer, below the face value of units. This is effected through the application of a *market value reduction* or MVR (see paragraph 76 below).

21. Dates when the guaranteed amount applies as the minimum amount which will be paid on a claim can also be termed 'MVR free' dates. Such dates can be whenever the insurer has specified when designing the policy, and set out in its literature. However, the guaranteed amount normally applies on death, on retirement and, for certain *endowments*, on maturity. With-Profits Bonds may offer the guaranteed amount at specified dates in the future, such as the tenth anniversary of the policy and every five years thereafter. Alternatively, or as well, there may be a facility to take a regular income from a Bond by surrendering some, but not all, of the units which will be free of a MVR if the amount is below a certain size (for example, up to 5% of the face value of units).

22. Some With-Profits Bonds offer reduced 'guarantees' or soft 'guarantees', whereby the insurer states that it is its normal practice not to apply a MVR on certain published dates or actions or on amounts below a certain size, but reserves the right to change its practice in exceptional circumstances.

Types of Policy

23. With-profits policies come in a variety of types and legal forms with respect to how long they last, what events will trigger a claim payment, and how any guaranteed benefits are expressed. The main with-profits policy types, all of which can be written in conventional or unitised form, are as follows:

- Whole life policy
- Endowment policy
- Pension policy
- With-profits Annuity

Whole life policy

24. These policies are open-ended with no defined maturity date at which benefits must be taken, other than on death. Premiums may, however, cease at a defined age. Since there is no defined maturity date, the taking of the benefits, which

are in the form of a cash sum, by the policyholder is equivalent to a surrender, or withdrawal, from the policy. A policyholder may also choose to surrender the policy in part only, often to achieve a regular income, leaving the remainder of the policy to continue in existence with a reduced level of benefit.

25. This type of policy is the basis for With-Profits Bonds which are sold as single premium investments. Even though in the form of a whole life policy with no defined maturity date, the contract provisions of such Bonds may offer certain selected dates on which a guaranteed amount can be taken on surrender, or on partial withdrawals of amounts below a certain size (see paragraph 21 above). In addition, there may be a defined 'maturity date' such as 15 years or age 85 whichever is the later.

Endowment Policy

26. These policies have a defined term from the start of the policy to a maturity date on which the benefit, in the form of a cash sum, will become payable if the policyholder has not previously died or surrendered the policy. A guaranteed amount will be paid at the maturity date provided the investment (payment of premiums) is kept up by the policyholder until the maturity date. This type of policy has been used extensively for the purposes of general savings and investment, often with a 10 year term, and for the repayment of mortgages where a target sum is required on a specific date, with policies written for far longer terms of 25 years or more.

27. Pension policies purchased to save for retirement usually now take the form of an endowment, with the policy delivering a sum on the date of retirement in a similar way to delivering a sum at maturity (see paragraph 28 below). However, to accommodate flexibility over when the policyholder retires a series of maturity dates, or even a range of years (sometimes as wide as ages 50 to 75), may be defined rather than just one date.

Pension Policy

28. As noted above, pension policies are now usually written in the form of an endowment. The policyholder is provided with a cash sum on the retirement date, which is subject to Inland Revenue rules that require that at least part of the cash sum must be used to purchase an *annuity*. The annuity may be purchased from the original insurer, or alternatively the policyholder may transfer the cash sum and purchase an annuity from a different insurer. The latter option is commonly called the 'open market option' or OMO. Benefits on death under the pension policy may range from a return of premiums (with or without interest) to a return of the accumulated fund.

29. Although no longer written there are still in existence certain older forms of pensions policies where the defined benefit at death or retirement is an annuity rather than a cash sum. These type of policies are often referred to as

deferred annuities, and bonuses added during the course of the policy will be expressed as an increase in the amount of annuity payable per annum, rather than as increases to a cash sum.

30. Either of the above forms of pension policy may include in their terms an option that enables the policyholder to convert the cash sum at retirement to an annuity from the original insurer at a rate defined at the outset of the policy (a *guaranteed annuity rate or GAR*) or, in the case of deferred annuities, to convert the annuity offered into a cash sum at a rate defined at the outset of a policy.

With-profits annuity

31. A policyholder on retirement may choose to purchase a with-profits annuity policy. This type of policy emerged recently due to policyholders wishing to remain invested in equities after retirement, given the expected out performance of equities in the longer term over fixed interest investments. The latter are normally used to support payments made under a standard, non with-profits, annuity.

32. A with-profits annuity policy invests in a mixture of assets including equities. The benefit is an annuity, to which a bonus is added each year in the form of a percentage addition to the annuity payment.

33. Policies usually provide for the policyholder to select an anticipated bonus rate (ABR) at the outset (currently typically in the range 0-5%). In contractual terms the annuity reduces in amount each year by the chosen ABR, but with the expectation that the amount will be restored through the annual addition of bonuses. The higher the ABR selected, the higher will be the starting amount of the annuity. Depending on the level of bonuses actually declared each year, and the level of ABR selected, the annuity in payment can increase over time, remain level, or decrease. Policies may also provide that under no circumstances will the annuity fall below a minimum amount (commonly know as the ‘floor guarantee’).

Industrial/Ordinary Branch business

34. With-profits policies written by insurers can be further divided as to whether they are Industrial Branch business or Ordinary Branch business. Industrial Branch business is characterised by regular premium policies where the premiums are collected door to door. Industrial Branch business is subject to legislation dating from the early 20th century and historically has tended to carry the burden of relatively high expenses due to the typically small premium levels and the method of premium collection. In recent years the policies sold have often been 10 to 15 year endowments, but older business includes large numbers of whole life policies, many of which were taken out to cover funeral expenses.

35. All other with-profits policies are known as Ordinary Branch business, and this branch makes up the overwhelming majority of with-profits liabilities in existence.

