Life Assurance Illustrations & Policyholders Reasonable Expectations

Actuarial Society of Hong Kong
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Mark Saunders
Principal & Managing Director, Asia
Outline

- Life Insurance Illustrations
  - Customer research
  - Comparisons with other countries
  - Choices in Design
- Policyholder’s Reasonable Expectations
  - What is PRE and how does it arise?
  - Factors shaping PRE
    - An interactive PRE exercise .......... Some Food For Thought!

THE VIEWS EXPRESSED IN THIS PRESENTATION ARE MY OWN AND DO NOT NECESSARILY REFLECT THOSE OF MY EMPLOYERS

This presentation is incomplete without reference to, and should be viewed solely in conjunction with, the accompanying oral explanation given by the author.
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Whilst under a different regulatory regime, it is useful to share some customer research undertaken in the UK

- Objectives of the disclosure regime in the UK have evolved over time:
  - 1st
    - give consumers the information they need about a product and its charges so that they can make informed decisions about whether or not to buy
  - 2nd
    - ensure that the information is presented in a format and at a time which helps consumers make comparisons between products and providers

- We will share some findings from the UK Financial Services Authority Consumer Research Report “Informed Decisions? How consumers use Key Features: a synthesis of research on the use of product information at the point of sale”

Much of this research focused on whether the Key Features Document met these objectives

- Key Features Document “KFD” is given to the customer at the point at which a recommendation is made and again following the completion of the purchase.

- KFD contains:
  - Generic product information
  - Personal illustration - where applicable

- Objectives of the KFD are to describe in clear and comprehensive terms:
  - What the product aims to provide to the customer
  - The risks associated with holding the product
  - The amount of charges and expenses and their effect
  - An explanation in Q&A form of how the product will work
Information provided in the KFDs - PRACTITIONERS VIEW

- Practitioners (providers or advisers) believed that the KFDs play a very small part in helping consumers make choices between products and providers:
  - Personal Illustration
    - Charges - useful in providing charges comparison but presented in a confusing format
    - Standard Growth Rates - added little to understanding as all on same basis
  - Generic Information
    - Aims - expressed clearly but in wide and bland terms
    - Commitment (premiums) - established early in fact-find
    - Risk - provides little to guide the understanding of consumers in assessing their own risk profile and determining what these risks might be
    - Questions - some value to less confident/experienced investors
Understanding of KFD - CONSUMERS VIEW

- Charges - other concepts less readily understood. However, little appreciation of the actual level of charges and the view that there was little difference between companies

- Risk - many had a broad understanding of risk. However, consumers regard the possibility of losing money remote, stating views such as:
  - “…adviser would not recommend a risky product…”
  - “…fund managers know what they are doing…”
  - “…because of long-term performance of the stock market…”

- Role of personal illustration - aware that investors could lose money but not personally:
  - “…fully aware can go up or down. Apart from a stock market crash, unless the manager is a complete plonker, they should get it right - more question of how right”
  - “Not guaranteed, not the percentage you will get back, but it is not like gambling on the stocks and shares, they choose the right time to invest, in Japan then the UK…”
Consumers’ use of KFDs

<table>
<thead>
<tr>
<th>KFD read /not read</th>
<th>Influenced Decision Making</th>
<th>No Influence on Decision Making</th>
<th>Total (%)</th>
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</thead>
<tbody>
<tr>
<td>Did not remember receiving KFD when re-presented with document</td>
<td>-</td>
<td>-</td>
<td>52%</td>
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<tr>
<td>Read in detail (%)</td>
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<td>7%</td>
<td>8%</td>
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<tr>
<td>Read in part (%)</td>
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<td>15%</td>
<td>16%</td>
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<tr>
<td>Did not really read or did not read at all (%)</td>
<td>-</td>
<td>-</td>
<td>24%</td>
</tr>
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</table>

The perspectives and this table clearly illustrate the issues
Outline

- **Life Insurance Illustrations**
  - Customer research
  - **Comparisons with other countries**
  - Choices in Design

- **Policyholder’s Reasonable Expectations**
  - What is PRE and how does it arise?
  - Factors shaping PRE
    - An interactive PRE exercise ..... some food for thought!
High Level Summary of New Business Illustration requirements across countries

<table>
<thead>
<tr>
<th></th>
<th>Commission Disclosure</th>
<th>Illustration Regulations</th>
<th>Prescribed Illustration Growth Rates</th>
<th>Actuaries Must Sign-Off Illustrations</th>
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<td>✓ x</td>
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</tbody>
</table>

