Annual Report to With Profits Policyholders 2017

24 May 2018

Wesleyan Assurance Society (Open Fund)

Wesleyan Assurance Society
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Introduction

This is the Society's annual report to the Open Fund with profits policyholders covering compliance with our Principles and Practices of Financial Management (PPFM) and the exercise of discretion. This report is in respect of the financial year ended 31 December 2017, including the bonus declaration in respect of that year made in March 2018.

The Open Fund includes all policies other than those in the MSS Fund. The MSS Fund consists of the in-force with profits policies sold by Medical Sickness Society before the merger with Wesleyan in July 1997.

We publish the PPFM on our website. This document describes the way we manage the Open Fund with profits business. It also includes a Glossary of some of the most common technical words and phrases, which may be useful when reading this report.

We have also compiled a set of guides called “How our With Profits Fund works”, which are also available on our website. These explain some of the phrases used in this report, such as Market Value Reductions, smoothing and bonuses.

Opinion

We believe that, throughout the year, the Society has complied with its obligations relating to the PPFM; has exercised discretion in a fair manner; and has addressed fairly any competing or conflicting rights, interests or expectations of policyholders (or groups of policyholders) including the competing interests of different classes and generations.

The reasons for that belief are set out below.

Governance Arrangements

The Society's Board takes overall responsibility for the PPFM in the course of managing the Society for the benefit of current and future policyholders. The Board has also established a With Profits Committee (WPC). Members of the WPC are appointed by the Board and are made up of non-executive Directors and external appointees.

The WPC's main role is to give advice, and make recommendations, to the Board on:

- the way in which the Open Fund and MSS Fund are managed by the Society;
- whether the Society is complying with the PPFM; and
- whether the Society has identified and addressed effectively the conflicting rights and interests of with-profits policyholders and other policyholders or stakeholders of the Open Fund and MSS Fund in a way that is consistent with treating customers fairly.

Day-to-day activity is more closely monitored by management. The WPC also considers changes to the PPFM as and when required, and advises the Board accordingly.

Tim Pindar, carried out the role of With Profits Actuary throughout 2017. Jonathan Welsh became With Profits Actuary with effect from 12 April 2018 following Tim’s retirement. The With Profits Actuary advises the Board on the key aspects of the discretion to be exercised in respect of the with profits business.

Compliance with each section of the PPFM is also monitored and compliance confirmed formally (with evidence) by the appropriate person(s).

The Society has taken advice from the WPC and the With Profits Actuary in preparing this report.

Additional Reports

The With Profits Actuary is also required to provide a report to with profits policyholders. This is attached to this report as an Appendix.

The WPC may also make a separate statement, or report, to with profits policyholders in addition to this report, if they wish. The WPC has decided that no report is necessary this year.

Policy Benefits

All of the changes to policy benefits paid on death or maturity during or in respect of 2017 were made after taking advice from the WPC, based on detailed reports and recommendations provided by the With Profits Actuary and after discussion with him.

Asset Shares

Asset shares, which form the basis for determining payouts on with profits business, were determined for relevant classes of business as described in the PPFM. The With Profits Actuary approved the parameters used in the calculation.

The Society has a number of “Industrial Branch” (IB) policies in force which are running off quickly. The run off could result in a very high level of expenses per policy as the Society’s fixed expenses would be shared over a reducing number of policies. In the interests of fairness, we have decided to set the level of expenses to be charged to IB business for the administration of each policy in 2018. The expense charge will then increase each year going forwards in line with a defined formula. This ensures that the level of expenses does not increase unfairly as the number of policies falls. Any difference between the expense amount charged and the notional expense will be funded by the estate.

Policies Where Premiums are Used to Buy Units

These unitised with profits policies use a shadow fund to determine the value of the policy. The shadow fund prices smooth the investment returns earned over the period since each investment in the fund was made. During 2017, prices were calculated monthly using the estimated year to date investment return and a formula as described in the PPFM.

Annual Bonus

Annual bonuses accumulate and, once added, are guaranteed to be paid on claim at maturity or death. The aim in setting annual bonuses is to increase the guaranteed benefits gradually whilst leaving a suitable margin between our best estimate of future investment returns and the return that needs to be earned to be able to pay out the guaranteed benefits at maturity. Any changes in annual bonus rates will be gradual (unless this puts the solvency of the fund at risk) and will broadly reflect changes in the general level of past and expected future investment returns.