Basis of profit (or loss) participation

36. The basis of with-profits policies is an entitlement to share in the profits (or losses) of the insurer through the system of bonuses described above. However, participation rights vary enormously and may include all, or only some, of the following:

- The investment return on the assets within the with-profits fund;
- The profits (or losses) arising from the company's with-profits business, including:
  - Expenses of selling and administering policies, and investing assets, being higher or lower than anticipated;
  - Levels of mortality (deaths) and morbidity (sickness or critical illness) being higher or lower than anticipated;
  - Surrenders or transfers being settled at claim values above or below the actual policy value;
  - Lapses (effectively surrenders where no claim amount is paid) recouping, or not, the expenses of selling the policy;
  - Cost of guarantees over or under any charges made for such guarantees.
- The profits (or losses) arising from other business in the long-term fund, such as non-profit business.

37. Different participation rights present different risks (and hence rewards) for the policyholder. All policies participate in investment return, which usually accounts for the largest proportion of the payouts provided to policyholders. Investment return includes investment income (interest and dividends), and changes (positive or negative) in the market value of the assets concerned.

38. Some policies only participate in investment return. The insurer will meet its expenses and profit margin from an explicit charge taken from the premium before investment and/or a defined annual management charge on the value of the fund. For these policyholders the position is similar to investing in a unit-linked fund, but with the addition of smoothing to partially even out fluctuations in the investment markets.

39. At the other end of the spectrum, some policies will participate in both investment return and all the other potential sources of profits listed above. As such they carry a *business risk* in addition to investment risk. In recent times, high costs have arisen from exposure to business risk, for example

pension mis-selling and the provision of guaranteed annuity rates (see also paragraph 84 on the uses of the *inherited estate*).

40. In between the two extremes above there can be found a wide variety of participation rights according to the policy design.

Basis of profit sharing

41. In proprietary companies the basis of profit sharing between with-profits policyholders and shareholders through the allocation of bonuses tends to conform to one of two basic types:

- 90/10: where shareholders will receive up to, or exactly, 10% of the value of profits distributed by way of bonuses with policyholders receiving 90% (which is algebraically equivalent to shareholders receiving up to 1/9th of the value of the bonus distribution to policyholders);
- 100/0: where 100% of the profits distributed by way of bonuses is applied to policyholders. Relevant business is usually unitised in form and participating only in investment returns, with the business risks of the insurer being retained by the shareholder outside of the with-profits fund. The bonus distribution is therefore from the investment returns achieved on the fund and is applied 100% to policyholders. The shareholders receive profits through the mechanism of an explicit charge on the policy premiums before they enter the fund, or though a defined annual management charge on the value of the fund. The application of such charges means it cannot be inferred that the payouts to policyholders from a fund operating on a 100/0 basis will be necessarily be better than those from a fund operating on a 90/10 basis with no explicit charges.

42. Mutual companies run most of their business on a 100/0 basis with profits being distributed to policyholders, as there are no shareholders. However, mutual companies can buy existing insurers that contain 90/10 funds, and thus may maintain within their structure 90/10 sub- funds or subsidiaries. The profits that a sub-fund, or part of a sub-fund, participates in may also be restricted, much as the 100/0 structure described above.

Policy Operation

Asset Share

43. A variety of methods have been used in the past to track the starting point for determining what would be a fair payout to a policyholder on surrender, maturity or retirement. The most common method today is the use of *asset shares*. Asset shares can be defined as the premiums paid by the policyholder,

less deductions for expenses, tax and other charges, plus allocations of business profits, accumulated at the rate of investment return achieved.

44. Where investment returns and experience have been smoothed asset shares are known as *smoothed asset shares*, and where not, *unsmoothed asset shares*. An insurer has significant discretion over its approach to calculating asset shares, and its smoothing policies (see paragraph 71 below). Whether an insurer holds records of both unsmoothed and smoothed asset shares, or only the former, will depend upon the smoothing approach adopted and the insurer's systems. Similarly, asset shares may only be recorded on a specimen, rather than individual, policy basis.

45. The allocation of business profits (or losses) may include those arising from mortality experience, surrenders, and the sale of non-profit business (see paragraph 39 above). In some circumstances, for example as part of demutualisation schemes or the operation of closed funds, asset shares may also be increased to reflect distributions that are being made from the inherited estate to augment claims. An asset share calculated before such allocations, and the deduction of charges (e.g. those to cover the cost of guarantees, or smoothing), is often termed the *bare asset share*.

46. Whilst now in common use, an insurer may not have sufficiently detailed records to calculate precise asset shares for policies that have been in force for lengthy periods, because the historic apportionment of, for example, expenses or investment returns, or the degree of participation in other profits or losses, have not been recorded in depth. The aggregate level of asset shares for older business may sometimes therefore need to make allowance for certain factors on an approximate basis.

47. Annexes C and D show illustrations of the build up of asset shares for conventional and unitised with-profits policies respectively.

Components of asset shares:

48. These can include:

- The premiums allocated to the with-profits fund; these would normally be the full premium for conventional business and older unitised business. For newer unitised business it will often be premiums less any initial charges.
- The investment return on the appropriate assets, such return being made up of capital changes and income combined, ignoring tax. The appropriate assets may be:
  - the whole fund if all the business is with-profits and the with-profits policies share in investment return equally, or

  - the specific assets backing the with-profits business if the with-profits policies share investment return equally, or
  - the specific assets backing a particular cohort of policies, if the asset mix of the fund and the policies have been designed on this basis.
- Profits or losses from other sources:
  - reflecting participation rights in business risk as described in paragraph 39 above.
  - any distributions being made from the inherited estate.
- Deductions to cover:
  - Expenses
    - Selling including commission, marketing, sales networks
    - Administration and claim payments
    - Costs of investment management

(These may be encompassed within explicit charges made on the policy if it is of a 100/0 variant within a proprietary company, see paragraph 41 above).