This table highlights some immediate questions for developing illustration regulations (see overleaf) and is incomplete without the accompanying oral explanation.
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Some questions for designing illustration regulations

- How to present commissions?
- What to do where competing products are regulated by different entities?
- How do you quantify the rates of return to use in self-supporting illustrations?
- Who should set the guidelines/regulations?
- How should they be enforced?
- How to treat products with guaranteed rates of return?
- What level of expenses should be assumed?
- How to allow for fund based charges?
- How many illustration scenarios?
  - How should each be positioned? E.g. worst case, best case
  - How to choose the worst case
- How to deal with different types of advisers/distribution channels?
In addition to a form of standardisation (“level playing field”), consider whether illustrations should be used as a basis of:

- Distinguishing between different companies, including:
  - investment performance
  - surrender penalty policy
  - manufacturing expenses
  - distribution expenses, including commissions
  - financial strength
  - guarantees offered
  - bonus/dividend policy
  - all product benefits
  - ........
5 Guiding Principles:

- Illustrations should not mislead
- Illustrations should be suitable to the intended target market
- Where premiums and benefits are illustrated, the conditions upon which these are payable should be clearly distinguished
- Due consideration should be taken into the marketing or distribution channel used to sell policies, and how the illustration should and could be used within this context
- They should be consistent with the compliance environment
To provide benefit to consumers we must consider the following fundamental criteria...

- **Content** - what do consumers need to know?
  - ...not everything we would like consumers to know

- **Design** - presenting concepts as simply as possible, in plain language so that it is read and understood by its intended audience
  - ...must not mislead consumers
    - What is guaranteed and what is not guaranteed?
    - Inflation adjusted?

- **Perceived Importance** - communicate the importance of the illustrations so that consumers both read it and are able to make educated decisions from reading it
  - ...must educate the customer so that they understand what purpose these illustrations serve
…with the ultimate aims

- The consumer understands what product he/she is buying:
  - Knows what could happen to that product in the future
  - and how the product would react under different circumstances

- These must also apply to the sales person!!!
And Next………

P. R. E.
In this section

- What is PRE and how does it arise?
- Factors shaping PRE
  - An interactive PRE exercise ……Some Food For Thought!
A definition?

- This is no generally accepted definition but widely considered as consisting of two aspects:
  - Policyholders should reasonably expect that contractual obligations can be securely provided for
  - Policyholder’s expectations with regard to the level of discretionary benefits (e.g. bonuses) or charges


- The issue of PRE is not restricted to with profits (participating) business. For example, PRE arises in relation to other exercise of discretion e.g. charges in Unit Linked business and Market Value Adjustments (“MVAs”)

- Changes in life office ownership or the transfer of portfolio liabilities between companies would involve a consideration of PRE
What shapes PRE in Hong Kong?

- There are no direct regulations which define PRE in the Hong Kong life insurance industry.
- However, Appointed Actuaries in Hong Kong are required by professional guidance to advise the company of his/her interpretation of PRE - Professional Standard 1 ("PS1").
- Recent legal cases in the UK which tested the concept?
- Different companies have different interpretations of PRE.
- However, it is understood by many companies that the policyholder himself generally has little understanding of the kinds of technical issues raised by PRE and so..........
- Generally the expression should be interpreted in the context of professional advisers acting on behalf of policyholders, the courts, the press and similarly well-informed observers of the life insurance industry.
What shapes PRE in Hong Kong? (Cont’d)

- The view that “we do not have to consider PRE very deeply because the policyholders would not understand it anyway” is largely rejected by companies.

- Despite companies having different interpretations, it is widely accepted that PRE in the context of bonus/dividend policy is shaped by factors which include:
  - Policy conditions
  - Communications with policyholders
  - Company past practice
  - Market practice
  - Mass media
  - Corporate literature and documents
  - ….
PRE Exercise….Some Food For Thought
The case of Mr. Smith vs. Big Life

— Has Big Life breached PRE?
PRE Exercise….Some Food For Thought
The case of Mr. Smith Vs. Big Life

Mr. Smith purchased a 25 year with profits endowment from Big Life in 1990. At that time Big Life sold three types of mortgage endowments each with different implications for premiums paid and corresponding likelihood of meeting his mortgage on maturity.