The investment return applied to asset shares in 2017 was above our expected return, following on from the previous year's strong equity market returns. However, our expectation of future returns remains relatively low, largely due to continuing low interest rates. This has resulted in us reducing our annual bonus rates for most categories from April 2018 to ensure that the guarantees we offer are fair and sustainable in current market conditions.

Final Bonus on Maturity or Death

The aim in setting final bonus rates is that policyholders should receive their policies' fair share of the fund. This is assessed using either asset shares or the value of units held in the shadow fund. We also apply smoothing in line with our smoothing policy, as described below.

For unitised with profits business, the final bonus depends on the difference between the value of the shadow fund and the value of the units purchased. This will change on a daily basis.

For all other with profits business, we normally review final bonus rates twice a year. Final bonuses were changed from 1 January 2018 and again following the March 2018 Declaration (in respect of 2017 experience).

When comparing payouts, we look at the expected progression of payouts on equivalent policies in future years. For example, we would compare the expected (or actual) payouts on a 30 year term policy that started in 1988 (maturing in 2018) with one that started in 1989 (maturing in 2019) and so on. Generally, particularly for longer term business, the progression is downward as our current expectation of future investment returns is not as high as returns that have been earned historically. The good investment returns that we have earned in the last two years, though, have meant that all policies that mature during 2018 will receive payouts higher than we were forecasting them to be.

Since 2005, we have guaranteed that the original mortgage amount will be repaid under all Open Fund mortgage endowment policies. Any resulting additional payments above asset share will be financed from the Society's estate and will not be met by paying lower benefits to other policyholders. The cost of this guarantee in 2017 was not significant.

Surrender and Transfer Values

In 2017, we carried out reviews of surrender values and transfer values for policies where premiums are not used to buy units (conventional with profits business).

Values generally increased for all types of business due principally to strong investment performance over 2017.

Market Value Reductions

For unitised with profits contracts, the surrender value is the value of units, to which a Market Value Reduction (MVR) may apply if the policy's fair share of the fund is lower. The need for MVRs is reviewed regularly and no MVRs were required in 2017.

Smoothing Policy

When determining payouts for maturity and death claims on conventional with profits business, we currently aim to equate average payouts to 100% of asset share within three or four years. In stable investment conditions we aim to change maturity values by no more than 10% from one year to the next, though the PPFM states that larger changes may be required following volatile investment conditions, significant changes in economic conditions, or in either periods of prolonged low investment returns or periods of prolonged high investment returns. For further details, please refer to the relevant 'How our With Profits Fund Works' document on our website (www.wesleyan.co.uk).

Almost all full year changes were less than 10%. Full year increases of more than 10% have been possible on some longer term IB and pensions policies.

Target Ranges

The PPFM contains target ranges for maturity and surrender payouts relative to their asset shares. Target ranges should be large enough that they do not unnecessarily restrict the management of the fund, but not so wide that it will undermine policyholder confidence. Our high equity backing ratio means that a relatively wide target range needs to be set, as we wish to smooth out the ups and downs of the equity markets. This smoothing is considered to be of benefit to policyholders.

We set our bonuses with the aim of keeping our payouts within the target range and ensure that we have good reason to believe that at least 90% of payouts are or will be within the target range.

Throughout the year, we monitor the ratio of actual claim values to their respective asset shares. Overall, 99% of maturity payouts and 100% of surrender payouts were within the target range in 2017. Six policies, for which an accurate comparison against their target range could not be made, are included in the percentages above but are not expected to be outside the target range in practice.

Investment Strategy

The Board sets our policy for strategic asset allocation for with profits business, and during 2017 the Investment Committee monitored adherence to these allocations and considered investment decisions and investment performance at a more detailed level on behalf of the Executive team.

Our investment strategy for assets backing with profits policies, as described to policyholders, has consistently referred to maximising returns based on significant equity investment where possible. We have been able to maintain this high equity backing ratio again during 2017. No significant changes have been made to the investment policy for these assets. A separate investment strategy is maintained for the rest of the assets, including the Society's estate.

The allocations of assets backing with profits policies at recent dates are shown below:

	31 Dec 17	30 Jun 17	31 Dec 16
Equity shares	60%	58%	59%
Property	9%	9%	8%
Fixed Interest	22%	23%	23%
Other	9%	10%	10%

The "Other" category mainly comprises cash deposits.

Charges and Expenses

Our aim in allocating expenses to with profits policies is to charge the costs incurred in selling and administering the policies, plus an appropriate share of overheads.