  - Other costs and charges:
    - Charges for insurance risks such as mortality or other risks, e.g. critical illness;
    - Regular charges made at pre-defined levels to cover costs arising on guarantees, smoothing, or the costs of being required to hold additional regulatory reserves;
    - Charges for shareholder profits, to cover the transfer to shareholders of up to 1/9th of the value of bonuses distributed in a 90/10 fund, or where such profits have not been encompassed within an explicit charge in a 100/0 variant.
  - Tax on the life assurance business. In some cases this includes the additional tax that arises on the shareholders' share of certain profits, such as pension profits. The actual tax charge of the insurer can be different from what has been provided from asset shares, leading to items of business profit or loss.
  - Charges for exceptional costs (for example, pensions mis-selling or GARs), or the difference between the actual costs of contingencies and the defined level of charges noted above.

Bonus policy

49. The bonus policy should follow the representations made to policyholders and the internal principles of the insurer. It will also take into account the basis on which the policies in force were designed; i.e. the dates on which they were taken out, their term and the levels of guaranteed amounts offered. Different bonuses may therefore be declared for different cohorts of policies.

50. As noted in paragraph 37 above, the main driver of the combined bonuses, regular and terminal, given to policyholders at the end of their policy is the actual rates of investment return achieved by an insurer, after deducting any rate of return already anticipated in the policy design and incorporated into the initial guaranteed amount. The level of overall bonus delivered in the form of regular bonuses, and the amount delivered as terminal bonus, will be influenced by a number of factors. These are considered below.

Regular Bonuses

51. In general, regular bonuses declared on a policy increase the guaranteed amount. The amount of regular bonuses must therefore be at a level that is sustainable into the future to ensure that the guarantees attaching to policies can be met. To declare all the investment return achieved year to year as regular bonus would over-heighten the level of guaranteed amount payable, which could not be counterbalanced by the declaration of a 'negative regular bonus' in years of negative investment return. Also, the higher the level of guarantees in a fund, the less investment flexibility it will have, particularly with respect to equities. A judgement must therefore be made at each regular bonus declaration on a prudent level which seeks to optimise the balance between the benefit of increased guarantees for the policyholder, the flexibility of the operation of the fund and its ability to ensure that those guarantees will be met in the future.

52. A number of methods of determining the rate of regular bonus are possible and commonplace, such as making it equal to:

- the bonus affordable on alternative less risky investments such as gilt edged securities (government bonds),
- the bonus affordable from a percentage of the anticipated future investment returns on the actual investment mix of the fund, or
- the bonus to achieve a desired target for the proportion of the eventual payout represented by terminal bonus (the appropriate level of regular bonus would be tested by projections to the terminal bonus target proportion).

53. At certain times, on certain assumptions, these three methods could result in the same rate of regular bonus. In any event, further considerations are likely to impinge on the decision:

- the representations made to policyholders and the actual practice of the company: for example, an insurer which made a point of delivering a high proportion of the overall bonus as regular bonus may be constrained as to its discretion over the rate declared;
- the competitive position of the insurer: a technically correct rate of regular bonus may be unattractive if very different from the levels offered by other insurers ;
- the shareholders will have an interest in the maintenance of the value of their 1/9th of profits distributed through bonuses, and which will depend to a degree on the level of regular bonus declared.

54. Changes in the level of regular bonuses year to year will be constrained by the reasonable expectations of policyholders (see paragraph 59 on treating customers fairly) and also by how accurately an insurer estimates future investment trends. The insurer which assumes correctly that a current exceptional investment year is to be followed by a number of poor years will be less likely to raise, and then drop, its regular bonus rate.

Terminal Bonuses

55. A terminal bonus paid when a claim is made will be the amount required to bring the total payout up to the 'fair share' due to the policyholder. For a claim made at a *guarantee date* where asset shares or similar methodology is used to derive that 'fair share', such a bonus would be based on the difference between the guaranteed amount and the asset share, with the latter enhanced as necessary for prior participation in business risks and any inherited estate distributions.

56. Payouts must, however, also reflect the reasonable expectations of policyholders, and smoothing. Terminal bonus rates will thus be adjusted to take account of whatever smoothing is in process, and any further constraints arising from what policyholders have been told about terminal bonus rates in operation, and how the company has actually operated.

57. In practical terms an insurer might be capable of accurate calculation of the exact terminal bonus for every policy existing. Alternatively it may only be capable, or have adopted a practice, of calculating terminal bonus for a few specimen policies. The declared rates of terminal bonus will therefore often be quite broad brush, designed to fit the range of policies in existence rather than to exactly track each policy. The declaration of terminal bonus may also be made only once a year, on assumed or historically achieved investment conditions. It thus represents more of an approximation as the year progresses. Any decision to review existing terminal bonus rates, other than at the habitual times of declaration by the insurer, will normally be driven by investment conditions, with volatile stock markets possibly leading to more frequent reviews of terminal bonus rates than normal (see also paragraph 71 below on 'smoothing').

Surrenders

58. Historically terminal bonus was not allowed for to any great extent in early surrenders or transfers of conventional business. Surrender profits thus provided significant profits for those participating in the business risk of the insurer. It is still the case that the amount of terminal bonus paid at non guaranteed dates may, at the discretion of the insurer, be set below the level that would represent a target of the policy's fair share, though this practice has declined markedly over recent years (see also paragraph 76 below on the application of market value reduction).