The policy Mr. Smith purchased was one that paid an addition to benefits through both Reversionary Bonus ("RB") and Terminal Bonus ("TB"). Mr. Smith recalls that he was told that if RB stayed at 60% of current levels then the final maturity payment would be sufficient to meet the mortgage.

For the last 4 years Mr. Smith has consistently been advised to top-up his premiums so that his expected payout meets his mortgage in 13 years time.

Mr. Smith has reviewed both his pre and post sale literature that he received back in 1990. In addition, he has spoken to a good friend who is an actuary. He and his friend both believe that he has good reason to take Big Life to court, as they have breached his reasonable expectations.
The Participants

- The Judge
  - Mark Saunders

- The Witnesses
  - Policyholder (Mr. Smith) — David Hughes
  - Original Sales Woman — May Chun
  - Independent Actuary — Steve Miles
  - Sales and Marketing Director of Big Life in 1990 — Paul Barber

- 12 Jury Members (1 spokesperson)

- Team of Defendant Lawyers (Lead lawyer and support for cross-examination)

- Team of Prosecution Lawyers (Lead lawyer and support for cross-examination)
Outline

- Each witness has been prepared prior to taking the stand
- Briefing on 4 witnesses (while the Jury is out of the room)
- 10 minutes preparation time for preparing your case and cross-examination questions. Each team of lawyers has a maximum of 5 minutes to cross-examine each witness and max. 2 minutes to close.
- Each jury member will cast verdict privately — majority decision wins
- Key issues to decide
  - How was PRE defined?
  - What is PRE in this case?
  - CASE TO ANSWER: Did the company breach PRE?
- After decision reached, each team is to submit a definition of PRE
  - The Prosecuting Team of Lawyers
  - the Defending Team of Lawyers
  - The Jury

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Mr. Smith - The Policyholder

- Very capable and bright
- Read about PRE in the FT about 1 year ago and has spent much time since then reviewing literature received from Big Life and his notes from the meetings with the sales woman (he is very diligent)
- Chose Big Life because of recommendation of his Estate Agent when he purchased his house. Estate Agent mentioned the high bonuses that Big Life had been paying over the past 5 years
- Never really expected bonuses to go down re-calls just being told, in print and orally, how high the historic bonuses had been
Original Sales Woman

- Retired at 35, 5 years ago, now lives in Spain
- Big break came when Big Life tied with an estate agency chain which provided her with masses of leads to sell these Mortgage Endowments
- Became an icon in Big Life though her prolific selling of Mortgage Endowments in the late 80’s and early 90’s - was top sales person for 3 years in succession (a record not yet matched)
- Sales method to focus on the historically high rates of bonuses paid on these endowments and that these rates would result in policyholders receiving an extra cash windfall on maturity - recalls it was an easy product to sell
- She believed that customers understood the bonus rates could go up or down but they never actually expected them to
- Has recently read about the endowment scandal in the press and believes that this is a storm in a teacup - “customers should read the literature it is very clear there” she once said over dinner
Independent Actuary

- The Appointed Actuary of Big Life in 1990 is now deceased. This Independent Actuary hardly knew the Appointed Actuary ( "AA" ) of Big Life

- Owns a small independent consulting firm, that he set up in 1995, prior to that he had worked in the product pricing department of a small Life office from 1975

- Has been asked by the defendant lawyers to contribute to today’s trial

- Prior to the trial he reviewed all the pre and post sales literature of Big Life and its competitors around the time Mr. Smith’s product was sold

- In addition, he reviewed the with-profits guide, marketing materials (placed in the estate agency) of Big Life

- When assessing the PRE expectations his views are:
  - All life offices that sold significant amounts of Mortgage endowments are now asking p/h to top-up premiums
  - Much of the promotional literature in 1990 (Big Life and other companies) concentrated on the high historic returns and expected payouts but all included the following caveat “investments can go up as well as down” but was not prominent on the literature
Sales & Marketing Director of Big Life in 1990