During 2017, we made appropriate charges in order to meet this aim.

Management of the Estate

We aim to provide the security of a strong estate. This allows us the freedom to invest asset shares in assets that we expect to give higher returns over the long term. We monitor the size of the estate over time, and ensure that the uses to which the estate is put are reasonable and appropriate.

In 2017 the estate was used for various activities, including meeting the costs associated with the Society's Solvency II project to adopt European solvency capital rules. Under the 2017 Mutual Benefits scheme, the cost of which was borne by the estate, a 15% discount on general insurance and surgery insurance was offered to eligible customers. Eligible customers were:

- all in-force with profits policyholders (other than pension and IB policyholders)
- members of the Society (other than those who are members solely because they hold a qualifying pension policy)
- policyholders who are within the two-year period before they qualify as members (other than pension policyholders).

The Society launched the Wesleyan Foundation in May 2017. The foundation is backed by the estate and will provide grants to community groups and charities. Members are able to nominate and vote on the grant recipients.

Despite our expectations of lower investment returns in the future, the Society is financially very strong and, as a consequence, we have decided to allocate an amount of £9m to the asset shares of with profits policies in the Open Fund. This addition will increase benefits on unitised with profits policies from 1 April 2018 and for conventional policies as part of our mid-year declaration in 2018.

New Business Volumes

Writing new business uses up capital initially. Therefore, we carry out projections of the future financial strength of the fund assuming different levels and types of new business, including policies with guarantees and both with profits and non profit business.

The Group's overall new business levels (excluding brokered business) in 2017 were 27.2% higher than in 2016. This was driven by a significant increase in sales of our With Profits ISA.

In 2017 we implemented a framework for hedging the guarantee costs associated with writing new with profits business. The objective of the framework is to minimise the capital strain incurred from writing new business with guarantees.

Other Business Activities

During the year, the Society's management and the WPC have monitored our business activity and the risks we run as a result, to ensure it is managed in line with the PPFM and to treat our customers fairly.

In July 2017, the Society completed the purchase of Quality Plan. Similar to previous acquisitions, Dental Plan and DPAS, Quality Plan are a provider of dental plans. They operate through Northern Ireland.

Communication

A guide to the bonus declaration, which also sets out changes made to the PPFM, is being included with statements sent to policyholders in 2018.

Further information is available on our website, www.wesleyan.co.uk (select 'Investments and Savings' and then 'With Profits Fund'). This includes our guides called 'How our With Profits Fund works'.

Changes to the PPFM

The following changes were made to the PPFM from 31 December 2017;

- In sections 3.2, 4.2 and 5.2 we describe how the increase in the level of expenses applied to IB policies from 2018 will be set according to a defined formula. We will monitor the actual costs and any losses will be met by the estate. (Conversely, any resultant profit would be passed to the estate.)
- In section 2.2.1 we confirm that Board approval is required for any investment in derivatives. Previously, the PPFM stated that this was only required for 'material' investment in derivatives.
- In section 1.2.1.1 we have removed references to the amounts received in respect of profit sharing and commission arrangements on Wesleyan general insurance business transferred to General Accident in 1995 as these amounts are now trivial.

- In section 3.2 we have removed reference to respreading the costs of implementing changes to the business from the end of 2012 to meet the requirements of the FSA's Retail Distribution Review. This is now complete and there are no further costs outstanding.
- In section 1.2.1.1 we clarify that any profits / losses from differences between future actual and expected IB business written off will be passed to IB asset shares (following the enhancement in respect of future write off profits applied in 2016 and 2017).
- In section 1.2.4 we have changed 'mediocre investment returns' to 'low investment returns' when describing the investment conditions that may lead to changes in payouts of more than 10%.

Changes are approved by the Board after taking advice from the WPC and details are provided on the Society's website.

Appendix

Annual Report for 2017 from the With Profits Actuary to Wesleyan Assurance Society's Open Fund With Profits Policyholders

Basis of Opinion

I have based my opinion below on the information and explanations provided to me by the Society and my operational involvement throughout the year. I have also taken into account, where relevant, the Financial Conduct Authority's rules and guidance in the FCA Handbook (section COBS 20).

This report complies with relevant actuarial guidance and standards, including the Technical Actuarial Standards (TAS 100 and 200).

Opinion

In my opinion, the Society's annual report and the discretion exercised by the Society in respect of 2017 take, or have taken, your interests into account in a reasonable and proportionate manner.

Jonathan Welsh
With Profits Actuary

24 May 2018