Treating customers fairly

59. There is little laid down in statute that governs the detail of how the discretion retained by an insurer is to be applied. However, a key factor that constrains the use of discretion is policyholders' reasonable expectations. Under current law, pre-N2, the directors of any insurer are required, amongst other things, to have due regard to policyholders' interests and to policyholders' reasonable expectations ('PRE') in the conduct of the business. The term 'PRE' is not used in the Financial Services and Markets Act 2000. However FSA Principle 6 requires regulated firms to have regard to the interests of their customers and to treat them fairly.

60. The Appointed Actuary to an insurer has a professional duty to advise the Directors of his or her interpretation of PRE having due regard to the broad nature of the company and its business and approach to the treatment of policyholders.

61. Although the phrase 'policyholders reasonable expectations' appears in the Insurance Companies Act 1982, the Act does not define the term. The following factors are however relevant to the determination of PRE in any particular case:

- The terms of the policy, including those implied from the way in which the policy was marketed;
- The past practice of the company;
- Statements made by the company to policyholders, including written or oral statements at the point of sale, and in marketing literature, policy documentation etc.;
- Industry practice.

Fund Operation

62. This section seeks to explain the basic operation of with-profits funds, and the factors that can influence it, with particular reference to:

- Pooling of experience
- Investment strategy
- Smoothing of claim payments
- Application of market value reduction (MVR)
- Role of the inherited estate

Pooling of Experience

63. A key feature of with-profits funds is the pooling of experience both within and between generations and classes of policyholders. The main visible financial effect of this pooling of experience is the smoothing of investment returns to 'cushion' the policyholder from the extremes of fluctuations in the equity markets. However, the impact of other adverse experience, such as costs arising from the provision of guarantees or other business risks, may also be evened out over different types of policy. A less visible effect is the common practice of maintaining a single asset mix for policies close to a date where guaranteed benefits are due and policies far from such a date.

64. The management of an insurer has considerable discretion over the extent to which the experience of different policy types is pooled, although this discretion will be constrained by the participation rights of different groups of policyholders, which must not be infringed, and by PRE. As noted in paragraph 46 above, the detail of such experience for policies written far in the past may not now be known accurately. Even current experience on new business is monitored with differing degrees of sophistication between insurers.

Investment Strategy

65. Premiums received from policyholders are used to invest in a pooled fund made up of a range of assets. The choice of assets that the fund is invested in is at the discretion of the insurer, but will be determined with regard to PRE and the following factors:

    - More volatile investments, such as equities, have traditionally been expected to outperform other investments in the longer term. Subject to other constraints, the fund would therefore normally have a substantial equity-type asset backing;
    - Most with-profits contracts contain guarantees which increase as the policies progress. It is essential that these guaranteed payments can be met when due;
    - The need for the insurer to be able to demonstrate its solvency, including under a range of adverse investment conditions, at all times.

66. The asset strategy can normally be approached at the fund level, where a mix of equities, property, and fixed interest and other investments is selected for the fund as a whole which, in the insurer's opinion, strikes the right balance between the factors above. Such an opinion would normally be based on testing the possible future scenarios an insurer might face, and their impact on the insurer's financial strength in future.

67. An insurer may set the long term proportions that it wishes to see by asset class, but within this blueprint grant its investment managers some freedom of manoeuvre, month to month, to adjust the weightings of each asset class depending on the managers' view of the investment outlook. The insurer may also have a defined rule to move into safer investments as markets fluctuate strongly to protect its smoothing strategy, or to use hedging instruments for the same reason.

68. The asset mix could, alternatively, be developed as the combination of suitable asset mixes for particular cohorts of policies. Such a situation arises where the with-profits fund contains a mix of very different with-profits policies, whose level of guarantees and/or PRE is so different that different asset mixes are needed. A cohort of policies with high levels of guarantees would, on its own, require a greater proportion of less risky assets to better match such guarantees.

69. It is uncommon, but not unknown, to set asset mixes for each policy (normally by the term left to run of the policies) and derive an overall mix by this means. Where used, it is normally to reflect a form of security/smoothing where policies close to maturity will be moved more into more secure, short-term, investments such as fixed interest instruments or cash deposits.

70. A typical asset composition of a with-profits fund overall would currently be:

- 65% equities
- 10% property
- 25% fixed interest and other investments

However smaller funds exist with low combined equity and property proportions (at around the 25% level), and within the bigger funds the <u>combined</u> equity and property proportion can vary from the 75% average above to between 65% and 90%.

Smoothing of claims payouts

71. The *smoothing rules* operated by insurers can take many different forms and vary from insurer to insurer. However the primary aim will be to smooth volatility in investment returns by holding back some of the return from good years, to pay out more than the return achieved in poor years. The way smoothing operates means that in any one year the claim amount paid out on a group of policies may be more, or less, than the unsmoothed asset share at

the time. However, smoothing is usually intended to have a zero cost over the longer term, with under and overpayments balancing out.

72. Insurers have a significant degree of discretion over their approach to smoothing. Smoothing is often a two stage process:

- The smoothing of asset shares: requiring an insurer to decide over what period to recognise the actual experience of investment returns i.e. how much of the recent experience should drive the asset share used to guide the terminal bonus. This could be gradual by averaging the return credited to the smoothed asset share over a period, for example, of up to five years. Such a method means poor investment years only slowly impact on the smoothed asset share, and likewise with good years. Alternatively, an insurer may wish to recognise recent experience more rapidly and average over less than two years, perhaps also weighting actual performance on a monthly basis;

- Placing a limit on the movement in the claim value or smoothed asset share year to year: many insurers will operate a smoothing rule such that payouts on policies of identical type should not vary by more than 10% in any one year. This part of a smoothing process is more visible to the policyholder.

73. Some insurers do not use smoothed asset shares, but instead aim instead to pay the unsmoothed asset share, subject to the second stage of smoothing claim values by limiting the movement upwards or downwards year to year.