- Currently serving as non-executive director on the boards of various FTSE 100 retailing companies
- Big break came in late 80’s when promoted to Sales & Marketing Director of Big Life
- First thing he did was sign a deal with the largest estate agency chain in the UK - Big Life paid a small amount of commission to the estate agency for each lead provided to Big Life
- Recalls that Big Life was regularly top of the new business league tables through the sales of Mortgage Endowments
- Remembers many conversations with Appointed Actuary at the time about the new business strain that this excessive amount of new business produced and the sales method being adopted by his sales force - he believed this was the AA just being jealous at the success being achieved by his department
- Recalls saying at one board meeting when hounded by the AA and is recorded in the minutes “this is a once in a lifetime opportunity for Big Life to become the leading insurer in the UK. In recent years we have provided our policyholders with great returns - why shouldn’t we shout about this. Do you really want to pull away from this product?”
Mr. Smith Vs. Big Life

THE COURT CASE
Mr. Smith Vs. Big Life

THE COURT CASE

VERDICT

...AND COMMENTS
What shapes PRE in Hong Kong? (Cont’d)

- The view that “we do not have to consider PRE very deeply because the policyholders would not understand it anyway” is largely rejected by companies.

- Despite companies having different interpretations, it is widely accepted that PRE in the context of bonus/dividend policy is shaped by factors which include:
  - Policy conditions
  - Communications with policyholders
  - Company past practice
  - Market practice
  - Mass media
  - Corporate literature and documents
  - Fair treatment of policyholders vis-a-vis shareholders
  - Fair treatment amongst different groups and generations of policyholders (in the context of distribution of bonuses)
Communications with policyholders

Communications with policyholders, both orally by agents and through written documents

- generates expectations with existing or prospective policyholders

In Hong Kong, Whole of Life policies account for the vast majority of the US style participating policies currently sold

- A number of agents have tended to focus the prospect’s attention on how the dividends will enable the policyholders to cease paying premiums after a period of time (e.g. 10 years) - the concept of “vanishing premiums”

- It could therefore be argued that policyholders might have some form of expectation that they will no longer have to pay premiums after the illustrated period despite this being not guaranteed…(!??)…. a lot will depend on the actions of the agent… ??

- Point for discussion: Companies considering PRE will need to consider these possible expectations in addition to the absolute amount of dividends….??

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Communications with policyholders

- Typical types of communications that can generate PRE include:
  - marketing materials
  - press releases
  - applications forms
  - illustrations - personal and generic
  - with-profit guides
  - policy documents and provisions
  - corporate brochures
  - annual reports
  - dividend statements

- Both up to the time of sale and post-sale
Company past practice

- Policyholders might reasonably expect determination of future dividend declarations to follow past practice
- Therefore, the bonus/dividend policy should have regard to the following areas:
  - Calculation methods for determining dividends
  - Historic relationships between asset shares and payouts
  - Historic year on year changes in dividends
  - Historic comparisons with market place dividends and market position
  - Bonus reports to Board and Management
  - Investment policy reports
  - ......
Market practice

- It is not usually considered essential for a company’s definition of PRE to be identical to that of the rest of the industry.

- However, unless differences have been clearly pointed out to a policyholder, they might expect a company’s practice to be broadly in line with market standards and practice.

- In practice the nature of competition in Hong Kong is such that life insurance companies whilst performing the necessary calculations will typically examine each other’s dividend scales. (More followers than leaders....??)

- In particular some practitioners are of the view that smaller companies might tend to look towards larger players for the lead, particularly when dividend rates are to reduce.....??

- In the past, dividend scales in Hong Kong have tended to move broadly in the same direction by similar amounts and at the same time. What about current times ??

Tillinghast - Towers Perrin
The regulatory environment

- Market practice is also largely shaped by the regulatory environment in respect of bonus/dividend distribution

- Distributable profits are either declared as bonus/dividend or transferred to shareholders (but not necessarily released)

- In certain countries proprietary companies are required to distribute a certain proportion of surplus arising from participating business to policyholders (e.g. Articles of Association typically specify minimum of 90% in UK)

- In Hong Kong, (generally) there are no such prescribed split constraints. Provided that dividend expectations are met, a number of practitioners express the view that policyholders appear to be relatively indifferent to the size of transfer made to shareholders

- Professional guidance......
Conclusions

- Time for action!
- Get up-to-speed on developments relating to interpretation on PRE (the range of interpretation of PRE by Appointed Actuaries in the past may no longer be acceptable)
- Gather your thoughts, articulate them and determine your definition of how PRE should be interpreted…….
- ….. and be able and prepared to defend it!

THANK YOU
Thank You

If you would like further information, please contact me or your usual Tillinghast consultant.

Tel  + (852) 2593 4535

Email  mark.saunders@tillinghast.com