74. Smoothing in this context normally only applies to the dates when guarantees apply under the policy. Smoothing at other times, normally on surrenders and transfers, will be in line with the practice and philosophy of the insurer, and any disclosure to policyholders. The approach adopted could range from such claims being unsmoothed, to enjoying similar smoothing as that afforded to claims at a guarantee date.

75. A number of factors can influence the smoothing policy employed:

- The financial strength of the fund: the stronger a fund is, the greater the degree of smoothing that can be operated. This strength can be applied in two ways. Firstly it will allow an insurer to bear the costs of longer periods of smoothing payments higher than the unsmoothed asset share, and thus the insurer may adopt methods that only slowly allow poor experience to impact smoothed asset shares. Secondly the insurer can treat with equanimity modest levels of smoothing caused by the every day changes in investment markets. A strong insurer, or one seeing little claims outgo, faces less pressure to amend published terminal bonus rates on a fall in investment markets even though the individual claims that are paid in the period enjoy quite heavy smoothing upwards;

- The investment policy of the fund: the typical high proportion of equity investment by the fund will lead to a correspondingly high degree of volatility of investment return that needs to be smoothed;
- The level of guarantees: a high level of guarantees may have been granted under the policies, or developed via high regular bonus rates. If these guarantees are at a level that the guaranteed amount on claim would be close to the unsmoothed asset share, then smoothing reaches a boundary. Should the guaranteed amount exceed the unsmoothed asset share, then a minimum degree of smoothing is mandatory, as the claim must equal the guaranteed amount if it is at a guarantee date. This will have a cost attached, and the strength of fund is again relevant since this position may be significant to a weak fund but less so for a strong one. This issue in turn will influence decisions over the appropriate balance to be maintained between regular and terminal bonuses;
- Commercial pressures: in particular, the competitive pressure to maintain high bonus rates to encourage new business.

Application of *market value reduction (MVR)*

76. The policy design of any given with-profits policy, conventional or unitised, will include some dates or circumstances (such as on death) when the guaranteed amount is payable. On non-guarantee dates however the insurer may, depending on the terms of the contract, be able to reduce claim values below the guaranteed amount. On conventional business this may be achieved via the calculation basis used for surrenders or transfers. The reduction made to the full face value of the guaranteed amount will depend on the practice of the insurer. In theory an insurer can offer the unsmoothed asset share on a non-guarantee date. The practicalities, and computer systems constraints, within an insurer's operations may however make this difficult or impossible to achieve in practice (see paragraph 80 below).

77. On unitised business the guaranteed amount is the face value of units. On non-guaranteed dates an insurer may reduce the claim payout below the face value of units through the application of a *market value reduction* or MVR (also known, less accurately, as a market value adjuster or market level adjuster). The application of an MVR is usually driven by movements in the market value of assets and, in particular, when a policy's resultant unsmoothed asset share has fallen below the face value of units. An MVR is not intended to lead to any profit to the insurer, and its effect is to reverse what would otherwise be the provision of unintended guarantees or smoothing. In its purest form, the level of MVR applied will be the precise percentage reduction in face value of units required to reach the unsmoothed asset share.

78. The decision to apply an MVR, and its size, will usually take into account the following:

- The amount of difference between the unit values and unsmoothed asset shares;
- The degree of smoothing the insurer habitually provides to claims at non-guarantee dates: if no smoothing is provided then an MVR will be applied to reduce the claim value to the unsmoothed asset share;
- The actual levels of claims being made, and consequently the costs to the fund of using the face value of units as the claim payout: a heavy smoothing 'up' of non-guarantee date claims at times when market values of the assets of the fund are depressed may disadvantage the fund (i.e. other non claiming policyholders) overall;
- The financial position of the fund and its ability to bear these costs;
- The public relations implications of the application of an MVR, both for existing policyholders and hoped for new policyholders.

79. The simplest forms of policies will apply terminal bonuses when increasing the claim value above the value of units, and an MVR when reducing the claim value below the value of units. It is however quite common for insurers to leave terminal bonus rates in place, thus increasing claim values, and then to apply a much larger MVR to reach the desired claim value. Although a different methodology, the same position can be reached by an insurer who first reduces terminal bonus rates and only then applies an MVR.

80. The practical application of an MVR can vary, even for the same desired philosophy of application, due to the practicalities of administration and data held. For example:

- Each policy may be considered individually and its unit value compared with the current asset share. The MVR required to reduce the unit value to the claim value is then calculated and applied. This approach can only be adopted if the company calculates asset shares on an individual policy basis and has the administration capability to deliver such up to date information as part of its claim processes;
- Alternatively the unitised with-profits business might not be so accurately tracked policy by policy. The need for an MVR may be considered across the whole fund or class of policyholders and a more global MVR applied, perhaps based on specimen asset share calculations. This broader brush approach will necessarily favour some policyholders and disadvantage others. In effect it involves a greater degree of smoothing that the method above, and reflects another aspect of the pooling of experience that occurs within a with-profits fund.

81. Historically the application of an MVR by insurers has been quite muted. In contrast, recent poor stock market performance has seen more widespread applications of an MVR since the beginning of 2001. Typically, however, death claims or claims on the maturity or retirement date specified in policies are exempt from an MVR. The terms of a whole of life policy, such as a With-Profits Bond, may also specify one or more dates on which a guarantee applies such that an MVR will not apply.

82. The MVR is conceptually distinct from any charge, typically applied in the first five years of a policy's life, to ensure an insurer is able to cover its expenses and profits if the policyholder leaves the insurer early.

The Role of the Inherited Estate

83. The term *inherited estate* is not a statutory concept and does not have a universally agreed definition. However, it forms part of the with-profits fund and can be described as the excess of assets maintained within the with-profits fund over and above the amount required to meet liabilities (including liabilities which arise from the regulatory duty to treat customers fairly in setting discretionary benefits).[1]

84. The inherited estate serves the function of working capital in a with-profits fund and supports the operation of the with-profits fund in a number of ways;

- To provide investment flexibility by enabling a higher proportion of investment in more rewarding but higher risk assets (such as equities);
- To facilitate the smoothing policy of the fund, particularly when there are sudden changes in the investment markets;
- To provide a 'cushion' against unexpected adverse events: major one-off costs, such as pension mis-selling, have often been borne by the inherited estate. Excessive expense costs may also be borne by the inherited estate where the insurer considers that a reasonable policyholder would not expect to bear such cost through a charge to their asset shares;
- To augment asset shares and thus claims: such a use is a typical feature of a number of demutualisation schemes where the estate is being distributed to the current policyholders. It is also often a feature of the operation of small closed funds in both mutual and proprietary companies;
- To develop the company's business, by investing to improve efficiency or the provision of additional services to customers;
- To support the sale of new business by the fund.

1 For a modern policy this would normally equate to the asset share, including adjustments for participation in appropriate profits and losses, smoothing, and any benefit subsidies being made from the inherited estate.

85. In most with-profits offices the inherited estate is largely derived from that part of past and present with-profits policyholders' investment return, or profits than have arisen from past surrenders or transfers, which have been retained and accumulated within the fund and not distributed. Other sources include past injections of capital by shareholders or the explicit reinvestment of shareholders dividends.

Close

86. This paper has sought, for reference purposes, to set out the general features of with-profits products, and the main practices and principles applied to the operation of with-profits funds. With-profits products have recently come in for a great deal of critical comment and concern arising from these features and practices, in particular over:

- The high degree of discretion given to insurance company management over how the with-profits funds are operated;
- The complexity and opacity of products;
- A lack of consumer understanding of the nature of the risks;
- The lack of transparency of the process of inherited estate attributions.

87. These issues, and how they might be addressed, will be covered in a series of Discussion papers to be issued during the course of the With-Profits Review under the following headings:

- Procedures for handling Inherited Estates
- Transparency & Plain Language
- Disclosure & Regulatory Reporting
- Unfair Contract Terms
- Governance & Discretion

With-profits funds glossary of terms

Accumulating with-profits	Another term for *unitised with-profits*
Annuity	A series of payments (annually, monthly) made for the period for which some defined status applies (e.g. the period during which the person to whom the annuity is paid remains alive).
Approved pension policy	See *Pension policy*
Asset mix	The spread of assets within a with-profits fund maintained by an insurer. The asset mix will usually include a large investment in equities (UK and overseas), some investment in commercial properties (offices and industrial units), an investment in fixed interest securities issued by companies or governments and cash.
Asset share Smoothed asset share Unsmoothed asset share	The premiums paid by the policyholder, less deductions for expenses, tax and other charges, plus allocations of business profits, accumulated at the rate of investment return achieved. Where investment returns and experience have been smoothed asset shares are known as smoothed asset shares and, where not, unsmoothed asset shares.
Bare asset share	An asset share calculated before allocations of business profits, and the deduction of charges (e.g. those to cover the cost of guarantees, or smoothing) is often termed the bare asset share.
Benefits	The claim payment(s) that will be made by the insurer on the happening of the insured event(s) including death, maturity or surrender (of a life policy) and transfer (of a pension policy) and with-profits annuity payments.
Bonus	An addition to any *guaranteed benefits* provided by the insurer. This might be a contractual addition or a discretionary addition representing the policy's share of surplus available which the insurer has decided to distribute.

Business Risk Miscellaneous Surplus	The risks (and rewards), other than investment returns, that a policyholder may be sharing in through the policy. These might include experience of mortality, morbidity and surrenders, the cost of guarantees, and the sale of other business. The profits or losses arising from such sources may sometimes be termed miscellaneous surplus.
Closed Fund	A fund which has stopped taking on new business.
Conventional with-profits policy	A policy which is not a *unitised with-profits policy*. Such policies usually have a fixed *premium* amount and defined *sum assured*.
Deferred annuity	A *pension policy* whose main *benefit* is the provision of an *annuity* on the insured's retirement.
Endowment policy	A policy on which the *benefit* becomes payable on the survival of the life insured to the end of the policy term or on his death if this occurs within the policy term, or on earlier *surrender*.
Face value of units Unit value	The current value of the units attaching to a unitised with-profits policy. This represents the *guaranteed amount* payable as a minimum on any *guarantee dates*. The number of units attaching to a policy will represent those purchased by premiums, less those deducted due to explicit charges and any withdrawals plus additions from regular bonuses (where the unit price is fixed).
Guaranteed amount or Guaranteed benefit	The minimum level of *benefit* which the insurer will pay if the insured event occurs on a *guaranteed date*. The amount usually increases over the period of the policy by the addition of *regular bonuses*.
Guaranteed Annuity Rate	Also known as a guaranteed annuity option. A defined minimum rate at which an insurer under the terms of certain pension polices has guaranteed to convert a cash sum delivered at retirement into an *annuity*, or in the case of *deferred annuities* to convert the *annuity* into a cash sum.
Guarantee Date	The date when the policy provides for a claim payment which, as a minimum, will equal the *guaranteed amount*. This is typically on death, retirement or maturity, or also on a specified fixed date for *unitised with-profits* policies.
Inherited Estate	The excess of assets maintained within the with-profits fund over and above the amount required to meet liabilities (including liabilities which arise from the regulatory duty to treat customers fairly in setting discretionary benefits). For a modern policy this would normally equate to the *asset share*, including adjustments for participation in appropriate profits and losses, *smoothing*, and any benefit subsidies being made from the inherited estate.
Interim bonus	An addition to a claim value in or for a period for which no declaration of *regular bonus* has yet been made.

Investment return	The combination of the income from assets (interest, dividends, rents) and changes in their market values. In any period the investment return could be positive or negative.
Market Value Reduction (MVR) Market Value Adjustment (MVA) Market Level Adjustment (MLA)	The reduction made to the *unit* value under a *unitised with-profits* policy in certain circumstances provided for in the policy conditions. The purpose is to restrict or eliminate potential losses to the fund by reversing what would otherwise be the provision of unintended guarantees or *smoothing* as a result of policyholders electing to have their policy benefits paid at a time when *unit values* exceed their *asset shares*.
Maturity date	The date at which the *benefit* from an *endowment* is targeted.
Pension	Another name for an *annuity*
Pension Policy	A policy whose main *benefit* is the provision of an *annuity* on the insured's retirement (*deferred annuity*), or a cash sum to purchase an annuity. Such policies usually limit the amount and type of benefits that can be provided such that they can gain approval from the Inland Revenue for favourable tax treatment.
Premium	The term used for the investment made by the policyholder into a policy. Premiums can be one-off (single premium), contractually to be made, usually, every month (regular premiums), or expected to be regular but on a non contractual basis (recurrent single premium)
Recurrent single premium	See *Premium*
Regular bonus	A *bonus* which, when added to a policy becomes payable in the same conditions as the *guaranteed amount/guaranteed benefit*.
Regular premium	See *Premium*
Regular withdrawals	The taking of partial surrenders from a *unitised with-profits policy* on an annual or more frequent basis. The withdrawals will lead to a reduction in the units attaching to the policy. Withdrawal dates may form *guarantee dates* under the terms of the policy if the amount of withdrawal is below a certain level.
Reversionary bonus	See *Regular bonus*
Single premium	See *Premium*
Smoothed asset share	See *Asset share*
Smoothing	A process applied to a claim value to reduce its volatility
Smoothing rules	The internal rules applied by an insurer to categories of with-profits business in smoothing policy claims.
Sum assured	The *guaranteed amount* at the start of a *conventional with-profits policy*.

Surrender Transfer	A policy claim other than on death or at maturity. For *conventional with-profits policies* surrender is unlikely be underpinned by a *guaranteed amount*. For *unitised with-profits policies* certain surrender dates may be *guarantee dates*. For a pension policy surrender is often called a transfer, as the claim value is usually transferred to another insurer under Inland Revenue rules.
Surrender penalty	The reduction to claim values early in a *unitised with-profits policy*'s life to recoup the charges for expenses and profit otherwise lost by the insurer.
Terminal Bonus	A discretionary payment which might be made by the insurer in addition to the *guaranteed amount* when the policy *benefits* become payable.
Transfer	See *Surrender*
Unit linked	A form of insurance policy that delivers a direct link to a fund constructed more on unit trust or OEIC lines. Policies are commonly offered to allow part of the premium to invest in unitised with-profits and part in property unit linked. The policies may also allow the switch of values from one type of units to another.
Unit value	See *Face value of units*
Unitised Unitised With-Profits	Describes the concept whereby a with-profits fund or sub-fund is subdivided into units for the purposes of determining *benefits* under (relevant) policies. The units are entitled to a share in some or the entire surplus distributed, usually by some form(s) of bonus additions.
Unsmoothed asset share	See *Asset share*
Whole life policy	A policy whose *benefit* becomes payable on the death of the life insured, but which may be surrendered. See *With-Profits Bond*.
With-Profits Bond	A unitised *whole of life* policy sold on a *single premium* basis. The aim of the policy is usually to provide an investment opportunity and, in many cases, a regular income each year.
With-Profits Unit	A unit within a *Unitised With-Profits* fund, having a value which might be constant or which might increase from time to time.
90/10 Fund	A fund whose rules provide that (no less than) 90% of the profits distributed by way of bonuses be allocated to with-profits policies of the fund, and (up to) 10% be allocated to shareholders.
100/0 Fund	A fund whose rules provide that 100% of the profits distributed by way of bonuses be allocated to policyholders.

Features of with-profits policies

Product	Purpose				Features					
	Mortgage	Pension	Savings	Income	Conventional/Unitised		Regular/Single premium		Benefit	Minm guar'teed amount payable
					CWP	UWP	RP	SP	Cash/Annuity	
With-Profits Bond			Y	Y		Y		Y	Cash sum	Varies
WP Endowment	Y		Y	Y	Y	Y	Y		Cash sum	Y
WP Personal Pension	Sometimes	Y			Y	Y	Y	Y	Either	Y
WP Executive Pension	Sometimes	Y			Y	Y	Y	Y	Either	Y
WP Stakeholder Pension		Y				Y	Y	Y	Cash sum	Varies
With-Profits Annuity		Y				Y		Y	Annuity	Varies

Examples of asset share calculations for conventional with-profits

Conventional 10 year endowment issued in Feb 1990, maturing Feb 2000

Year End	Premiums	Ded'ns	Investment return	Unsmoothed asset share	Total premiums	Guaranteed benefit
0						5,429
1	600	299	13	314	600	5,650
2	600	30	78	963	1,200	5,851
3	600	30	314	1,846	1,800	6,059
4	600	31	-106	2,309	2,400	6,244
5	600	34	479	3,355	3,000	6,433
6	600	35	462	4,382	3,600	6,629
7	600	35	917	5,864	4,200	6,831
8	600	36	732	7,160	4,800	7,039
9	600	37	585	8,309	5,400	7,253
10	600	37	482	9,353	6,000	7,473

Profits or losses have been added (business risk participation) by increasing/decreasing the amount of investment return allocated. The guideline for the total payout to be made is the asset share, adjusted to take account of smoothing. The initial guaranteed amount, the sum assured, was £5,429 and regular bonuses declared have increased the guaranteed amount to £7,473

The insurer's smoothing rule limits rises and falls in claim values to 10% year on year, and a 10 year endowment paid £8,400 in 1999. The insurer therefore pays a maturity value of £9,240, 10% higher than 1999. The claim represents 99% of the unsmoothed asset share of £9,353.

The terminal bonus declared to achieve a claim of £9,240 would need to be £1,767, and would represent 24% of the guaranteed amount (1767/7473), or 19% of the total claim ((9240-7473)/9240).

Conventional 10 year endowment issued in Feb 1990, maturing Feb 2005

Year End	Premiums	Ded'ns	Investment return	Unsmoothed asset share	Total premiums	Guaranteed benefit
0						5,429
1	600	345	21	276	600	5,594
2	600	35	120	961	1,200	5,764
3	600	36	147	1,672	1,800	5,940
4	600	37	147	2,383	2,400	6,120
5	600	37	147	3,093	3,000	6,306
6	600	38	-46	3,608	3,600	6,498
7	600	39	266	4,435	4,200	6,696
8	600	40	322	5,317	4,800	6,900
9	600	41	382	6,258	5,400	7,109
10	600	41	446	7,262	6,000	7,326

No other profits or losses are attributable to the policy (no business risk participation payment).

Continuation of the 2000 regular bonus rate of 3% has been assumed to 2005. The projected unsmoothed asset share is less than the guaranteed benefit of £7,326. In such a situation the insurer would have to pay at least £7,326, which would mean a zero addition for terminal bonus. In practice the smoothing rule of the insurer may mean a higher claim value needs to be paid, i.e. with some terminal bonus being added.

25 year endowment issued in Feb 1975, maturing Feb 2000

Year End	Premiums	Ded'ns	Investment return	Unsmoothed /bare asset share	Total premiums	Guaranteed benefit
0						13,799
1	600	288	32	344	600	14,505
2	600	19	124	1,049	1,200	15,247
3	600	19	161	1,790	1,800	16,027
4	600	20	266	2,637	2,400	16,847
5	600	20	460	3,676	3,000	17,709
6	600	20	556	4,812	3,600	18,615
7	600	21	913	6,305	4,200	19,567
8	600	21	1,162	8,045	4,800	20,569
9	600	21	1,278	9,902	5,400	21,729
10	600	22	1,237	11,717	6,000	22,954
11	600	23	2,278	14,571	6,600	24,429
12	600	23	1,422	16,570	7,200	25,617
13	600	24	2,986	20,132	7,800	26,794
14	600	25	2,542	23,250	8,400	28,025
15	600	29	-198	23,623	9,000	29,167
16	600	29	3,523	27,717	9,600	30,355
17	600	30	2,942	31,229	10,200	31,435
18	600	30	7,498	39,297	10,800	32,553
19	600	31	-2,149	37,717	11,400	33,543
20	600	34	7,029	45,312	12,000	34,563
21	600	35	5,651	51,529	12,600	35,614
22	600	35	10,070	62,163	13,200	36,698
23	600	36	7,449	70,176	13,800	37,814
24	600	37	5,610	76,349	14,400	38,964
25	600	37	4,325	81,236	15,000	40,149

Other profits or losses are attributable to the policy, i.e. business risk is participated in, but the insurer's systems do not add them year by year. An uplift for such profits, which amount to 10% of the bare asset share, is therefore required. The initial guaranteed amount, the sum assured, was £13,799 and regular bonuses declared have increased the guaranteed amount to £40,149.

Allowing for business risk participation, the maturity value would be 110% of the bare asset share (or £89,360). In practice the insurer uses smoothed asset shares to decide on the claim, and 110% of such smoothed asset shares amounts to £88,000. The payout is therefore set at £88,000. The terminal bonus added to achieve this would be £47,851, and would represent 119% of the guaranteed amount, or 54% of the total claim.

Example of asset share calculations for unitised with-profits

With-profits bond – fixed unit price, no MVR applying

Year	Number of ordinary units	Bonus units	Face value of all units (£1 each)	Unsmoothed asset share
0	10,000	0	10,000	10,000
1	10,000	400	10,400	10,600
2	10,000	800	10,800	10,700
3	10,000	1,200	11,200	11,500
4	10,000	1,600	11,600	12,100
5	10,000	2,000	12,000	12,800

The insurer offered the 5 year point as a guarantee date on this policy type, and thus must pay at least £12,000 (the face value of units). It is however currently augmenting asset shares by 5% as a distribution from its inherited estate (increasing the unsmoothed asset share to £13,440).

The insurer's smoothing rules limit rises and falls in claim values to 10% year on year. The augmented unsmoothed asset share falls within these limits, and no further adjustment is necessary. A payout of £13,440 is therefore due. To achieve this claim value the terminal bonus might be expressed as 12% of all units (= 1440/12000), or 10% of non-bonus units and 22% of bonus units.

Single premium pension policy–variable unit price, MVR applying

Year	Unit price	Face value of units	Unsmoothed asset share
0	1.00	10,000	10,000
1	1.04	10,400	10,600
2	1.08	10,800	10,700
3	1.12	11,200	11,500
4	1.16	11,600	12,100
5	1.20	12,000	12,800

The policy is being transferred, but not at a guarantee date; it is the insurer's policy not to smooth transfer values in these circumstances. The insurer is also currently making a deduction of 2% across all with-profits policies for the cost of guarantees.

The target transfer value is therefore 98% of unsmoothed asset share, or £11,368. This is below the face value of units (£12,000). The insurer's systems allow calculations to be made at the individual policy level, and hence an MVR of 5% (=(12000-11368)/12000) is applied to the policy's value of units to reach the transfer value paid of £11,368.